

The Policy and Legal Framework for Microfinance in China

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Executive Summary

There are currently three types of microfinance in China: public-interest, mutual and commercial microfinance. Chinese microfinance started as public-interest projects, normally operated by Non-Governmental or Non-Profit Organizations (NGOs/NPOs). Mutual funds have been developing rapidly in recent years while commercial microfinance projects have started to become undertaken by commercial banks, which have legal banking licenses. Theoretically, it is illegal in China for NGOs/NPOs to provide financial services. However public-interest Microfinance Institutions (MFIs) have become an important component of the microfinance industry in China and receive governmental support in a variety of forms. The Chinese government will have to continue to focus on improving the legal and policy environment for microfinance if the industry is to continue to grow and prosper.

1. Microfinance Players in China

1.1 Definition of Microfinance in China¹

In China, microfinance only consists of microcredit operations and does not include savings, insurance or transfer payments. In rural areas, microfinance institutions (MFIs) tend to target clients from farming households and rurally-based microenterprises whilst in urban areas the institutions focus on laid-off and unemployed workers and urban-based microenterprises..

¹ The definition of microfinance differs between the People's Bank of China (PBOC), CBRC and NGO microfinance promoters. NGO microfinance promoters emphasize the fact that microfinance is a tool to reduce poverty, targeting mid/low income and poor clients, and that institutional sustainability is a way of promoting social development in the long run. The PBOC also has the similar requirement that clients of microfinance should be from mid/low income microenterprises in rural areas. The CBRC does not make any requirement on its clients' economic status, i.e. whether they are poor or not, but does insist that rural microcredit should involve small loan sizes and be granted to households, individual businesses and small enterprises in rural areas.

1.2 Categories and Providers of Microfinance in China

The Chinese microfinance industry can be divided into the following categories:

1.2.1 Public-interest Microfinance

Public-interest MFIs are operated by non-government organizations (NGO) or the government and their principal objective is to reduce poverty and promote social development. The main difference between NGO and governmental MFIs is that NGO MFIs pursue self-sustainability whereas sustainability is not a goal of governmental MFIs. This paper will focus on NGO MFIs.

1.2.2 Mutual Microfinance

In recent years, an emerging mutual fund model in rural communities has received significant attention from governments and donor agencies. Chinese civil society has a long history of mutual funds, known as Hehui, or ROSCA in the west. Mutual funds were created by farmers themselves, or with support from the government or international development organizations. An example of such a fund is the rural community revolving fund which was created with the support of the State Council's poverty alleviation office. External supporters also provide technical assistance and additional funds, and act as policy coordinators. Loan capital for mutual fund operations is usually mainly provided by the fund members themselves. Mutual funds are managed by, and in the interests of, the fund members.

In 2007, the Chinese Banking Regulatory Commission (CBRC) permitted the registering of a new type of mutual fund, known as a rural mutual credit cooperative (RMCC). RMCC is the only form of mutual financial institution recognized by financial regulators.

1.2.3 Commercial Microfinance

The term 'Commercial Microfinance' refers to the microfinance services provided by formal financial institutions. The objective of commercial microfinance is to achieve commercial sustainability as opposed to poverty alleviation. As a result microfinance products from these providers tend to be targeted towards the mid/low income market segment.

Commercial microfinance providers include rural credit cooperatives (RCC), rural commercial banks, rural cooperative banks, village banks (VB), lending companies (LC), urban commercial banks, postal savings banks and microcredit companies (MCC). However RCCs, VBs, and MCCs are the main players in this sector and therefore the focus of analysis in this paper.

MCCs are a new type of microfinance provider and were first created in 2005 as a

pilot program initiated by the People's Bank of China (PBOC). With the exception of MCCs, all commercial microfinance providers are registered financial institutions.

2. Development of the Policy and Legal Framework for Microfinance in China

In 2005, Prof. Du Xiaoshan gave the following summary of the development of the Chinese policy and legal framework for microfinance:¹

'In September 1996, the Central Committee of the Chinese Communist Party (CCP) and the State Council convened a 'high-level' meeting in order to discuss the national poverty alleviation strategy. In the meeting, an increase in poverty alleviation funds and the availability of such funds for individual villages and households was emphasized.

In February 1998, Chen Junsheng, the head of the national poverty alleviation project, stated, in a national-level meeting, that: "Microfinance is an effective tool to reduce poverty. We should experiment with microfinance projects in some areas and then spread these projects to other areas. The key characteristic of microfinance operations is that funds directly reach the poorest rural households and that the rate of repayment is high." As a result of the meeting it was decided to give support to provinces in order to allow the commencement, or expansion of, pilot microfinance projects.

On October 14, 1998, the 'Central Committee of the CCP on Agriculture and Rural Areas' identified the emerging necessity of ensuring that the rural poor received sufficient food and clothing. As a result it was decided to advocate the expansion of effective microfinance projects in order to ensure that poverty alleviation funds reached the hands of the rural poor. This was the first time that the effectiveness of microfinance operations in achieving these goals was recognized by the Central Committee of the CCP. The belief was reiterated during the '1999 central poverty alleviation meeting' and in the 'Ten-Year Rural Poverty Alleviation Plan (2001- 2010)'.

In July 1999, the PBOC published its 'Temporary Management Methods for RCC Microcredit Loans'.

In January 2000, the managers responsible for overseeing the 'RCC Joint-guarantee Loan Project' examined the institutional structure of NGOs and quasi-government organizations that had implemented microfinance projects and encouraged the undertaking of practices such as: joint guarantees, forced deposits, group savings funds, installment repayments,

¹ Du Xiaoshan: The Regulatory Environment for Microfinance in China. April, 2005. www.cgap.org/regulation.

and continuous loans.

In December 2001, the PBOC published its: 'Management Guidelines for RCC Microcredit Loans and requirements for implementing microfinance.'

In April 2004, the policy paper entitled: 'Improvement in Granting Microfinance Loans and Serving the Rural Poor', further strengthened the management, systemization, and support of RCC microfinance.'

From Prof. Du's analysis, we can observe two features of the development of Chinese microfinance policy and its legal environment before 2004:

Firstly, the organizational legal basis of microfinance changed from multilateral or bilateral cooperative agreements to non-profit organizational laws. Public-interest microfinance generally started as poverty alleviation projects assisted by international donor agencies. The legal basis behind these projects lies in the agreements made between the government and donor agencies. MFIs were created in order to alleviate poverty in a sustainable manner. Due to the nature of public-interest microfinance, MFIs are generally registered as non-profit organizations (NPO), such as societal organizations, privately-run non-profit enterprises, foundations and institutions, which are formed in accordance with the respective non-profit laws.

Secondly, the legality of microfinance operations was transferred from the policy level to the level of both policy and legislation. During the early stages of microfinance in China, the main industry players were NGOs and NPOs which could not obtain business licenses or authorization from financial regulators. Since 2004, Chinese Communist Party (CCP) policies, together with recognition and praise for microfinance operations from the party's leaders, have helped to create a positive environment for microfinance development. Once formal financial institutions also started microfinance operations, more and more regulations were issued by the industry's regulators. However these regulations were not applicable to public-interest MFIs.

The most recent changes in the policy and legal environment started to occur in 2005. The PBOC launched MCC pilot projects in five provinces in the same year, and some 7 MCCs have been established thus far. As a result, the PBOC published new guidelines for MCCs in 2006. In December 2006, the CBRC published a policy paper entitled: *'Opinion Regarding Easing Market Access for Banking Financial Institutions in Rural Areas in order to better Support the Construction of a New Socialist Countryside'*. The paper advocated the creation of three new types of rural financial institutions: Village Banks (VBs), Lending Companies (LCs), and Rural Mutual Credit Cooperatives (RMCCs). In January 2007, the CBRC issued further microfinance policy papers entitled: *'Provisional Rules on the Administration of Village Banks'*, *'Provisional Rules on the Administration of Lending Companies'*, and *'Provisional Rules on the Administration of Rural Mutual Credit Cooperatives'*. In December 2006

the CBRC started pilot projects in 6 provinces and then expanded the project to a total of 31 provinces, autonomous regions and municipalities in October 2007. There are currently 11 VBs, 4 LCs and 8 RMCCs operating throughout China.

3. The Policy and Legal Environment for Public-Interest Microfinance

3.1 Legal Status

3.1.1 Non-Profit Organizations

There are currently four different organizational forms for public-interest MFIs: societal organizations, foundations, privately-run non-profit enterprises and institutions. The following legal documents detail the legal frameworks behind these four organizational forms: *'Rules on the Administration of Societal Organizations'*, *'Rules on the Administration of Foundations'*, *'Provisional Rules on the Administration of Privately-run Non-profit Enterprises'* and *'Provisional Rules on the Administration of Institutions'*.

The following articles are of interest:

- Article 2 of *'Rules on the Administration of Societal Organizations'* stipulates that a societal organization is a non-profit social organization
- Article 29 of *'Rules on the Administration of Societal Organizations'* states that a societal organization is prohibited from performing for-profit business
- Article 2 of *'Rules on the Administration of Foundations'* explains that a foundation is a non-profit legal organization engaging in public-interest undertakings
- Article 2 of *'Provisional Rules on the Administration of Privately-run Non-profit Enterprises'* elaborates that a privately-run non-profit enterprise is a social organization undertaking non-profit social services
- Article 2 of *'Provisional Rules on Administration of Institutions'* underlines that an institution is a social service organization set up by the state with state-owned assets for social public-interest purposes, undertaking efforts relating to education, technology, culture or healthcare.

3.1.2 Non-Financial Institutions

Article 21 of *'General Lending Rules'* states that an institution engaging in lending must be approved by the PBOC (CBRC, after the year 2003), must have received a

'*Financial Institution Legal Organization*' or '*Financial Institutional Operation*' license from the PBOC (CBRC, after the year 2003), and must be registered with the Administration for Industry and Commerce (AIC). Article 19 of the '*Banking Regulation and Supervision*' law stipulates that without the authorization of the State Council's banking regulatory authority, no institution or individual can create a banking institution or engage in banking operations (N.B: all credit related activities are considered as banking operations).

Thus far public-interest MFIs are yet to have obtained any approval or license from the banking regulatory authority. In addition no public-interest MFI has registered with the AIC. As a result there is currently no legal basis for the operations of public-interest MFIs.

3.1.3 Basis of Legality

However, public-interest MFIs are a reality and have been developing for more than ten years. The legality of these operations stems from the following three aspects:

a National policy on poverty alleviation, rural financial reform and innovation

Since 2004, the major annual policy documents from the CCP have all been related to rural development. All of the policy papers in this area call for rural financial reform and innovation. Microfinance has been recognized and promoted as an innovative method of rural financial reform and an effective tool for poverty reduction. The policy paper of 2006 clearly advocated the formulation of regulatory rules for the administration of MFIs, while that of 2007 identified microfinance as an indispensable part of the overall financial system, including commercial finance, cooperative finance and policy finance (finance provided by government banks). In January 2007, the third national conference on finance concluded that it was necessary to further facilitate rural financial reform and financial organizational innovation, as well as to actively support various forms of microfinance.

b International cooperative agreements

Most public-interest MFIs originated from poverty alleviation projects, financed by international donor agencies. The projects typically involved donor agencies signing agreements with the Chinese government in order to facilitate the creation of independent NPOs. These NPOs would then guarantee the continuation of microfinance operations after the end of the project phase.

c Government-approved poverty alleviation and financial innovation pilots

Microfinance operations are consistent with the Chinese government's strategy of promoting poverty alleviation, rural financial reform and innovation. Results demonstrate that microfinance can deliver higher efficiency and effectiveness in these

areas. It is because of the positive results generated thus far that the microfinance industry has been left free to develop and attract attention and support from national and local government, regulators and domestic and international investors.

3.2 Financing

3.2.1 Current Funding Sources

Currently, public-interest MFI funding sources include international and domestic donations, and subsidies from government for such expenses as: offices, transportation, partial salaries or allowances, accumulative net earnings, small amounts of compulsory savings, and, on some occasions, fiscal funds for poverty alleviation.

3.2.2 Equity Financing

The majority of public-interest MFIs are based on one of the four forms of NPOs mentioned above. The providers of NPO funds are prohibited from receiving any economic returns on their investments and from obtaining ownership of the organization. In addition, since public-interest MFIs are state-owned, private or foreign investment is prohibited. The nature of the NPOs and state-owned institutions acts as a barrier against equity financing of public-interest MFIs.

In practice, some larger supporting organizations and foundations charge fees, based on profits, to local public-interest MFIs. The rationale for these charges is that the supporting organizations or funding foundations need to cover the cost of mobilizing funds, technical support, policy coordination and supervision of the MFIs. This practice provides a possible route towards equity financing.

3.2.3 Liability Financing

There are two main types of liability financing in general: public savings and loans from commercial banks. Unfortunately, these options are often unsuitable for public-interest MFIs.

Firstly, without licenses from financial regulators, any person or organization is strictly prohibited from working with public savings. The social and economic costs of disobeying these rules are so high that no public-interest MFIs work with public savings. Some MFIs collect a small amount of compulsory savings from clients as part of their lending methodologies, for example, as a guarantee for a loan.

Secondly, the banking regulators forbid commercial banks from supplying loans to the MFIs registered as NPOs.

3.2.4 Foreign Investment

There are two kinds of foreign investment: direct investment and indirect investment. Direct investment refers to equity investment whereas indirect investment is received in the form of loans.

As detailed above, legal barriers are currently in place prohibiting equity investment. However, it is still possible to receive foreign loans if strict conditions are followed. According to the law: *'Provisional Measures on Administration of Foreign Debts'*, foreign debts include: foreign government loans, international financial institution loans and international commercial loans. Article 21 of this law stipulates that without the approval of the State Council, any governmental organs, social organizations or institutions are forbidden to take-on foreign debt.

Currently, there is only one case of a foreign loan being approved in China - the long-term favored loan transaction between KFW and Zhaowuda Women Sustainable Development Association in Inner Mongolia. The negotiation, application and approval process for the loan has lasted for almost 4 years, with the involvement of the national governmental agencies of National Development and Reform Commission (NDRC), Ministry of Finance (MOF), State Administration of Foreign Exchange (SAFE), and the relevant departments at the autonomous region and municipal level. The procedure is expected to end this year.

There are currently no cases of short-term commercial microfinance loans in China.

3.2.5 Wholesale Funds

In some countries wholesale funds, such as PKSF in Bangladesh, have been created in order to support NPO MFIs. Although such a fund is yet to be created in China, a number of microfinance promoting agencies or foundations act as wholesale funding agencies. For example, the China Development Bank (CDB) offers microcredit capital to some MFIs at local level, as well as to bigger national foundations such as the China Foundation of Poverty Alleviation (CFPA). In addition, the China International Center for Economic & Technical Exchanges (CICETE) and the Beijing Nongfa Foundation of Poverty Alleviation (known as 'Funding the Poor Cooperative' and founded by the Rural Development Institute of CASS) also provide credit capital to affiliated MFIs.

3.3 Monitoring and Supervision

Public-interest MFIs may be regularly or irregularly monitored by donor agencies and relevant local official agencies. After the closure of a project, donors usually have no budget for, energy to, or interest in, monitoring the performance of the institutions. Neither do the relevant government departments and registration organs have the

required levels of professional staff or knowledge to supervise the MFIs. In addition the responsibilities of financial regulators do not extend to the supervision of MFIs.

Although the above-mentioned supporting organizations, which mobilize funds and provide technical support to MFIs, play some part in supervising the institutions, they are not officially authorized supervisory bodies, and should in themselves be supervised for matters such as the receiving of donations.

The China Association of Microfinance (CAM) has tried to construct a regulatory framework for public-interest MFIs. The 'Citi training center of the China Academy of Social Sciences' (CASS) has made significant efforts to provide technical training to MFIs. However, owing to their unregistered status, the CAM's requirements have no binding power over any MFI without authorization from the government. The poor performance of public-interest MFIs in China is, to a significant extent, attributable to the lack of an effective supervisory system..

3.4 Staff

The unclear legal status of public-interest MFIs means that the sector's future is uncertain, making it difficult to recruit and retain qualified professionals - one of the major obstacles to the institutions obtaining institutional sustainability.

3.5 Clients

Furthermore, again as a result of their unclear legal status, some public-interest MFIs were sued by clients in an attempt to avoid repaying their loans. The Funding the Poor Cooperative (FPC) in Hebei Province was once faced with such an embarrassing situation. Although the FPC won the lawsuit, the issue of an unclear legal status still remains a significant problem.

3.6 Taxation

As NPOs, public-interest MFIs have enjoyed exemption from corporate and income tax since their creation. However in an exception to this treatment, the FPC in Nanzhao County, Henan province, was taxed and then partially refunded at a later date. Such cases highlight the uncertainty of the tax exemption status of MFIs engaging in profit-making lending activities.

4. The Policy and Legal Environment for Commercial Microfinance

In rural areas, RCCs are typically regarded as being the largest microfinance providers. However, due to complicated problems regarding ownership, governance, and management, many RCCs are currently undergoing significant internal reform. From an investment perspective, this paper focuses on analyzing VBs and MCCs.

4.1 Ownership

The main problem concerning ownership lies in the limitations placed on VBs. Article 25 of the *'Provisional Rules on Administration of VBs'* states that the controlling shareholder, or sole shareholder, of a village bank must be a banking institution and that the controlling shareholder, a banking institution, shall hold at least 20 per cent of the VB's total equity.

However a number of international microfinance providers that are not financial institutions would like to start licensed microfinance operations in China. In addition, a number of owners of MCCs who are natural persons or non-financial institutions would like to convert into formal financial institutions. Although village banks are an ideal choice for both domestic and international investors, the above limitations on ownership prevent international non-financial institutions from investing in them. Moreover, domestic owners of MCCs are often unwilling to lose control of their institutions. As a result of these limitations and complications potential investors are often prevented from investing in village banks.

4.2 Registered Capital

The registered capital of county and township based village banks must be no less than 3 million and 1 million Yuan respectively whilst the registered capital of a MCC must be no less than 5 million Yuan.

Since commercial banks are the largest shareholders in village banks and are subject to stringent financial supervision and regulation, village banks are licensed to work with public savings - even though their registered capital is less than that of MCCs.

4.3 Sources of Funds

As mentioned above, all financial banking institutions are licensed to work with public savings whereas MCCs can only receive funds from their owners, as donations or as

wholesale funds from one source. Furthermore, MCCs are not allowed to receive loans from banks.

The limitations on funding sources make it difficult for MCCs to rapidly expand their credit operations. As a result, potential investors tend to prefer VBs to MCCs.

4.4 Business Region

RCCs, VBs, LCs and MCCs can only do business in their registered administrative region. Moreover, VBs can only be registered in rural areas. The term “rural areas” as defined by the CBRC refers to counties (cities) and sub-county (city) areas in the central-and-western regions, northeastern regions, Hainan Province, state and province designated poverty-stricken counties, and sub-county areas in other provinces (autonomous regions and municipalities).

Although such limitations are useful for controlling financial risk within a small region, they are not conducive to the expansion of these operations.

4.5 Interest Rate

The microcredit interest rate cap for RCCs is less than 2.3 times that of the basic interest rate set by the PBOC whilst there is no specific interest rate limitation for VBs, LCs and MCCs. Nevertheless, all financial institutions must adhere to the Civil Law which states that interest rates shall not be more than 4 times the basic interest rate set by the PBOC.

Even with such interest rate limitations, financial institutions can still make significant profits in China. The present basic lending interest rate is 7.47% and some MCCs make full use of the above provision, allowing them to charge an annual rate of approximately 24%.

4.6 Loan Size and Risk Concentration

RCCs offer two different types of microcredit products: compulsory group loans and credit loans with collateral or guarantee. According to PBOC rules, loan amounts for compulsory loans must be decided on the basis of actual needs. In principle, loan amounts should be no larger than the annual income per capita of local households. Credit loans must be within the official credit line and are set by the county (city) rural credit union after considering the local economic situation, farmers’ income levels, and the level of funds available to RCCs. In addition the credit line must be approved by the county (city) PBOC sub-branch. By taking these measures, RCCs are able to set reasonable loan sizes, in accordance with the actual needs of the borrower.

The CBRC requires that VBs and LCs provide ‘small’ loans without actually defining the term ‘small’ and tends to only pay real attention to the issue of risk concentration. The outstanding balance of loans disbursed by a village bank, to one individual borrower or business group should not exceed 5% and 10% of the bank’s net capital respectively. In the first year of the village bank pilot phase, there was no evidence to suggest that RCC and public-interest MFI clients were accessing VB loans.

MCCs are restricted to an average loan size of no more than 100,000 Yuan and no individual borrower can receive a loan worth more than 5% of the institution’s registered capital. The MCC average loan size of 100,000 Yuan is extremely large in comparison with the public-interest MFI average loan size of 2,000 - 3,000 Yuan - indicating that public-interest MFIs are the most important financial service providers for low-income and poor households in China.

5. The Policy and Legal Environment for Mutual Funds

5.1 Rural Mutual Credit Cooperatives

RMCCs have emerged as a new type of rural credit cooperative and have been granted with a license to work with savings among its members. RMCCs are basically regarded as being banks at the village level. In order to ensure the sound development of RMCCs, stringent regulations have been put in place by regulators. However the strict requirements have led to the cost of creating and running RMCCs becoming extremely high. Examples of such prohibitive requirements are those relating to areas such as: business premises, safety precautions and other facilities.

5.2 Government/ Development Agency Supported Mutual Funds

Since the mid-1990s, a number of mutual funds have been created by international development agencies in China. Most funds are based on the share capital of its members and grants from aid agencies. It is common for a number of different names, such as ‘community development funds’ and ‘revolving funds’, to be used instead of ‘Mutual Fund’.

In recent years, community mutual fund microfinance operations have attracted attention from the government. The State Council’s ‘Poverty Alleviation Office’, in collaboration with the World Bank, initiated four mutual revolving fund pilot projects in rural communities and operate another mutual fund program, based on a different model, in over 270 villages.

5.3 Mutual Funds Created by Farmers

There has been a long history of mutual funds in Chinese civil society. In some villages, farmers create mutual funds themselves, sometimes with outside technical or financial support.

5.4 Problems of Mutual Funds without Financial Institution Status

RMCCs can be defined as licensed mutual funds or credit cooperatives, meaning that they are formal financial institutions. The other two types of mutual funds analyzed above do not have the legal status of financial institutions. Although these types of mutual funds can, theoretically, apply to register as RMCCs, the high costs involved, due to strict legislation, prevents them from doing so.

It should be noted that some informal mutual funds take the form of societal or specialized cooperatives instead of legal entities.

6. Expected Changes, Challenges and Impacts

6.1 Expected Changes and Challenges

6.1.1 Public-Interest Microfinance

From the perspective of financial regulators, it will be less possible for them to grant financial licenses to public-interest MFIs or to clarify their legal status. However, it is also unlikely that they will set additional limitations on public-interest MFIs.

Besides the loan agreement between KFW and the Chifeng MFI in Inner Mongolia, a number of other financing transactions, which would offer potential solutions to MFI financing difficulties, are under negotiation.

6.1.2 Commercial Microfinance

Some foreign and international, non-banking, microfinance providers have showed interest in investing in the Chinese microfinance industry. Village banks are considered as a good option to engage in microfinance operations in comparison with the other existing financial institutions types. However, the main barrier lies in the requirement that the largest shareholding party is a bank. The CBRC and PBOC have reached an agreement that a MCC can be converted into a VB by abiding by the rules set by the CBRC.

The removal of this limitation would result in a significant increase in investment in the Chinese microfinance industry. Such an increase would require a corresponding

increase in supervision and would be a considerable challenge to industry regulators.

6.1.3 Mutual Microfinance

Mutual fund pilot projects will continue to be undertaken and regulators will not be involved in the supervision of mutual funds which adopt democratic management structures. However this will only be the case if mutual funds can prove that they can help solve the financing problems of low-income and poor farmers without mobilizing savings from other people than their members. Indeed, if thousands of RMCCs are created or if unregistered mutual funds become registered institutions, financial regulators could be faced with a major challenge.

6.2 Recommendations and Likely Impact

6.2.1 Public-interest Microfinance

a Orientation and Position

Public-interest microfinance is viewed as being an indispensable part of the inclusive financial system, which should comprise: governmental/policy finance (financial services offered by government banks), commercial finance (financial services offered by commercial banks) and social finance (financial services offered by NGO/NPO MFIs and cooperative funds). Public-interest MFIs should retain their social finance nature, taking poverty alleviation as an organizational mission. Public-interest microfinance policies and legislation should be based on the framework detailed below:

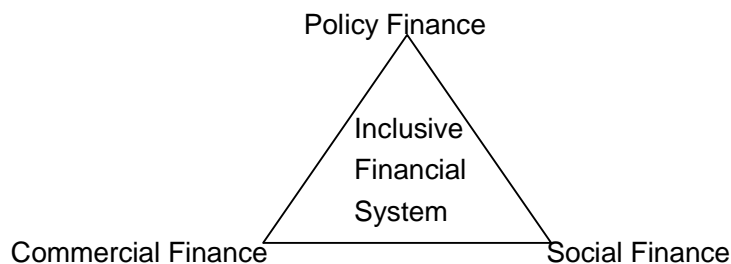


Figure 1: Public-interest framework

b Legal Status and Special Regulations

As a general rule, the legal status of an MFI is firstly determined by the organizational law under which the MFI is registered (such as the country's company or non-profit law), and secondly by the financial laws and regulations under which the MFI is

regulated¹. For example, in Brazil, microcredit NGOs are legally registered as non-profit organizations, just like any other non-profit organization. NGOs can then register with the Ministry of Justice as a microcredit provider in order to become a legally authorized lending entity. (Kate Druschel, 2005)

The Chinese government may consider the opening of a special window in order to allow NPO MFIs to undertake microfinance operations whilst maintaining their NPO identity. Such a concession could be performed by simply amending the existing non-profit law to allow, subject to certain restrictions, for the carrying out of lending-only activities.

c Financing

It is rational to put strict requirements on mobilizing public savings so as to safeguard the public interest and the safety of the financial system. Nevertheless, there should be alternatives for MFIs to solve financing related problems.

NPO MFIs that are performing well should be authorized to refinance credit from the central bank, sub-loan from commercial banks, or be entrusted with loans from policy and commercial banks.

Establishing a wholesale fund should also be considered as an option for financing public-interest MFIs.

d Non-prudential Supervision

The extent of supervision or monitoring of financial institutions in a stringent regulatory framework should depend largely on the level of risk that such an institution brings to the financial system. This is why more severe regulations should only be applied to deposit-taking MFIs (CGAP 2003).

Since public-interest MFIs are not allowed to collect public savings, it is not necessary to adopt a high level of supervision.

e Industrial Self-regulation

In order to protect the interest of the beneficiaries (the poor, low-income earners, social development, etc.), attain investor confidence and facilitate healthy development of public-interest MFIs, an appropriate supervisory system should be put in place.

The most practical form of supervision would be via industrial self-regulation. Therefore, the financial authority should support an industrial association, such as CAM, to take the responsibility of supervising the industry.

¹ Kate Druschel: *The Ultimate Balancing Act: Investor confidence and Regulatory Consideration for Microfinance*, microReport #28, USAID, July 2005.

f Taxation

The government should create a new policy which clearly states public-interest MFIs' exemption from taxation.

g Commercial Microfinance

The financial regulators should consider allowing, subject to certain restrictions, non-financial institutions to be the largest shareholders of village banks. The lifting of current restrictions would ensure that village banks would have a bright future.

h Mutual Microfinance

The *'Farmers' Specialized Cooperative'* act provides a legal framework for farmers to set up specialized economic cooperatives. Although the CBRC allows the establishment of RMCCs in rural areas, stringent regulation means that the vast majority of farmers cannot afford the cost of establishing and operating RMCCs. A solution to this problem may involve permitting the creation of a combination of specialized cooperatives and mutual funds. In this way, supervision responsibilities could be entrusted to another organization by the CBRC.

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