Chapter 12

Building a Conceptual Model of Factors affecting Personal Credit and Insolvency in China based on the Methodologies used in Western Economies

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ABSTRACT

Chinese economy is developing at an unprecedented pace. This expansion is prominent not only in the external aspect (increased export), but also internally in the increase in the demand for goods and services by common Chinese families. This demand cannot always be met by the monthly salary and therefore the need for personal credit. Because of the substantial risk involved in lending, there is need for robust and reliable credit evaluation procedures, strategies, policies, and systems. Lessons learned from the subprime mortgage crisis in U.S. are that lending can be a very risky activity that can lead to recession for a whole economy. Banks and other financial institutions in China are in need of appropriate procedures and systems should a barrier to further economic development be avoided. Besides, existing models and systems that are prevalent in the West may not fully match Chinese banking environment or the society itself. An appropriate personal credit rating methodology should take into account the differences between the Western and Chinese society and culture. There apparently does not exist such a methodology in literature that takes into consideration the unique Chinese situation. The aim of this chapter is to begin to fill this gap in knowledge by building a conceptual model of factors influencing demand for consumer credit and insolvency (bad debts) in China, based on the available methodologies used in the Western societies.

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BACKGROUND

Unprecedented growth in recent years may be an indication of Chinese success in all regards, including finance. It may be a sign of an improvement in the Chinese banking system. Simultaneously, demand for the personal credit in China has continued to increase at a very high rate (Alicia et al., 2006). This increase has benefited both indigenous and Western financial organisations that have gained from the entry of China into the World Trade Organisation (WTO) in November 2001. This entry was crucial for the development of China as it beckoned a new era of consumer choice with the lifting of all restrictions to foreign trade from 2007. For transitional economies as China the Western financial interest is mainly in the credit card business that tries to fill the credit needs of the citizens (Zhao et al, 2010). It is however difficult for the Western banks to enter and compete in the Chinese financial services market under the numerous administrative and legal restrictions as well as the impediments of the historical, cultural and structural differences that make the Chinese financial market unique. In order to maintain a high economic growth and its commitment to fully open up its banking system to foreign competition, China urgently requires a more comprehensive strategy, with a long-term vision of the desired structure of the Chinese banking system (Steve, 2005). A very early attempt to achieve this objective is the model developed by this chapter for assessing demand for credit as well as bad debts.

The rest of this chapter will present (a) factors affecting demand for personal credit in China, (b) credit rating methodologies used in the Western societies, (c) construction of a theoretical model and (d) summary, implications and areas for further investigations.

DEMAND FOR PERSONAL CREDIT IN CHINA

With the increased capitalization of housing and urbanization in China, personal assets have much increased but also has demand for personal credit risen (Smith, 2009). However, most of the borrowers have poor credit history including late payments, high debt levels, low incomes and inconsistent employment history, which lead to their low credit ratings. Though the lenders’ profits are rising, the lenders are taking increased risk in “overlending” to customers with unstable income and low ability to repay the loans (Whale, C. 2005).

Durvasula & Lysonski (2010) compared personal credit markets in China and the U.S.A. They noted that China is “undergoing an unprecedented metamorphosis as it evolves from a Communist society with government planning to one that is more market driven and consumer oriented” (Durvasala & Lyonski, 2010). This change in the economy has a profound effect in the psyche of Chinese consumers as well. Money, its possession and its pursuit has taken on a more important role. Almost 50 percent of Chinese think that money is either as important as or more important than friendship or ideas (Rosen, 2004). These changes were also noticed by the press (Fan, 2007). New extremely rich Chinese upper class with a high income can buy anything from expensive cars to posh apartments. Attitude to money of other Chinese who observe the rich is also changing. It may be observed that money has become an important topic in China; people are being encouraged to seek it, acquire it and flaunt it. Wang (2005) notes that in the modern China it is true that “you are what you consume – for those situated lower on the hierarchy, there is no faster way of acquiring social prestige than emulating the lifestyle of those higher up on the pecking order” (2005). Author noted the so-called “bobo” subculture – very rich individuals, who demand
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