Microfinance Regulation and the Chinese Context:

An Opportunity for Making a Major Impact on Reducing Poverty

by

Lynn Chia and Alex Counts, Grameen Foundation USA

Introduction

Since the 1980s, several microfinance programs have operated in China under different organizational structures. Their organizational forms have included (1) Non-government Organizations (NGOs), (2) programs sponsored through a specific government initiative or office (e.g., Funding the Poor Cooperative, or FPC), (3) Formal Banks (e.g., the Agricultural Bank of China), and (4) Regional Credit Cooperatives (RCCs). Overall, these programs have shown the promise of microfinance in reducing poverty in China. However, in order to achieve meaningful scale, the Chinese microfinance industry will likely require a more supportive regulatory environment. The adoption of best practices by the Chinese microfinance community continues to progress with the assistance of early Chinese innovators and support organizations such as Grameen Trust, Grameen Foundation USA, and others, but these qualitative improvements cannot translate fully into programmatic impact until these regulatory issues are resolved.

Based on interviews and key texts written by key microfinance practitioners, supervisors, donors, and experts from the microfinance community, as well as a review of the experiences of Grameen Foundation USA and Grameen Trust in working in partnership with Funding the Poor Cooperative and, more recently, several other Chinese MFIs, this paper will outline key limitations and implications of the current regulatory environment on microfinance organizations and programs in China, as well as present some potential alternatives to the current regulatory/supervisory environment. Specifically, the following questions will be addressed:

- What is the current regulatory environment in China relative to microfinance programs and activities? What are the implications of this environment on the successful development, expansion, and sustainability of microfinance in China?
- How does China's current legal/regulatory environment compare with legal/regulatory frameworks proposed by industry leaders?
- What are recommended potential initiatives to address key regulatory and supervisory issues faced by China's microfinance industry in the short and long term?

Characteristics of the current regulatory/supervisory environment

Overall, as in many countries, there is a lack of formal polices and regulations in place to govern the creation, operation, and supervision of microfinance programs and organizations in China. This is not surprising, as micro-finance is a relatively new strategy that has not gone to scale in all but a handful of countries, such as Bangladesh and Bolivia. We believe now is an ideal time for the Chinese government to develop an enabling environment that will let micro-finance reach its full potential as an anti-poverty and women's empowerment strategy in China.

By way of background, while the State Council has historically endorsed microfinance as a means to alleviating poverty and contributing to an underserved segment of the overall financial market, it has yet to develop specific polices and regulations governing microfinance activities – even though regulated RCCs represent the greatest proportion of microcredit activity. The implication of not having specific policies in place to regulate MFIs subjects both the clients of those institutions and the institutions themselves to uncertainty and real or perceived risk of losing their assets. For clients, an inadequately supportive regulatory framework means there is no protection against predatory or unfair lending practices, including the assurance that the lending institution is qualified to provide those financial services and that, where appropriate, proper disclosures are made to educate the client on complex or nontraditional lending or savings products. (Please see the annexed GF-USA white paper for more recommendations on this and other issues raised in this paper.) Because the popularity of savings products continues to increase and become a larger proportion of client banking activity, being able to understand the terms of his/her deposit as well as gain assurance that the deposit is safe from bank failure or fraud is critical to fostering a savings-minded culture. For the MFI, being able to provide assurances and demonstrate credibility to depositors, whether wholesale or retail, provides the ability to mobilize funding from a wider range of sources, which allows that institution to (1) obtain sustainable sources of on-lending capital, (2) offer a wider range of products to its clients, and (3) mitigate balance sheet risk through increased diversification.

Perhaps the most important issue is that while it allows micro-finance activities to go on, the current environment also does not recognize a clear and unambiguous legal basis for MFIs to operate and plan for growth and sustained impact. Even if a formal regulatory framework for MFIs did exist, it would be difficult to determine which programs and organizations fit under that framework. Currently, microfinance programs generally "negotiate" a solution to their legal standing on an ad hoc basis. There are no standard operating procedures or protocols for which to apply to be an MFI. Instead, many microfinance programs gain informal acceptance and license to operate through a memorandum of understanding between the donor and local government. From the standpoint of credibility, sustainability, and an above-average risk of loss – MFIs are subject to playing by rules that are fluid and subject to change. This may have been a good stopgap solution that allowed the sector to evolve while regulators gained a greater understanding of it, but we believe that a more permanent and supportive framework is now needed. By not having a formal operating charter, and existing only as "experimental" or "pilot" programs, MFIs are left completely exposed and subject to being compromised by changing political factors and "governance by interpretation." The lack of a clear legal status for MFIs presents a perceived high risk of loss and deters new entrants and investors (philanthropic and commercial) into the microfinance marketplace. Furthermore, in addition to the uncertainty and instability an MFI faces in this environment, hiring staff willing to endure an unstable work environment also limits the pool of qualified candidates willing to give up the stability of their government jobs.

The current lack of a clear legal status for MFIs is not, however, a reason to retro-fit these organizations into existing legal structures. Rather, varying frameworks and guidelines should be formulated to facilitate different applications of microfinance based on their pre-approved charter. For example, depending on the market an MFI chooses to serve, the type of activities it chooses to perform, or the type of organization structure it embodies (e.g., bank vs. NGO) – the guidelines and operating requirements one MFI is subject to could be quite different from another. By having different types of pre-approved MFI charters (that can be developed in consultation with existing microfinance practitioners in China, leading international experts, and micro-finance savvy financial institutions like Citigroup) in place, Chinese government and banking authorities would be able to more efficiently evaluate, compare, and license microfinance activity. That said, putting forth multiple "tiers" or standards of operation could result in a form of unintended "regulatory arbitrage" if criteria for different MFI operating charters are not clearly and specifically delineated.

In the current environment, the receipt of foreign currency loans also causes complexities, as there are strict restrictions over the transfer and conversion of these monies overseas. By not liberalizing the policies for which MFIs can obtain funding, both domestically and internationally, potential future donors may view these complexities as a deterrent to future investment and thus further limit the sources of funding available to MFIs. (Indeed, these restrictions caused a delay in the implementation of the Citigroup-funded project that this conference is also supported by.) Although funding received from government sources have been significant, the practice of earmarking funds for specific lending programs can also limit the flexibility an MFI has in meeting client demand and directing the funds to where they can make the greatest impact.

In the current environment, there is also a tendency towards interest rate ceilings on loan products. Although this methodology may be consistent with other subsidy-based poverty alleviation efforts, implementing an interest rate cap on microcredits can be debilitating and ultimately result in the failure of that MFI to reach full cost recovery in the medium-term. Fundamentally, "microcredit" exists to serve unmet needs or demand – the provision of financial services to a segment of the population that historically has not had access to traditional capital markets. Because this provision is demand-based, interest rates are an integral component to regulating the supply of microfinance offerings. The key to protecting client borrowers is not to restrict interest rates, but to ensure sound lending standards, an appropriate repayment schedule, robust monitoring procedures, and appropriate incentives that lenders do not over-leverage borrowers. Consumer protections such as proper disclosure, transparency in rules, and education also contribute to an appropriate relationship that benefits both the borrower and lending institution.

Comparison of Key Attributes of China's Legal and Regulatory Environment with Recommendations from Top Industry Authorities

The following chart is an effort to compare aspects of China's legal and regulatory framework towards microfinance and past recommendations (that are not specific to the Chinese context) from Grameen Foundation USA and the Consultative Group to Assist the Poorest (CGAP).

Key Attributes Impacting Supportive Legal and Regulatory Environment	China 2003	Recommendations Grameen Foundation USA	Recommendations CGAP
Separate Microfinance Policies vs. All-inclusive Bank Regulatory Policies	‣ No policies specific to microfinance	‣ There should be policies specific to microfinance relative to: capital requirements, interest rates, lending portfolio composition, licensing requirements, permissible activities, permissible clients (e.g. focus on poor), supervision requirements, reporting requirements, ownership structure	‣ There should be policies specific to microfinance activity, including
Legal Status vs. Non-Legal Status –**Based on 1995 Commercial Banking Law and Regulations for the Management of Rural Credit Cooperatives (1997)**	‣ Legal status only for Banks and RCCs, which may engage in microfinance ‣ NGOs and government programs (e.g. pilots) are not legally sanctioned	‣ All microfinance organizations should have the opportunity to apply to become legally licensed, based on different "charter" levels or "tiers" ‣ These tiers can be defined by geographic areas served, breadth of microfinance activity, and ownership structure	‣ Suggests microfinance organizations will not be able to realize their potential unless in a licensed environment: "The requirements for a regular banking license are too high for the institutions interested in poor clients. Thus we need a separate window for MFIs, with lower barriers to entry and standards better suited to microfinance." ‣ Although believes in separate and formal licensing, CGAP also questions whether there are currently enough MFIs suitable for licensing – believes this may be a premature demand for a number of countries
Direct Supervision vs. Indirect/Non- supervision	‣ No direct supervision of MFIs or other microfinance organizations ‣ Formal Banks regulated by China Banking Regulatory Commission (CBRC), while RCCs regulated by CBRC's Department of Cooperative Finance	‣ Microcredit organizations should be supervised by a separate regulatory body, distinct from the existing bank regulatory body –Proposes "Microcredit Regulatory Commission" commissioned by the Central Bank	‣ Suggests several models for how MFIs could be regulated, including –MFI can partner with an already-licensed institution (e.g. microfinance organization partners with an existing Bank and would therefore be regulated by that Bank or corresponding bank supervisor) –Delegated supervision (e.g. Supervisory body delegates supervision to another body, similar to the Microcredit Regulatory Commission proposed by Dr. Yunus) ‣ Does not believe credit rating agencies or "self-regulation" are effective means of supervision, due to the lack of "enforcement" options ‣ Credit-only MFIs should not be subject to "prudential" regulation ‣ Believes cost of supervision in many cases outweighs the benefits, and this should be a consideration – when selecting supervision techniques ‣ Also concerned with over-regulation of MFIs that might impede growth and innovation
Interest Rate Caps vs. Interest Rate Flexibility	‣ Currently imposes interest rate caps on microcredit loans, commensurate with caps imposed on other types of loans	‣ There should be no restrictions on interest rates set by microfinance organizations ‣ There should, however, be full disclosure as to how interest rates are calculated and charged	‣ There should be no restrictions on interest rates set by microfinance organizations
Restrictions on Funding Vehicles vs. Liberalization of Funding Vehicles	‣ Currently restricts mobilization of retail deposits by microfinance NGOs and other "non-financial" organizations/programs ‣ Restrictions on foreign loans	‣ There should be no restrictions on funding to the microfinance organization, including local subsidized or grant funding and foreign grants or equity	‣ There should be no restrictions on funding to the microfinance organization ‣ Proponent of some form of deposit insurance for MFIs
Qualification and Training of Microfinance personnel	‣ No certification or training of microfinance personnel currently required	‣ Instead of using donor money to fund ongoing operations that should be funded with local deposits, donor money can be used to help establish and fulfill start-up needs, including training	‣ There is a shortage of qualified MFIs for international organizations to invest in (equity capital) – this speaks directly to the strength of existing MFIs and indirectly to the qualification of personnel running those MFIs

Based on this comparison, we assert that in many fundamental ways, China's current regulatory and legal environment can be improved in ways that will be more supportive of the growth and expansion of microfinance programs and organizations. In particular, China has no policies in place that specifically address microfinance issues – a situation that presents an opportunity to leapfrog many other nations and become a global leader. Of the organizations that do exist within China's microfinance industry, none are specifically licensed or chartered to perform activities within this industry, and thus appropriate standards of performance are ambiguous while opportunities to realize increased efficiencies and market share are limited. Although there are diverse viewpoints across the industry towards how MFIs should be supervised, China's MFIs do not currently subscribe to any form of supervision or regulation. Although no particular form of supervision has been widely adopted, the consensus is that supervision of some sort is of value and that the ideal solution would encompass consideration for the continued innovation, entry/exit, and expansion of MFIs, while ensuring a prudent operating environment projecting safety and soundness to clients and funders. (Of course, the wrong kind of supervision, that borrows to heavily from traditional approaches to lending that have excluded the poor in China and in almost every country, will be worse than no regulation at all, and this scenario must be avoided by, among other things, closely consulting with leading practitioners who can best assess the impact of new regulations on short-term and long-term program growth and impact.)

The challenge is to arrive at a balance that is both effective and cost-effective. As such, traditional on-site supervision and central reporting requirements typically imposed on Formal Banks would not yield the same benefit, consistency in comparison, and analysis of financial health when imposed on an MFI.

In addition to the organizational issues outlined above, other environmental concerns are perhaps more philosophical or political in nature. Perhaps counter-intuitively, interest rate ceilings do not, in general, support the growth of the micro-credit sector. The ability to adjust rates in accordance with demand and cover operating costs is what will ultimately define which MFIs can evolve over time to serve the changing needs of their clients and deliver services more efficiently. By capping interest rates, not only will existing MFIs struggle to survive, but this may also present a disincentive for new MFIs to enter the market. The work of reducing the cost to end-borrowers should center around improving efficiencies through implementation of best practices and automated management information systems, and through spurring competition amongst micro-lenders in an environment where full disclosure of rates and fees is required. Similarly, restricting access to funding is also an inhibitor to successful microcredit lending. In fact, if there are low-cost funds that an MFI could access, it would also then be in a better position to offer more favorable rates on loan products as they attempt to progress towards full operational and ultimately full financial self-sufficiency. However, in order to prevent risk to the financial system and secured deposits, it is also important to designate standards and qualifications for which organizations can accept retail deposits. Implementing specific standards, including provisions for the acceptance of deposits, could become part of the licensing process. To further ensure appropriate accreditation and also ensure adequate capital for on-lending, Dr. Muhammad Yunus and others, including recent studies commissioned by CGAP, suggest that deposit insurance for microfinance depositors could yield a large amount of capital to MFIs from borrower and non-borrower savings, which would be insured up to an agreed-upon amount.

Finally, one of the key attributes for improving access to microfinance services is improving the level of service offered to clients. Currently, there is a lack of knowledgeable personnel running the microcredit programs. Training or pre-certification on some licenses may be necessary depending on the scope of activity.

Recommended Potential Initiatives

As discussed in the previous sections of this paper, key issues to be addressed include (1) the lack of formal policies and regulations that govern microfinance activity and institutions, (2) the lack of a clear legal status for MFIs in China, (3) the lack of a supportive environment for mobilizing deposits and other funding sources, and (4) the lack of a supportive environment to implement demand-driven microfinance activity.

Based on the thought leadership of key industry authorities, the following are recommended as potential initiatives to pursue in the short and longer term for facilitating a supportive legal and regulatory environment for microfinance:

<u>Short Term</u>

- Draft key pieces of microfinance policy to be incorporated into current banking regulation that (1) lifts interest rate caps, (2) liberalize acceptance of funding from all wholesale sources (domestic or international) by all microfinance organizations
- Develop and implement training for current microfinance personnel
- Allow community credit unions and microfinance organizations to take retail deposits from clients, if in partnership with an already-supervised financial entity (e.g. Formal Bank, RCC, etc)
- Institute a policy requiring microfinance organizations to provide proper disclosures on their process and calculation of interest rates

<u>Medium-Longer Term</u>

- Develop full set of policies governing microfinance activities and organizations in China, including those that clearly delineate microfinance organizations from other financial organizations – as well as the requirements for maintaining a microfinance charter
- Develop standards for licensing different types of microcredit organizations in China, to be fully sanctioned by the government
- Develop certification standards for MFIs to meet, in order to receive partial or full benefits of other financial institutions (e.g. acceptance of retail deposits, eligibility for insurance, etc.)
- Develop and implement formal training for all MFIs seeking to become certified and continue to perform outreach to other MFIs in order to educate both microlending personnel and the community for which they serve

- Develop full set of disclosures to be implemented by different levels of MFIs, based on the activities they are permitted to engage in
- Identify and develop an entity, such as the Microfinance Regulatory Commission, to supervise all microfinance entities in an effective and cost-effective manner
    - Make use of risk-based assessment criteria that can be self-reported by organizations on a regular basis
    - Make use of off-site monitoring and supervision techniques
- Collaborate with international organizations to set uniform methods for accounting, reporting, and supervising MFIs
- Develop means to compare MFIs, e.g. rating system, to help clients and donors to become more informed about MFI performance

About the Authors

Lynn Chia. Ms. Chia has extensive professional management experience in banking supervision, management consulting, and product management. Ms. Chia became interested in microfinance during her tenure as a Bank Examiner for the Federal Reserve Bank of Chicago and currently serves in an advisory capacity to Grameen Foundation USA. Ms. Chia is an Associate at Booz Allen Hamilton Inc., a global management consulting firm based in the Washington D.C. area. Ms. Chia holds a B.A. from the University of Michigan, M.B.A. from the University of Chicago, and completed studies at the London School of Economics.
E-mail: Lchia@gsb.uchicago.edu

Alex Counts. Mr. Counts has been a micro-credit practitioner and advocate since he served as a Fulbright scholar at the Grameen Bank of Bangladesh in 1988. He lived in Bangladesh for six years, during which time he authored Give Us Credit, a book chronicling the success of micro-credit in Bangladesh and inner-city Chicago in the U.S.A. Since 1997 he has been serving as the President and CEO of Grameen Foundation USA, which is based in Washington, DC, and written several articles on poverty and micro-credit for the poor that have appeared in the Washington Post, Christian Science Monitor, Miami Herald, International Herald Tribune, and elsewhere. Mr. Counts holds a degree in Economics from Cornell University.
E-mail: Acounts@gfusa.org

About Grameen Foundation USA

Established in 1997 and based in Washington, D.C. , Grameen Foundation USA seeks to enable the world's poorest families to lift themselves out of poverty with dignity through access to finance and information. By providing strategic financial, technical and technological support to micro-finance institutions around the world, Grameen Foundation USA advances the successful micro-finance methodology pioneered by the Grameen Bank of Bangladesh.

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