

# The Influence of Formal and Informal Institutions on Microcredit: Financial Inclusion for Micro-Entrepreneurs by Lender Type

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## Abbreviations

CBRC China Banking Regulatory Commission

MCC Microcredit Company

NGO Non-governmental Organisation

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PBOC People's Bank of China

RMB Renminbi

VTB Village and Township Bank

## 2.1 INTRODUCTION

Despite major advances in development, more than two billion people worldwide continue to live in poverty, at levels below US \$2.00 per day. The provision of microfinance loans to poor entrepreneurs is one method to address this inequity, yet serious constraints exist to microlending and financial inclusion for low-income residents. This paper examines the role of formal and informal institutions in shaping the development of the microfinance industry, with the goal of reducing poverty, in the context of China. Qualitative case studies of seven microfinance organisations operating in different regions reveal that deficiencies in formal regulatory frameworks restrict the ability of both commercial and public interest lenders to expand the reach of microcredit, especially among the poorest recipients. In addition, flaws in the formal institutional environment have led both types of organisations to rely on informal institutions as a substitutive mechanism by which to reach poor entrepreneurs.

This paper applies the Helmke–Levitsky framework (Helmke and Levitsky 2004) to understand the interaction of formal and informal institutions in fostering or constraining financial inclusion, thereby projecting future pathways for the industry. We build on previous research pertaining to the ethical implications of microfinance and the influence of institutional environment on the development of the industry. Key ethical issues in microfinance include interest rates and the growing tension between financial viability and social mission (Boatright 2010), as well as the capacity of the industry to reach the poorest clients. Evaluative studies of microfinance have found that microloans generally have a positive effect on the well-being of recipients, yet regulation can support or hamper the reach of such loans (Argandoña 2010). Ensuring fair access to credit requires a range of public and private actors to work to establish an effective institutional order for inclusive finance (Hudon 2009). By viewing microcredit as an ethical response to the failure of traditional banks to reach underserved populations (Cowton

2010), we examine how constraints on credit thus limit reach to the unbanked, with serious implications for lenders and their clients. We also address institutional effects in light of the debate over fair interest rates (Argandoña 2010; Boatright 2010) and the effect of microcredit regulation on credit access for microentrepreneurs.

Scholars have recognised the effect of formal and informal institutions on microfinance expansion in Southeast Asia, Africa and Latin America (Barboza and Trejos 2009; Battilana and Dorado 2010; Hermes et al. 2005). However, there has been limited focus on the factors that influence the provision of microcredit in transition economies such as China, which are characterised by high levels of state control in some areas, yet dysfunctional or nonexistent formal institutions in others (Boisot and Child 1996; Peng 2000). We expand this discussion by identifying the deficiencies of the formal institutional framework governing the microfinance industry in China, and the extent to which informal institutions support microlending. The Helmke–Levitsky typology (Helmke and Levitsky 2004) allows us to classify how informal institutions either support or hamper the functioning of formal institutions. In doing so, we investigate the influence of formal institutions on the operations of non-profit and for-profit microlenders in China, while examining the extent to which informal institutions have filled the gap to increase the reach of lending. These questions have ethical relevance because impoverished people suffer due to poor institutional contexts, including ineffective government and regulatory agencies, thereby hampering the lending relationship necessary for financial inclusion (Chakrabarty and Bass 2014).

## 2.2 CONTEXTUAL AND THEORETICAL BACKGROUND

Over the last two decades, private firms, governments and non-governmental organisations have increasingly established microfinance programmes throughout the poor and mainly rural areas of the world as one means of fostering economic development and reducing poverty. Although definitions vary, microfinance generally encompasses a range of financial services—including loans, savings deposits, insurance and money transfers—provided to low-income clients who lack access to formal financial services. Microfinance is primarily intended to reduce poverty by empowering low-income populations to participate in economic activities and build small businesses, thus closing a gap in the provision

of credit and other services to markets traditionally underserved by mainstream banks.

In the present study, we answer the calls of previous researchers (Khavul 2010; Khavul et al. 2013) to investigate the effect of the institutional environment on shaping the expansion of the microfinance industry in developing economies. We achieve this through case study analysis of interview data from senior executives and loan officers at seven Chinese microfinance institutions. More specifically, we examine how the formal institutional framework and informal institutional environment differently affect the operations of commercial ‘for-profit’ microfinance providers (village and township banks or ‘VTBs’) and public interest microfinance providers (microcredit companies or ‘MCCs’). In doing so, we primarily focus on microcredit, which refers to small, unsecured loans to poor (usually rural) clients to support the start-up and expansion of microenterprises (Khavul et al. 2013).

While previous studies have explored institutional voids as areas of entrepreneurial opportunity (Mair and Marti 2009; Tracey and Phillips 2011), we seek to identify the main deficiencies in the formal institutional framework governing the microfinance industry in China, and the extent to which informal institutions support its functioning. In doing so, we follow previous work by applying the Helmke–Levitsky typology (Helmke and Levitsky 2004) of informal institutions to explore the interface between formal and informal institutional structures (Estrin and Prevezer 2011). Such an approach is unique in the microfinance literature and is particularly useful in the context of transition economies—in this case, China.

The main contributions of this paper are threefold. First, we seek to gain a deeper understanding of the existing formal institutional environment enveloping the microfinance industry in China, with a particular focus on the different ambiguities facing commercial (VTBs) versus not-for-profit (MCCs) actors. Second, we advance theory regarding the role of informal institutions, and whether they support the formal institutional framework in transition economies in general, and in China in particular. Third, we contribute to the discussion regarding microfinance as an ethical approach to inclusive finance for underserved populations by illuminating the institutional factors constraining microcredit provision, including the role of regulation and the tension between financial viability and social mission among lenders.

### 2.3 MICROFINANCE IN GLOBAL CONTEXT

Microfinance has attracted increasing attention among academics and policy-makers during the last decade (Barboza and Trejos 2009; Bruton et al. 2011; Chiu 2014; Hermes and Lensink 2007; Tavanti 2013). In 2006, microfinance initiatives received worldwide acclaim when Muhammad Yunus—a Bangladeshi economist and founder of the Grameen Bank (a non-governmental microfinance organisation)—won the Nobel Peace Prize in recognition of his contribution to the development of microfinance as a mechanism for helping alleviate global rural poverty.

Due to the expansion of mainly non-governmental, not-for-profit microfinance organisations and initiatives in Bangladesh and other countries with large, poor rural populations in South Asia, microfinance is viewed as a critical means by which to increase access to financial services for poor and rural populations (Barboza and Trejos 2009; Beck et al. 2009; Mendoza and Thelen 2008; Spencer and Wood 2005). However, from the perspective of commercial financial institutions, microfinance is increasingly considered a means of generating profits (Bruton et al. 2011; Chiu 2014). As a result, a growing number of microfinance providers entering the industry are dominated by a ‘commercial logic’, rather than ‘public interest logic’, as originally envisaged by Yunus and his colleagues at Grameen Bank (Battilana and Dorado 2010; Chiu 2014).

The movement of the industry towards financial sustainability has resulted in increasing criticism that too many microfinance institutions seem to have little interest in poverty alleviation and are instead focusing on profits (Britta and Fouillet 2010; Cull et al. 2009; Hulme and Mosley 1996; Woller et al. 1999). As an example, in a recent review of the literature focusing on studies that examine the efficacy of microcredit, Roodman (2012) concluded that microcredit appears to have little influence in terms of helping poor, rural clients out of poverty. Despite these criticisms, profit-oriented microfinance organisations continue to expand, and many practitioners and scholars argue that there seems little choice but to take a more ‘commercial’ approach to ensure the economic and institutional viability needed to achieve the scale and developmental influence envisioned by early advocates of public interest microfinance (Schmidt 2010). Others argue that encouraging universal access to credit necessitates a range of institutional actors, both public

and private, supported by a governance framework in which both for-profit and nonprofit entities have key roles to play (Hudon 2008, 2009).

## 2.4 MICROFINANCE DEVELOPMENT IN CHINA

Although China has witnessed rapid economic expansion during the last 30 years, this has been accompanied by increasing financial and social disparities that are placing pressure on China's political and social stability (See 2009). China's population of rural poor, earning less than US \$2.00 a day, is second only to India, while up to one-third of all Chinese citizens have no access to formal financial services (Cerny and Tou 2010).

Microfinance institutions have been operating in China for more than 20 years; however, it was not until the mid-1990s that China's central government officially sanctioned microfinance as a tool for enhancing access to financial resources and alleviating poverty in rural areas of the country (Turvey and Kong 2010). Microfinance was seen as an important avenue of support for potential rural entrepreneurs, given the significant hurdles they face in accessing formal sources of finance from the banking sector due to high levels of asymmetric information and strict collateral requirements (Khavul 2010). Following trials by scholars at the Chinese Academy of Social Sciences in 1994, the government began to provide capital to local governments and financial institutions for the purpose of supporting the development of microfinance organisations in rural areas (He et al. 2009; Park and Ren 2001; Tsai 2004; Turvey and Kongn 2010). This led to a proliferation in the number of foreign and domestically owned microfinance providers operating in China.

Today, two key types of microfinance provider dominate the microfinance industry in China. The first group includes VTBs, which tend to operate in small rural towns (Cerny and Tou 2010). As financial institutions that are governed by China's central bank, VTBs can accept deposits and tend to provide larger loans of between 5000 and 500,000 renminbi (RMB). Currently, there are an estimated 726 VTBs in China, making more than 60 billion RMB in loans (Wu and Yuan 2013). Approximately 80% of these were established by domestic commercial banks and 20% by foreign financial institutions (Sparreboom and Duflos 2012). In 2007, the China Banking Regulatory Commission (CBRC) introduced rules governing the ownership and operation of VTBs. Among these regulations is a rule requiring a 20% controlling stake by

a registered domestic or overseas financial institution. In addition, other nonbank shareholders cannot hold more than 10% of the equity of VTBs.

The second type of microfinance provider in China is the more traditional ‘public interest’ microfinance provider, known as an MCC (Cerny and Tou 2010). These organisations tend to be run by non-governmental organisations (NGOs) or local governments and operate in more remote, rural areas of the country. MCCs are not considered part of the Chinese formal financial system; thus, they are only able to provide lending services and are prohibited from accepting deposits. In contrast to VTBs, MCCs make much smaller loans, with an average loan size of 5000 RMB. Although it is difficult to calculate the exact number of microfinance clients in China, research published by PlaNet Finance estimates 4282 MCCs, with outstanding loans of 39 billion RMB (Wu and Yuan 2013).

Although China’s central government has no specific law governing microfinance activities, the CBRC and China’s central bank, the People’s Bank of China (PBOC), have publicised a series of regulations designed to support and promote industry development, as explained in greater detail in the Findings section.

## 2.5 INSTITUTIONAL THEORY: FORMAL VERSUS INFORMAL

In the absence of an established theoretical framework for studying the microfinance industry, this paper employs insights from institutional theory to examine the development of the microfinance industry in China. Institutional theory contends that the behaviour of individuals and organisations is significantly shaped by regulatory (formal) and social (informal) institutions (DiMaggio and Powell, 1983, 1991; North 1990; Scott 1995). Recent studies have found institutional theory to be an effective tool for examining and understanding how organisations develop and operate in emerging economies such as China (Estrin and Prevezer 2011; Hoskisson et al. 2000; Peng et al. 2008; Wright et al. 2005). Institutions shape the behaviour of organisations and influence their ultimate failure or success (Peng 2003; Wright et al. 2005). Institutional theory is valuable for research about Chinese organisations because China’s unique institutional environment has a profound influence on how business activities are conducted (Bruton et al. 2010). The historical legacy of socialism and strong cultural traditions make the

process of conducting business in China quite different from that in the West (Boisot and Child 1988; Child 1994).

In recent years, researchers have begun to recognise the significant influence of both formal and informal institutions on the development of the microfinance industries in emerging economies in South East Asia, Africa and Latin America (Battilana and Dorado 2010; Hermes et al. 2005; Ito 2003; Khavul 2010). However, none of this research has investigated the extent to which institutions influence the development and operation of microfinance providers in China. Given that China possesses an institutional environment that is significantly different to that of other countries due to relatively high levels of state control over the economy, the Chinese microfinance industry is expected to have developed unique characteristics to other countries (Peng 2000).

Before institutional theory can be employed to explain how the microfinance industry in China has developed, it is useful to discuss what is meant by 'institutions'. North (1990) defined institutions as 'the humanly devised constraints that structure human interaction, which include formal rules such as laws and regulations, and more informal constraints such as cultures, social norms and customs'. Scott (1995) categorised institutions into three main groups: regulatory, normative and cognitive. Regulatory institutions are those that are most formalised and represent formal laws and regulations sanctioned by the state. In contrast, normative and cognitive institutions are less formal and codified and propagate themselves through shared societal culture. They define the roles and behaviour that are expected of individuals within society. Normative institutions manifest themselves through accepted authority systems, such as professional standards and commercial conventions, whereas cognitive institutions refer to the generally accepted rules and beliefs that are established as a result of social interactions between members of a society (DiMaggio and Powell 1983).

Previous research has examined the nature of institutions and the process by which both formal institutions (such as laws and regulations) and informal institutions (such as relational ties [*guanxi*] and family networks) influence economic exchange and development in emerging economies such as China (Helmke and Levitsky 2004; Peng and Heath 1996). In general, these studies have found that, in economies characterised by weak or poorly designed formal institutional systems, organisations rely on building connections with government officials and other social actors as a mechanism by which to reduce uncertainty and improve



**Table 2.1** A typology of informal institutions

<i>Goals of actors</i>	<i>Effective formal institutions</i>	<i>Ineffective formal institutions</i>
Convergent goals between those leading formal and informal institutions	Complementary	Substitutive
Divergent goals between those leading formal and informal institutions	Accommodating	Competing

Source Helmke and Levitsky (2004)

business performance. Application of these theories in China suggests that regulatory institutions are restrictive (Boisot and Child 1988; Peng and Heath 1996), possess a relative lack of professional (or normative) standards (Bruton and Ahlstrom 2003) and restrict the flow of information (Hoskisson et al. 2000), thereby posing significant environmental constraints to entrepreneurs.

More recently, scholars have begun to further explore the nature and importance of the interaction (interface) between formal and informal institutions in shaping organisations. For example, building on the research of North (1990), Helmke and Levitsky (2004) argued that informal institutions can either support or hamper the functioning of formal institutions. Based on this intersection between formal and informal institutions, as well as the goals of the actors leading these institutions, Helmke and Levitsky developed a typology of informal institutions, as shown in Table 2.1. The insight provided by the Helmke–Levitsky framework is its recognition of the conditions under which informal institutions either support or weaken formal institutions.

The first dimension of Helmke and Levitsky’s (2004) typology is the effectiveness of the formal institutional environment, where effectiveness depends on both the existence of laws and regulations that enable markets, and the extent to which these rules are enforced. The second dimension under the typology is the extent to which the goals of actors in formal institutions are convergent with the goals of actors in informal institutions.

Since initiating market-oriented reforms more than 30 years ago, the liberalisation and development of a market-based financial sector in China has not kept pace with other economic reforms. As a result, the eruption of entrepreneurial activity during China’s reform period has

relied largely on continuously evolving and developing informal financial structures. As discussed extensively by Tsai (2002), while economic structures left over from the pre-reform period resulted in diverse attitudes about formal financial sector development, supportive informal structures organised to fill the deficiency on the formal side. It is largely through the endurance and support provided by these informal financial mechanisms to entrepreneurs that China's economic phenomenon has been bankrolled. Some scholars (Estrin and Prevezer 2011) point to China's historically ineffective and inefficient formal institutional structures as creating an institutional void that affects both formal and informal institutions.

In the present study, we apply the Helmke–Levitsky typology of informal institutions to frame our understanding of how the interaction between the formal and informal institutional environment enveloping China's microfinance industry has shaped its development. In doing so, we seek to answer two main questions:

1. How has the formal institutional framework governing the microfinance industry in China influenced the operations of MCCs and VTBs differently?
2. To what extent have MCCs and VTBs used informal institutions to support the development of their Chinese operations?

## 2.6 RESEARCH METHODS

This study employs a multiple case study approach through analysis of interview data, site visits and document review (Eisenhardt 1989; Eisenhardt and Graebner 2007), using the individual microfinance organisation as a unit of analysis. This methodology enables researchers to build on existing theory and provide explanations for observed phenomenon (Lee 1999). Given the paucity of research on this topic, a qualitative methodology was considered appropriate, as exploratory case studies can illuminate relevant themes rooted in institutional systems, thereby generating a broader holistic understanding of the topic (Tan 2009). The study takes place in China, with implications for micro-lending in a range of emerging economies. China was chosen because it has a large population of which more than 300 million live in poverty, has high growth rates and has a relative lack of coverage thus far in the microfinance literature. China's population of rural poor, earning less

than US \$2.00 a day, is second only to India, while up to one-third of all Chinese citizens lack access to formal financial services (Cerny and Tou 2010; See 2009). China is particularly appropriate for investigation into institutional influences, given its nascent microfinance industry in which credit demand outstrips supply and complex institutional environment that features both formal and informal actors. The profile of case studies in our sample is highlighted in Table 2.2.

The organisations for the study were chosen using theoretical sampling in order to represent a range of institutional experiences, such as non-governmental, government, nonprofit and commercial organisations (Glaser and Strauss 1967). To conduct interviews, we obtained the contact details of 15 microfinance institutions from the leading trade organisation, the China Association of Microfinance. Seven organisations agreed to participate; of these, four were NGOs, two were state sponsored, and one operated branches in each sector. Fieldwork occurred during 2011 in five provinces in northern, western and north-eastern China, including visits to headquarters and branch offices to conduct in-depth semi-structured interviews with senior executives and managers.

Before conducting the interviews, the study questions were piloted using contacts in the microfinance industry to confirm their appropriateness and applicability. One of these contacts was a representative of a microfinance provider not included in our sample, and the other was a Chinese academic involved in microfinance research. Our expert contacts suggested that we rephrase certain questions of a sensitive nature. They also advised that we ask microfinance respondents to discuss their organisation's history and their experience in the microfinance industry at the beginning of the interviews in order to better understand the issues they faced and to build rapport with them before asking more sensitive questions.

All interviews were conducted in Chinese. The interviews were recorded, transcribed and translated into English using the back-translation procedure recommended by Brislin (1993). We undertook follow-up contact to clarify any uncertainties in the data. Data collection continued until we felt that subsequent interviews would not provide significant new insights (the saturation point had been reached). In the interest of confidentiality, the comments provided by the interview respondents have been kept anonymous.

Table 2.2 Profile of sample case study microfinance organisations

<i>Name of organisation</i>	<i>Legal status</i>	<i>Start date of Chinese operations</i>	<i>Location(s)</i>	<i>Client base</i>	<i>Sources of finance</i>	<i>Average loan size in 2011</i>	<i>Interviewees</i>
Organisation A	Public interest MCC/VTB	2009	Chifeng, Inner Mongolia	Rural entrepreneurs: sole traders and registered small and medium-sized firms	Funds from United States	US \$5952	Microfinance representative
Organisation B	Public interest MCC	2009	Partners in: Yilong, Sichuan Chifeng, Inner Mongolia	Rural entrepreneurs: sole traders (75% female)	Donations from individuals/corporate entities	US \$300	Microfinance representative and three loan officers
Organisation C	Public interest MCC	2000	Hebei Shanxi	Rural entrepreneurs: sole traders	Donations from individuals/church groups	US \$932	Microfinance representative and three loan officers
Organisation D	Public interest VTB	2006	Harbin, Heilongjiang	Rural entrepreneurs: sole traders and registered small and medium-sized firms	Savings deposits Equity from overseas partners	US \$3991	Microfinance representative

(continued)

Table 2.2 (continued)

<i>Name of organisation</i>	<i>Legal status</i>	<i>Start date of Chinese operations</i>	<i>Location(s)</i>	<i>Client base</i>	<i>Sources of finance</i>	<i>Average loan size in 2011</i>	<i>Interviewees</i>
Organisation E	VTB	2009	Hulunbuir, Inner Mongolia	Rural entrepreneurs: sole traders and registered small and medium-sized firms	Savings deposits and interbank deposits Equity from local partners	US \$4615	Microfinance representative and three loan officers
Organisation F	Public interest MCC	1996	Chifeng, Inner Mongolia	Rural entrepreneurs: sole traders (100% female)	Donations from individual/corporate entities Donations from overseas aid agencies	US \$615	Microfinance representatives
Organisation G	Public interest MCC	1998	Chengdu, Sichuan	Rural entrepreneurs: sole traders	Donations from the government Funds from overseas partners	US \$780	Microfinance representative

## 2.7 DATA ANALYSIS

Data analysis began immediately after each field visit in order to understand the emerging themes, which could then be incorporated into subsequent visits (Bryman 2008). We took an inductive approach to data analysis through the use of thematic coding, in a manner consistent with grounded theory research design (Ryan and Bernard 2003), and we adopted a mixed approach to coding. First, we developed a list of analytical categories (codes) based on the previous literature, prior to conducting the interview fieldwork. This enabled analysis of the interview data as they were collected, and attributed codes to statements made by respondents in the interviews. Second, we developed new categories of codes to reflect themes that emerged during the analysis of interview transcripts, if a theme did not fit into the existing categories (Miles and Huberman 1994). We then applied the new coding category to the data already coded. The use of thematic coding enabled quantification of how frequently specific themes were addressed in the interviews, and facilitated quick retrieval of statements from across all interviews referring to the same theme (Kvale 2007). After completing all interviews, we compared the patterns observed in each of the cases and focused on identifying common themes and differences between the organisations. To increase the validity of the data analysis, we arranged interviews with two Chinese microfinancers, in which they were asked to comment on the findings of the study. The results of these interviews were consistent with those provided by the respondents, which served to strengthen the validity of the findings.

## 2.8 FINDINGS

The findings from this study are presented in two main sections. In the first section, we examine the influence of the formal institutional environment on the operations of Chinese microfinance providers. In doing so, we examine distinct differences between commercial microfinance providers (VTBs) and not-for-profit microfinance providers (MCCs) in terms of how regulatory deficiencies constrain their ability to operate effectively. In the second section, we examine how both MCCs and VTBs have used informal institutions to support the development of their business operations. Tables 2.3 and 2.4 present the main findings from the data analysis.

**Table 2.3** Deficiencies arising from the formal institutional framework

<i>Theme number</i>	<i>Identified theme</i>	<i>Number of MCCs</i>	<i>Number of VTBs</i>	<i>Indicative comments from representatives</i>
1	Inability to accept savings deposits	3 out of 5	0 out of 3	<i>The inability to take savings deposits has a huge impact on our business growth. We long to be able to accept deposits as one source of funding. It would allow us to reduce our cost of capital. ORG F (29 June 2011)</i> <i>It would be helpful if we could take savings deposits and it would allow us to grow faster. ORG C (30 May 2011)</i>
2	Lack of appropriate regulatory framework for 'public interest' microfinance providers	3 out of 5	0 out of 3	<i>In other countries in which we operate, there is a very clear regulatory framework that governs our activities. However, in China, there is no regulatory framework for establishing a 'public interest' microfinance institution. This has made it difficult for us to grow and achieve larger scale operations. We would like to see a new kind of regulatory framework that is suited for poverty alleviation microfinance. This would allow us to establish a stable, replicable business model. ORG B (18 July 2011)</i> <i>The fact that we are not formally registered as a financial organisation creates a bad perception of us on the part of prospective customers and employees. ORG F (29 June 2011)</i> <i>The regulations governing MCCs, and which government has supervisor capacity over them, are very unclear. In addition, the staff members the local government financial office have limited knowledge of public interest microfinance. ORG A (15 July 2011)</i>

(continued)

**Table 2.3** (continued)

<i>Theme number</i>	<i>Identified theme</i>	<i>Number of MCCs</i>	<i>Number of VTBs</i>	<i>Indicative comments from representatives</i>
3	Inability to charge sustainable rates of interest due to interest rate caps by regulatory authorities	0 out of 5	2 out of 3	<i>A major challenge we face is about government control of interest rates. The government has imposed a very low interest rate cap which limits our ability to develop competitive new products. ORG E (5 July 2011) (see note)</i>
4	Inability to expand lending activity due to government imposition of low deposit/lending ratio	0 out of 5	2 out of 3	<i>This year, the government has restricted the amount of credit we can provide. This has affected our operations significantly ... Although we had planned to lend over 200 million RMB this year, we are only able to lend 50 million as a result of the new regulatory constraints. This has caused our clients to lose trust in us. ORG E (5 July 2011) The PBOC regulations recently published require that the credit we provide to clients should be less than double the amount of registered capital. However, we used up our entire quota of credit by the end of March. This limitation means that we might have to break the contract with our clients. ORG D (13 July 2011)</i>
5	Inability to expand business into new geographic areas due to difficulties in obtaining regulatory approval	3 out of 5	2 out of 3	<i>It is already difficult to find new clients. If we were permitted to set up more branches covering a wider geographical area, the situation would be better. ORG G (30 June 2011) In 2007, the local government allowed us to expand into two new districts. However, in 2008, the CBRC introduced new regulations which prevent MCCs from opening outside of areas in which they are initially registered. As a result, they requested us to close down two of our sub branches. ORG A (15 July 2011)</i>



**Table 2.4** Use of informal institutions to manage institutional deficiencies

<i>Name of organisation</i>	<i>Use of informal institutions to support business activities</i>	<i>Indicative comments from representatives and loan officers</i>
Organisation A	Developed relationships with provincial government to attain temporary business license Found a business partner with strong relationships with provincial government	<i>We have built guanxi [connections] with provincial leaders in order to obtain a new business license ... getting a license depends on guanxi, not regulations. Representative (15 July 2011)</i> <i>The non-transparent connections behind government and local business also presented a challenge when we first established. In order to succeed in China, it is important to have a well-known partner that has guanxi with the local authorities. Representative (15 July 2011)</i>
Organisation B	Lend through local partners with strong government connections	<i>In order to build support with the Chinese government authorities, we conduct our lending through Chinese partners, rather than do it by ourselves. Representative (18 July 2011)</i>
Organisation C	Obtained support from government and quasi-governmental bodies to get license and ongoing support	<i>We have built close relationships with local government and quasi-government bodies in order to get our business license. This cooperation has enabled us to operate well within our lending areas. Representative (30 May 2011)</i> <i>We actively look for government partners, such as the Poverty Alleviation Bureau, the Women's Association, and the Labor Union. We often get referred to these local government bodies through an introduction from someone within China's microfinance advocacy community Representative (30 May 2011)</i>
Organisation D	Hire staff recommended by local government	<i>We hire staff recommended by the local government to collect information from the local area. This enables us to show respect to local authorities. Representative (13 July 2011)</i>

(continued)

**Table 2.4** (continued)

<i>Name of organisation</i>	<i>Use of informal institutions to support business activities</i>	<i>Indicative comments from representatives and loan officers</i>
Organisation E	Rely on network of village accountants to build legitimacy in rural areas	<i>To find new clients, we mainly depend on village accountants. Village accountants are members of the village committee [rural government]. They keep track of every economic transaction made by villagers and know them very well. They enjoy very high respect among villagers. Since many of the loan officers from our institution are not from the village they are responsible for, we have much less local knowledge than the village accountants. The village accountants not only help us to build relationships with new clients, but also help us to maintain client relationships. For example, they help us to supervise clients and to communicate with them. It seems it would be very difficult to avoid our dependence on village accountants during the next few years. Loan Officer (5 July 2011)</i>
Organisation F	Obtained strong support from quasi-governmental body in order to attract donations	<i>We build strong relationships with the Chinese government in order to obtain adequate financing from overseas donors. Representative (29 June 2011)</i>
Organisation G	Obtained support from government and quasi-governmental bodies to get license and ongoing support	<i>In order to get a business license in China, we need to get the support of government. In order to do this, we need to have guanxi with government leaders or their friends. Representative (30 June 2011)</i> <i>'Public interest' MCCs are prohibited from operating unless they are supervised by a government department. We need to follow their guidance. However, it is difficult to gain their support if you don't have personal relationships with senior government officials. Representative (30 June 2011)</i>

## 2.9 INFLUENCE OF FORMAL INSTITUTIONS ON CHINESE MICROFINANCE

The analysis of the interview data highlighted five main deficiencies arising from the existing formal institutional framework in China in terms of its effect on the business activities of microfinance providers. Table 2.3 presents the main themes highlighted by organisations and indicative quotations from their representatives provided during the interviews to illustrate how such deficiencies affect their business operations.

It was clear that the formal regulatory framework influenced MCCs and VTBs in different ways. Respondents from the majority of MCCs highlighted three main deficiencies in the formal regulatory environment that affect their business activities: (1) their inability to accept savings deposits, (2) the lack of an appropriate regulatory framework for ‘public interest’ microfinance providers in China and (3) their inability to expand business operations. The first two deficiencies arise from the fact that MCCs (unlike VTBs) are not covered by most of the regulations introduced to govern the Chinese microfinance industry (He et al. 2009). Being outside the formal regulatory framework, and consequently being unable to accept savings deposits, means that MCCs typically have irregular access to capital and insufficient cash flow to cover financing and operating expenses. This subsequently hampers their ability to grow and expand. One MCC also highlighted that not being part of the formal financial system also adversely affects their ability to build legitimacy with potential customers and to hire staff.

In contrast to MCCs, VTBs suffer from different constraints arising from deficiencies in the formal regulatory environment. Although they are able to accept savings deposits, they are hampered by expansive state controls that hinder their ability to operate effectively. For example, at the time of this study, respondents from two of the three sampled VTBs explained that their inability to charge higher risk-adjusted interest rates due to the imposition of interest rate caps by the regulatory authorities made it difficult to earn a sufficient return on small-scale loans, given their higher administrative and monitoring costs relative to larger loans.<sup>1</sup> As a result, these respondents explained that, to remain economically viable, they have gravitated from making smaller loans to poorer clients to making larger loans to wealthier clients, in order to contain administrative costs. Two of the three VTBs also highlighted difficulties in expanding lending activities due to the imposition of a low deposit-lending ratio by regulatory authorities.

Of all of the institutional constraints identified by respondents, only one was cited as having a significantly adverse effect on the business operations of both the MCCs and VTBs in our sample—namely the regulatory restriction on geographically expanding business operations outside of the organisation’s original area of registration. Respondents from five of the seven organisations highlighted this as a factor that has a significant negative effect.

## 2.10 INFLUENCE OF INFORMAL INSTITUTIONS ON CHINESE MICROFINANCE

To overcome deficiencies in the formal institutional environment discussed in the previous section, analysis of the interview data revealed several means by which the microfinance providers in our sample used informal social and cultural institutions to build legitimacy and support the development of business operations in China. Table 2.4 presents the main ways in which organisations have used informal institutions to support business operations, accompanied by indicative quotations from their representatives.

Respondents from all of the MCCs and VTBs sampled emphasised the need to build strong relationships with the government to operate effectively in China. Informal connections with the government were especially important to the MCCs, who depended on these relationships to smooth the process of seeking regulatory approval in order to start up and develop business operations. Three of the four MCCs in our sample highlighted how they had built informal connections with government officials at the local and provincial level—either themselves or through intermediaries—in order to expedite entry to the Chinese microfinance industry. In addition, both MCCs and VTBs emphasised the importance of building informal relationships with the local government to establish legitimacy within the communities in which they operated—particularly given their relatively short operating history compared to other local lenders. Strategies included using government-affiliated village accountants as loan officers and hiring indigenous staff with well-established local government connections.

## 2.11 DISCUSSION

The microfinance literature has largely neglected the role of the formal regulatory environment and more informal sociocultural institutions in shaping the development and operation of the microfinance industry

in the context of emerging economies (Battilana and Dorado 2010). Similarly, the literature applying institutional theory to China and to entrepreneurship has generally not addressed the specific realm of microfinance. In the present study, we answer the calls of researchers to investigate how institutions have shaped the development of microfinance in emerging economies that are characterised by a weak and ineffective institutional environment (Khavul 2010). We also make an additional contribution to the microfinance literature by examining how the institutional environment influences the operations of nonprofit MCCs and more commercially oriented VTBs in different ways. While microcredit is considered to have a generally positive influence on the well-being of loan recipients and fills a critical gap when traditional banks fail to serve poor residents (Cowton 2010), its reach and concomitant benefits are constrained by these institutional factors.

In examining these issues, we apply the Helmke and Levitsky (2004) typology to examine how informal institutions work alongside more formal institutional frameworks to influence the operations of microfinance providers in China. Within this context, our interviews revealed that, with the Helmke–Levitsky framework, both MCCs and VTBs rely on substitutive informal institutions to support their business activities. We found that China reflects many of the norms of an emerging economy in terms of an underdeveloped formal institutional environment, yet exhibits unique institutional characteristics because of the high levels of state control over the economy (Boisot and Child 1988; Child 1994). This includes a constraining role for regulatory institutions (Boisot and Child 1988; Peng and Heath 1996) in the case of VTBs, and the lack of a supportive regulatory structure or legal status for MCCs, constituting not a ‘vacuum’, but an ‘institutional void’ (Mair and Marti 2009). In other words, our analysis suggests that the Chinese institutional environment affects MCCs and VTBs in different ways due to their differential regulatory status within China’s financial system.

The objective of this paper is to better understand two key questions that remain unaddressed in the microfinance literature: to what extent have the formal regulatory frameworks established by China’s governing bodies affected the business models adopted by microfinance institutions in China, and to what extent have informal institutions helped or hindered the development of the Chinese microfinance industry? Through the interview process, we found that the answer to these questions differed significantly depending on whether the microfinance provider was operating as a VTB or an MCC.

## 2.12 FORMAL INSTITUTIONAL INFLUENCES

In terms of formal institutional influences, Chinese VTBs are regulated because they fall within the scope of China's formal financial system. One strategy China could pursue to promote the development of micro-finance is to strengthen and support the effectiveness of formal institutions such as VTBs and the agencies that govern them. Currently, regulatory constraints reduce the incentive to make risky small loans, thereby leading to larger average loan sizes that crowd out rural entrepreneurs. As a result, these smaller borrowers must rely on informal financial networks to obtain their needed funding. One strategy policy-makers could employ to foster a more robust and competitive micro-finance industry to stimulate rural development within the formal financial system is to modify interest rate regulations on VTBs. Given the low penetration of microfinance lending in China, recent loosening of the interest rate cap will reveal whether this triggers growth.

Further enhancing the effectiveness of formal institutions would involve increasing the clarity and predictability of VTB oversight provided by the CBRC and PBOC, especially with respect to regulating the amount of credit available for lending. This would help strengthen credibility and relationships between clients and VTBs. Similarly, softening restrictions on geographical expansion for both VTBs and MCCs would better allow the sector to serve clients, especially in rural areas with dispersed populations. In particular, policymakers might reduce geographical constraints on rural VTBs, while retaining them on the urban financial institutions that such policies are arguably designed to monitor.

While excessive or poorly conceived regulations characterise the formal institutional environment governing VTBs, the lack of an established regulatory framework characterises the formal institutional environment governing MCCs. In general, the MCC respondents reported that the absence of a formal legal or regulatory framework inhibits their development by delegitimising their operating activities. The respondents explained that this lack of legal standing leads to a diminished reputation, thereby limiting development by constraining their ability to attract quality staff and customers. MCCs' lack of legal status and resulting inability to collect deposits lead to irregular access to capital through reliance on an unpredictable and irregular stream of donor funding. Indeed, since the collection of data for this study, one of the NGOs studied ceased operations largely due to funding constraints. To enhance the

development of Chinese MCCs in order to aid in poverty alleviation, our findings suggest that policymakers should consider providing them legal status and permit them to accept deposits. In the context of the Helmke–Levitsky typology (Helmke and Levitsky 2004), strengthening the effectiveness of formal institutions may reduce the need for substitutive informal institutions. In this case, providing a regulatory framework to govern MCCs would legitimise them by making them official members of the formal financial system. Another scenario described by the Helmke–Levitsky typology permits very strong informal institutions to ‘crowd out’ formal institutions, as reviewed below.

### 2.13 INFORMAL INSTITUTIONAL INFLUENCES

The absence of a legitimate legal and regulatory framework to govern MCCs and the ineffective and inefficient regulatory structures controlling VTBs have led to dependence on informal institutions and networks by many rural borrowers in China, resulting in a suboptimal mechanism for fostering rural poverty reduction. The poorly conceived regulatory environment governing China’s microfinance industry poses a significant challenge to the development and realisation of its mission. Most private individuals in China have been excluded from its formal financial sector; thus, informal financing mechanisms—such as borrowing through social and family networks—have established themselves as a means of filling the institutional gap. Over time, these informal financing channels have become pervasive, particularly throughout social and political structures in rural areas of the country. Geographical separation and low levels of out-group trust have led to a continued reluctance by many rural Chinese residents to seek formal financing from outside their immediate social networks. This has constrained the development of formal microfinance organisations—particularly ‘outside’ organisations that do not have strong ties to local communities.

Thus, to succeed, formal microfinance organisations must integrate themselves into local member-based institutions, such as village accountants, and employ loan officers with well-established connections with the local community and local government. This is particularly true for ‘public interest’ MCCs, which are unable to operate without the close cooperation of local government officials. As noted above, providing effectively structured legal status for MCCs should support industry growth and competition, thereby leading to expanded and more

affordable financial services options for the Chinese population and ultimately resulting in reduced rural poverty.

Within the context of the Helmke–Levitsky typology, informal institutional structures have developed as substitutes to fill the formal institutional void that has resulted from the regulatory constraints plaguing VTBs and the absence of legitimacy confronting MCCs. Incomplete and/or ineffective institutional structures (Estrin and Prevezer 2011), coupled with compatible interests between industry actors and government officials (Ahlstrom et al. 2008), have led to the development of a largely supportive informal institutional environment. For the informal institutions themselves, spanning institutional voids is difficult and complex because it involves high levels of ambiguity and risk (Tracey and Phillips 2011). However, as noted by Helmke and Levitsky (2004), informal structures such as *guanxi* play a crucial role in achieving desired goals within China's authoritarian systems.

Finally, a prominent feature of emerging economies is that the institutional environment within which they operate is generally dynamic and immature. In fact, according to Meyer (2001), 'the essence of economic transition is the replacement of one coordination mechanism by another. Yet efficient markets depend on supporting institutions that can provide ... the formal and informal rules of the game of a market economy' (p. 358). Thus, the formal institutional structures governing China's microfinance industry—though currently immature and unsupportive—could be expected to change and perhaps improve over time. Within the context of Helmke and Levitsky's (2004) typology of informal institutions, as the formal institutional structures governing China's microfinance industry move from being relatively ineffective to effective over time, informal financial networks could become complementary or accommodating, depending on the extent to which the goals between actors in formal and informal institutions are compatible.

The results of this study provide a point of reference for additional research about the influence of formal regulatory and more informal sociocultural institutions on the development of microfinance in emerging economies. Conceptualising the development of China's microfinance industry within the context of the Helmke–Levitsky typology of informal institutions also helps shape our understanding of the importance of the interface between the formal and informal institutional environment in developing supportive financial resources to help alleviate poverty by using the bottom-up approach—as envisioned by



the originators of microfinance. Given the current global economic conditions—characterised by austerity and reduced government spending that seems likely to constrain the aid designed to support the disadvantaged—the results of this paper could be instrumental in providing guidance to microfinance organisations, government officials and policy-makers in emerging economies about how to support the development of this important industry and its role in reducing global poverty.

## 2.14 CONCLUDING REMARKS

As with all research, this study has certain limitations. The findings of this study must be understood within the context in which the research was undertaken, and cannot necessarily be generalised to other emerging economies, given the significant institutional differences found in the Chinese environment. Future research should be undertaken in the different institutional contexts existing in other countries to establish how institutional differences have led to divergent models of microfinance being adopted across the globe. In particular, research employing the Helmke–Levitsky typology could be conducted in other rapidly growing and emerging countries with large populations of rural poor to establish whether microfinance providers face similar or different institutional constraints and gaps to those encountered in China. Cross-cultural research could enable identification of common institutional characteristics that best support the development of microfinance. Additional research within China could focus on developing a model for better inclusion of MCCs within a structural framework that overcomes institutional deficits, without imposing additional constraints. Such research would move the field further towards the vision of an institutional order that fosters inclusive finance and access to credit (Chakrabarty and Bass 2014; Hudon 2008).

The present study contributes to the growing literature applying management theory to microfinance (Battilana and Dorado 2010; Bruton et al. 2011), as well as ethical discussions on ensuring access to credit among the world's poorest residents. Using in-depth interviews with respondents from microfinance organisations in China, our research highlights the importance of formal regulatory institutions and more informal social and cultural institutions in influencing the development of the microfinance industry and its resulting reach to clients. Our findings add to a growing body of evidence that institutions are

important and drive the strategic decisions made by financial organisations operating in emerging economies (Bruton and Ahlstrom 2003; Hoskisson et al. 2000; Peng et al. 2008; Wright et al. 2005). This is important given the potential microfinance has to address the severe poverty that persists in China and other emerging economies.

## NOTE

1. In July 2013, China's central bank liberalised upper controls on lending for rural finance, although strict interest rate caps (versus exorbitant rates in some locales, as well as very high rates for 'back alley' lending) continue to be an issue for sustainable microcredit provision in Asia.

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