Microfinance Regulation in China and India

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ABSTRACT

The regulatory responses of Governments in different countries to emerging microfinance sectors have varied dramatically and as a result so have the outcomes for these sectors. As two of the fastest growing developing countries in the world over the last two decades, both with vast poor rural populations lacking access to credit, the potential demand for microfinance in India and China is enormous. Yet where the microfinance sector in India has been one of the fastest growing in the world with a diverse range of successful for-profit and non-profit microfinance institutions, the microfinance sector in China has failed to find its feet with microfinance institutions unable to attract commercial funding to expand or to achieve financial self-sufficiency. In this thesis I provide a comparative analysis of the regulatory frameworks for microfinance in China and India in order to demonstrate how the more restrictive and uncertain regulatory environment in China has hindered the development of the sector. In the next section of the thesis I bring the discussion of the regulatory frameworks into the broader political and economic contexts of the countries to answer the question: why have the Governments in India and China regulated the emerging microfinance sectors so differently? I argue that rising inequality and poverty alleviation plans conditioned the goals of the Governments for the microfinance sector and that the broader level of financial sector liberalization conditioned the feasible set of microfinance regulations for the Governments.

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Contents

Chapter 1: Introduction

From its origins as a research project of the University of Chittagong in rural Bangladesh, Microfinance has grown into an enormous global industry which holds hope for many as a path towards a large scale, sustainable reduction of poverty internationally. That research project was established as the Grameen Bank in 1983 by Muhammad Yunus and has grown to serve 8.29 million borrowers annually with 2,564 branches serving 81,367 villages in Bangladesh (www.grameen-info.org). Estimates of the global industry suggest that by 2007 microfinance institutions (MFIs) were serving around 150 million clients around the world (Gine et al 2010). Microfinance sectors have thrived across the globe, flourishing in countries as diverse as Bolivia, Bangladesh and Indonesia. In order to try and promote the spread of microcredit for financial inclusion, the UN designated 2005 as the Year of Microcredit and in 2006 Muhammad Yunus was given the Nobel Peace Prize for his work in microfinance.

Yet despite the phenomenal growth of the industry and the celebration by many of it as an innovative development tool, microfinance is the subject of a great deal of controversy and debate. Of particular concern is whether it is possible for MFIs to pursue both commercial goals and social goals, with some arguing that the latter will inevitably be compromised by the former. Others argue that the only way for the microfinance industry to become truly scalable and to therefore meet the credit demands of the poor is for MFIs to attract commercial funding and that the only way for this to happen is if MFIs can offer a reasonable return on equity. Another accusation leveled at microfinance is that it mostly serves the needs of the marginally poor, whereas the very poor are in need of more basic help, such as food and immunization,

and that an overemphasis on microfinance in development strategies is detracting from those in more need.

It is in the context of the enormous growth of the industry and of the growing controversy of the apparent trade-off between commercial and social objectives that the debate about the appropriate regulatory framework for an emerging microfinance sector has been conducted. Internationally a wide variety of approaches have been taken by Governments and regulatory authorities with regards to microfinance; some have created entirely new regulatory windows for microfinance, some have amended existing financial regulatory frameworks to account for MFIs, some have ignored microfinance entirely. Many argue that because of the particular mechanisms and operating environment of the industry, regulation must be flexible in order for microfinance to succeed. Others argue that it is important to regulate microfinance closely in order to protect the poor from exploitation and over-indebtedness. Some argue that interest rates should be limited as the poor cannot afford to pay higher rates, others that because of high operating costs and small loan amounts MFIs must be able to charge higher interests or else they will not be able to lend to the poor. Detractors of direct Government involvement say that it perverts the underlying incentive mechanisms of microfinance, proponents argue that Governments are best placed to implement microfinance on a large scale quickly. Different regulatory environments have seen microfinance sectors develop on very different trajectories and with hugely varying degrees of success both in terms of sustainability and in terms of outreach.

India and China have been two of the fastest growing developing countries in the world over the past couple of decades. At the same time both countries still have a vast number of people living in poverty, particular amongst the rural population, in which there is a huge demand for credit which is unmet by the formal financial system. Yet the growth and development of the microfinance sector in these two countries has been extremely different. In India, the microfinance industry has been amongst the fastest growing in the world over recent years, reaching an estimated 76.6 million clients by 2009, up from 56 million the year before reaching 234 of the 331 poor districts identified by the government with more than 50% of poor households covered by sort of microfinance project (Srinivasan 2009). Grameen style NGO microfinance institutions flourished and spread quickly throughout the country, at the same time the Self-Help Group program, supported by both the Government of India (GoI) and by Development Finance Institutions (DFIs), has grown to be called the "biggest microfinance program in the world" (NABARD 2009) and more recently the for-profit Non-Bank Financial Companies (NBFCs) MFIs have grown at astonishing rates, attracting huge investment from private equity companies and culminating most recently in the IPO of SKS Microfinance on the Bombay Stock Exchange, an IPO which raised around $350mn for 20% of its equity which it is thought will set a precedent for others in the industry to follow. The for-profit microfinance industry has in fact grown so fast that concerns are beginning to be raised about whether it can continue to serve a social purpose, Muhammad Yunus said of the recent IPO "this isn't mission drift, its endangering the whole mission" ("SKS launches India's first microfinance IPO" AP Jul 28 2010), and even amongst some of the non-profit organizations high leverage ratios are leading to aggressive lending practices of questionable social benefit. In China, conversely,

microfinance has failed to find its feet. NGO programs, having started in the early 1990s reached a peak of around 300 institutions but there are thought to be only around 100 operating today. A huge Government microfinance programme was initiated towards the end of the 1990s but funds have failed to reach the very poor and bad implementation has led to extremely low repayment rates. The Government also directed the vast network of Rural Credit Cooperatives (RCCs) to engage in microfinance but these programmes have suffered from similar problems to the Government run programme. More recently a few types of private MFIs have been legally recognized and show some promise but as yet have not taken off because of burdensome restrictions.

The different performances of microfinance sectors in China and India can largely be explained by the extreme difference between their legal and regulatory treatment. In India social organizations have legally been able to innovate in grassroots financial services, NGOs and other non-profit MFIs have had a number of options to register as formal institutions without facing prudential regulation and all MFIs have operated without interest rate restrictions or overly burdensome funding restrictions. In China only formally registered financial institutions can offer any financial services and NGO-MFIs, even after almost twenty years of operation have been granted no legal status, all MFIs have faced extremely burdensome interest rate, funding and geographical restrictions, Government run programmes have been favoured over private initiative and until a few years ago there were no legal routes for private commercial microfinance; for those private institutions that now do exist the prudential and interest rate restrictions make commercial sustainability extremely difficult to achieve (Geraci et al 2010).

Given there are strong precedents of success and failure internationally in microfinance regulatory frameworks and that despite much debate over regulation there are substantial areas of consensus on notions of regulatory best practice within frameworks, why do different Governments regulate microfinance so differently? Why, more specifically, have India and China, two countries with a vast potential market for microfinance, treated the emergence of the microfinance sector so differently?

Microfinance regulatory structures are not determined by an isolated consideration of the optimal implementation of those regulations most conducive to the emergence of a strong, sustainable microfinance sector. They are determined within the particular political and economic context of the country in which they are to be implemented and are constrained by the parameters of that environment. Microfinance occupies a peculiar place within the broader economic framework by straddling a boundary between development policy and commercial finance. Not only may the feasible set of regulations be different between countries but the goals of the government with respect to the microfinance sector may differ.

India and China are two countries on a similar growth trajectory, who have both undergone a significant process of liberalizing reform over the last few decades. However, they are very different in many ways too, India is the world's largest democracy and has been so since its dependence in 1949 whereas China is ruled by an authoritarian Communist party in a one party system, India is a more ethnically and culturally heterogeneous society than China and though both have grown fast, the impetus of growth has come from different sectors of the economy. I identify two factors rooted in the process of political and economic reform in both countries

which I believe have conditioned the emergence of the regulatory framework for microfinance. In doing so I neither pertain to comprehensive in explaining the factors which have impacted on the development of the frameworks nor to be able to firmly prove that these conditions have had the impact I suggest but I hope to encourage further consideration of the factors that condition the emergence of microfinance regulation.

The two factors that I argue have conditioned the microfinance regulatory frameworks in the India and China are:

- Differing Goals: In the context of rapidly rising inequality and with the broader poverty alleviation (PA) strategy moving from a regional to a household focus, I argue that the Chinese Government commandeered microfinance to achieve its PA goals and as such had little concern for the development of a sustainable sector. In India, rising inequality was less prevalent and the Governments broader PA strategy was moving from direct intervention to a more facilitative role, in this context the focus for microfinance was for economic empowerment through self-employment and financial inclusion leading to a government focus on creating a regulatory environment conducive to a sustainable sector.
- Financial Sector Reform: Whilst both countries have undergone extensive reform in their financial sectors, I argue that greater progress on interest rate liberalization and the development of private sector financial institutions in India allowed for the emergence of regulations conducive to sustainable microfinance which were less feasible in the Chinese context.

The goals of the Government for microfinance present an interesting paradox, it is the pursuit of explicit poverty alleviation goals by the Chinese Government which has slowed the emergence of an industry which might have had a longer term sustainable impact on the poor. The Government pushed poverty alleviation funds through state-owned banks and poverty alleviation offices as 'microfinance' programmes which they were ill structured and incentivized to administer. For NGO-MFIs and private MFIs, restrictions intended to protect the poor, such as interest rate controls and controls on debt financing, instead prevented these MFIs from achieving financial self-sufficiency and forced them to lend larger amounts to less risky borrowers. In India, the self-sustainability of the industry was much more explicitly pursued as a goal. The Government, concerned with engendering the most conducive regulatory environment, convened task forces with committees of practitioners, bankers and government representatives whose recommendations formed the basis of Government policy-making. This led to a less stringent prudential framework and fewer restrictions on MFI operations, allowing them to grow and exploit economies of scale to lower costs per borrower, whilst the Government restricted its role to a facilitator, funding and supporting the socially organized Self-Help Groups through the Swarnajayanthi Gram Swarozgar Yojana (SGSY) initiative.

The relevance of the progress of financial sector reform lies in the dual role of MFIs as both development organisations and as financial institutions. Whilst discussions of regulatory best practice for microfinance often consider those sets of regulations which will be most conducive to the development goals of microfinance, including sustainability, these regulations must be developed within the context of the broader financial regulatory framework. Whilst liberalised interest rates may be the optimal policy for microfinance, in a country where interest rate

controls exist throughout the financial system, such as China, it may be politically very difficult to create an exception. Similarly if private financial institutions have a limited role in the financial sector and regulatory and institutional infrastructure to cope with them does not yet exist, then a Government or regulator may be unwilling to allow NGO-MFIs or private MFIs scope for expansion. The broader financial regulatory structure determines the feasible set of regulations for microfinance.

The next chapter of this paper will be a literature review covering some of the debates around microfinance, microfinance regulation and of financial regulation more generally. In Chapter 3 I will undertake a comparative analysis of the microfinance regulatory frameworks in China and India which is something that has been missing from the microfinance literature to date; I do this by focusing on a few key, institutions in each country. In Chapter 4 I will elaborate on and attempt to substantiate my hypotheses on the determinants of microfinance regulatory structures. In Chapter 5 I will make concluding remarks and discuss the broader implications of the thesis.

Chapter 2: Literature Review

Much of the literature on microfinance involves examinations of the mechanisms and incentives which underpin its success, although this microeconomic literature is valuable it is not pertinent to the questions of this paper. The debates in the literature relevant to this paper are: what are the different goals for microfinance? How do MFIs best achieve those goals? What is the appropriate role of the Government? What is the best way to regulate an emerging microfinance sector? What affects the Governments approach to the microfinance sector and to microfinance regulation?

2.1. Outreach, Sustainability and Impact

In the large body of microfinance literature the goal of microfinance projects is considered to be the sustainable expansion of credit to the poor. Gonzalez Vega (1998) separates these into two separate measures of microfinance performance: outreach and sustainability. Outreach he defines as an aggregate of the quality, cost, depth, breadth, length and variety of microfinance products. In Park and Ren's (2001) examination of Chinese microfinance programmes they divide this further into targeting (outreach), financial and operational performance (sustainability) and program benefits to those served (impact). The argument over what constitutes sustainability is much more contentious, particularly with regards to the role of donor financing and subsidisation. Brau and Woller (2004) separate the two major sides of the argument into the institutionalists vs. the welfarists. The institutionalists argue that microfinance cannot be sustainable if it is subsidized so that the measure of sustainability should be whether a company can cover all of its operational and financing costs with its revenues. Hollis and Sweetman (1998) study 19th century loan funds in the UK, Germany and

Italy and find that those which were subsidized were more fragile and ultimately less sustainable. The Welfarists conversely suggest that subsidies and donor funds should be considered as a sort of equity which has a social return so that Microfinance Institutions can be considered sustainable without meeting the criteria of financial and operational self-sufficiency of the institutionalists (Woller, Dunford and Woodworth, 1999). Morduch (1999a, 2000) suggests that the problem with the institutionalist view is the belief in the "win-win" proposition that those institutions which adhere closest to the principles of good, sustainable banking will be those that alleviate the most poverty; he suggests that there is little evidence to back this up and that subsidisation may be justified insofar as if microfinance institutions are to try and alleviate poverty and extend outreach, sustainability may be very hard to achieve. In an in-depth study of the Grameen Bank (Morduch 1999b) shows that much of the success of the Grameen Bank has been because of continuing substantial subsidization and argues that the dogma of those who hold that financial self-sufficiency is necessary for the success of microfinance is preventing serious in-depth analysis of the impact of subsidized programmes and the capacity for them to co-exist with commercial microfinance.

A further step from the argument of the institutionalists are those argue that MFIs must not just become financially self-sufficient in order for microfinance to be successful but that in the long run, for the credit demands of the poor to be met, MFIs must offer a sufficient return on equity to attract commercial capital. Funk (2007), in discussing the IPO of the Mexican bank Compartamos, an event of considerable controversy, puts forward this viewpoint arguing that it would take $30bn annually in order to reach the world's poor with microcredit and that to do this will necessarily involve private investors. On the same topic Von Stauffenberg (2007) says

that Microfinance has "outgrown donations" and will have to "play by the rules of the market" to succeed. On the other side of the argument, Muhammad Yunus (2007) weighs in saying that this push to profit-driven models is "leading microcredit in the moneylenders direction" and argues that microcredit companies have a responsibility to keep their interest rates as close to the cost of funds as possible. Using a comprehensive dataset from the Microfinance Information Exchange (www.mixmarket.org), Cull et al (2008) empirically examine the effect of commercialisation on microfinance and find that commercial MFIs are less likely to serve the very poor and disadvantaged groups such as women, if this is the case the argument of commercialisation may involve a value judgement of depth of outreach (how poor are those being served) versus breadth of outreach (how many are being served).

The question of the social impact of microfinance is pertinent when considering whether Governments should allow microfinance special regulatory and tax treatment and especially when Governments include microfinance as part of Poverty Alleviation Programmes. There are many individual country studies which go about trying to measure the social impact of microfinance programmes (e.g. Mosley (2001) on Bolivia, Park and Ren (2001) on China), the majority of which find at least some positive impact on income. One interesting study was conducted by Karlan and Zinman (2010); to overcome problems of selection bias, because those who receive loans are the most productive, he convinced an African lender to randomnly select from a group of people who had originally been marginally denied loans and extend loans to them anyway, after two years those who had received loans were better off than the control group in terms of employment, hunger and poverty. Mosley and Hulme (1998) conduct a cross country study of 13 MFIs in Bolivia, Indonesia, Bangladesh, Sri Lanka, Kenya and India

and find that there is an inverse relationship between the depth of outreach and the positive impact on those targeted, suggesting that the slightly less poor benefit more from microfinance.

2.2 The Role of the Government

A widely used guideline document by the Consultative Group to Assist the Poorest (CGAP 1996) suggests that Governments should not offer subsidized credit and that interest rates to the end borrower should not be subsidized because this often results in low repayment as loans are treated as grants, rationing of loans which favours the wealthy and politically connected and institutional corruption through staff arbitrage. Lapenu (2000) argues that while the primary role of the Government is to offer a "conducive regulatory and economic framework to allow... microfinance institutions to develop without constraint" [p.33], Government subsidies are necessary for start-up investment and network building and for the "development of innovations as a public good" [p.33] and that there is a role for the state in investing in complementary services such as infrastructure, health and education.

In terms of Government run microfinance programmes, there is plenty of literature on the previous failures of Government Subsidized Loan Programmes (e.g. Adams and Von Pischke 1984) before microfinance. Park and Ren (2001) conduct an in depth study of a Government run programme, a mixed government and NGO programme and a pure NGO programme in China and find that the government programme is worst on all three measures of targeting the poor, sustainability and impact, where the pure NGO programme is best in all three.

2.3 Microfinance Regulation

Although there are large areas of debate over the correct framework for regulating emerging microfinance sectors, there are various documents, particularly those from CGAP which pertain to lay out considerable areas of consensus. Christen, Lyman and Rosenberg (2003) wrote a comprehensive document for CGAP, in their Consensus Guidelines series, called "Guiding Principles on Regulation and Supervision of Microfinance". Some of the tenets of this doctrine are to only prudentially supervise MFIs which mobilize deposits, removal of interest rate restrictions, a focus on functional regulation (which regulates on the type of activity regardless of the type of institution) rather than institutional regulation (which regulates according to the type of institution), removal of limits on unsecured lending and relaxation of provisions for unsecured lending, simplification of loan documentation and procedural requirements and relaxation of restrictions on foreign funding. A question often raised is whether microfinance should have its own specific regulatory window or regulation should mostly take the form of amendments to existing laws. Van Greuning et al (1998) advise against an entirely separate set of regulations and instead argue that an extension of existing financial regulatory environments where financial institutions are tiered according to the source of funding is appropriate. Meagher (2002) advocates a tiered approach with the smallest institutions and non-deposit taking institutions being largely left out of regulation. He is positive about the benefits of hybrid systems which combine a degree of regulatory oversight with systems of self-regulation such as MFI Networks.

As with the literature on the social impact of microfinance, there is a lot of in depth single country case studies on the outcomes of different regulatory environments but little cross-country work on the impact of different levels or types of regulation. In one of few multiple

country studies Hatarska and Nadolnyak (2007) run cross-country regressions on 114 MFIs from 64 countries and find that regulated financial institutions do not achieve better sustainability and outreach. Cull, Demirgüç-Kunt and Morduch (2009) use a database of 245 of the world's largest MFIs and finds that the stringency of prudential regulation and supervision is negatively related to depth of outreach and lending to women in for-profit institutions and is associated with significant losses of profitability in non-profit institutions. They take this as evidence that supervision imposes costs on MFIs and that for-profit MFIs absorb these by curtailing expensive small loans to poorer and disadvantaged groups. Staschen (2003) conducts a comparative review of legal frameworks for microfinance in 11 countries, focusing only on those countries which have created a separate regulatory framework for microfinance he illustrates the range of options and outcomes on measures such as prudential vs non-prudential regulation and the legal definition of the target group; although frameworks are evaluated against each other on a topic by topic basis it is difficult to draw general lessons.

2.4 Determinants of Regulation: Motivation and Feasible Sets

Whilst most country case studies will consider microfinance within the political and economic context of the country being examined, literature specifically addressing the political and economic factors that influence microfinance regulatory frameworks is rare. The two approaches by which this topic is usually tackled are in discussions of factors which affect the goals of a government for microfinance in a country and in discussions of the feasible set of regulations.

In the CGAP consensus guidelines (Christen, Lyman and Rosenberg 2003), the difficulty of allowing liberalised interest rates for certain governments is confronted. If governments have

some authority over interest rates it may be difficult for them to set an interest rate limit high enough for sustainable microfinance and it may be extremely hard for them to allow MFIs to freely set interest rates; this is because the need for high interest rates in microfinance is poorly understood by the public and frequently by politicians. Christen and Rosenberg (2000) suggest it may be more difficult for transition countries to have an open regulatory structure for microfinance because of exclusionary regulatory systems which make financial institutions illegal unless specifically said otherwise.

The motivations behind Government involvement in microfinance may differ as well. Christen and Rosenberg (2000) suggest that Governments may be motivated to regulate microfinance tightly because of the involvement of foreign-funded NGOs and grassroots social movements which they may wish to clamp down on, an argument that Tarun Khanna has made to explain the Chinese Government's treatment of NGO-MFIs (Google Tech Talks March 2009). They also suggest that the global prominence of microfinance itself may spur Governments to rush into regulation because of a feeling that they have to "do something about microfinance". Heloise Weber (2002) argues that the microfinance movement is part of a new global development architecture based on the imposition of capitalism and that Governments push microfinance as a means to facilitate financial sector liberalisation and as a political safety net quelling resistance to broader liberalisation measures whilst legitimating a capitalist paradigm by adhering to principles of free market capitalism.

The literature on microfinance and on microfinance regulation is extensive and yet it is not common for there to be a systematic comparative analysis of two countries regulatory

frameworks in order to explain microfinance outcomes. Certainly it seems to not have been done for China and India, two countries that are frequently used together in comparative studies. To combine a comparative analysis of microfinance regulatory frameworks in two countries with a discussion of the broader political and economic context that has conditioned these regulatory outcomes is something not currently present in the literature on microfinance and is an exercise I believe to be of value in understanding the context in which this innovative sector is developing. It is to this exercise that I turn in the following chapters.

Chapter 3: Comparative Analysis of Microfinance Regulation in China and India

Endeavouring to engage in a comprehensive and succinct comparative analysis of microfinance regulatory structures between countries is a challenging task. Microfinance activities can be undertaken by a vast array of different institutional types and the institutional types that appear in any given country can be entirely different from those that appear in another. Amongst many others microfinance can be undertaken by commercial banks, cooperatives, directly by government initiatives, by NGOs, by producer groups and by both for profit and non-profit limited companies. The regulations that affect particular institutions in one country, though pertinent to their own operation, may not be easily comparable with those regulations which govern the types of MFI in another country. Financial regulation across countries can differ between institutional regulation and functional regulation, which of these is predominant in a country will impact the structure of microfinance regulatory frameworks (Staschen 2003). Some countries create new regulatory windows for microfinance, with microfinance specific laws and guidelines, other countries will simply make amendments to and create exemptions from existing financial regulations in order to encompass the particular characteristics of microfinance.

In both India and China the path of the development of the microfinance sector has led to the emergence of a large variety of types of institutions engaging in microfinance. Many of these institutions are particular to their country, in their structure and in their scope of operations. The emergence of new regulations in China has generally followed a pattern of officially

recognizing new types of institutions which are permitted a specified scope of activities or in changing the scope of permitted, or mandated, activities of existing institutions. In India various institutional types have usually found their way into the existing financial regulatory framework and regulatory advances have mostly involved amendments within this framework to accommodate microfinance activities.

Despite the complex and variegated nature of the microfinance institutions in India and China, there exists a solid basis for comparison particularly among the most significant of the types of MFIs. In the areas of prudential and non-prudential standards, interest rate controls, funding restrictions and taxation there is rich opportunity to demonstrate the degree of differentiation in the regulatory approaches of the two countries.

In this chapter I will first use the Microfinance Information Exchange (MIX) Asian Microfinance Analysis and Benchmarking Report 2009 (MIX 2010) to illustrate the different performance of MFIs in India and China in terms of their growth, their outreach, their sustainability and their profitability, I will then describe the development of the microfinance sector in each of the countries before describing the institutional structure in each country. My analysis of the regulatory environment will focus on a few of the most important, and comparable, institutional types. I will then compare the regulatory environment of the two countries generally across a few key factors.

3.1 Performance Indicators

Through the description of the development of the microfinance sectors in each country and the performance of the individual institutional types it will be possible to establish a more nuanced view of the performance of the microfinance sectors in China and India. It is useful, still, to have some general performance indicators to demonstrate the variation in outcomes of microfinance that is being explained. The MIX dataset is composed of a large set of indicators reported by MFIs across many countries who voluntarily report to the organization; it is not necessarily representative of the entire industry but is useful for guidance.

The MIX Asia 2009 Microfinance Analysis and Benchmarking Report (MIX 2010) finds that the growth rate in total borrowers in the years 2004-05, 2005-06, 2006-07 and 2007-08 was -35%, 10%, 48% and 34% respectively in China whereas in India the corresponding growth rates were 95%, 54%, 46% and 57%. A measure of the depth of outreach, the average loan balance divided by GNP per capita, shows little difference in the level of poverty in borrowers despite the explicit focus of the Chinese sector on poverty alleviation goals; it is 13.8% and 11.1% in China and India respectively. In terms of sustainability, the Indian MFIs were financially self-sufficient at 104.1% in 2006 and at 108.7% in 2008, in China this increased from 91.8% to 98.5% from 2006 to 2008 but the MFIs still failed to achieve financial self-sufficiency. In terms of the ability to attract commercial funding, the MFIs in India offered an 8% profit margin and a 12% return on equity; in China the profit margin in 2008 stood at -1.5% with a return on equity of -0.6%. Tighter prudential controls and a lack of access to commercial funding are evident from the capital/asset ratios and debt/equity ratios, these are 32.7% and 1.4 respectively in China compared to 13.3% and 6.2 in India.

These performance indicators demonstrate that across a range of measures the MFIs in India have been outperforming those in China. The full range of types of MFI are not necessarily represented by the MIX dataset but the statistics are indicative of the broader picture. A more complete picture of the emergence and performance of the different players in the microfinance sectors in each country follows.

3.2 Development of the Microfinance Sector

3.2.1 China

Du Xiaoshan (2005) separates the development of the microfinance sector in China into three stages.

The first stage was the *experimental* stage from 1993-1997 when, apart from some patchy early forays by foreign-aid projects in the 1980's to early 1990's, the Microfinance Industry in China began when the Rural Development Institute of the Chinese Academy of Social Sciences (CASS), with funding and support from the Foundation for Poverty Alleviation and Grameen Bank, started three Grameen methodology microfinance projects in Yi County of Hebei Province and Yucheng and Nanzhao Counties in Henan province called the Funding the Poor Cooperatives (FPC) [He Guangwen et al 2009]. As this took off other projects from international organisations, such as those of the UNDP and UNICEF, started to implement microfinance initiatives working with Chinese partners, such as the Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and the Women's Federation, in the countryside. At this point projects were only either quasi-official organizations or NGOs who were allowed to operate only by

informal operating permissions and given temporary legal statuses. These projects were funded almost entirely by soft loans and by international donors with almost no government support.

Following initial skepticism, as these projects proliferated and proved successful at achieving high repayment rates, many achieving rates of close to 100% (Park et al 2003), and increasing outreach over the following years, the Government decided in 1997 that it would engage directly with the microfinance movement. This is the phase referred to by Du Xiaoshan (2005) as the *expansion phase*. The Government implemented a Grameen-style approach to the subsidized-loan program of the Agricultural Bank of China (ABC) as well as establishing and rapidly expanding poverty alleviation cooperatives. These government programs had reached 600 counties in 22 provinces in just two years by August 1998 [Park et al 2003], already vastly greater in scale than the NGO programs that had preceded them. Soon after the administration of these poverty alleviation loans was taken away from the poverty alleviation cooperatives and returned fully to the responsibility of the ABC. These Government microfinance programs have had extremely poor repayment rates hardly any better than those from the individual subsidized loan programs they were replacing; their rapid expansion meant that they had poorly trained staff and management and subsidized interest rates led to targeting of the loans by the wealthier and better connected (Park and Ren 2001).

The third phase of the development of the microfinance sector in China was the formalization stage as the Government promoted the entry of formal financial institutions. Having begun experimental programs in some provinces promoting microcredit loans from Rural Credit Cooperatives (RCCs) in 1999, in 2001 the People's Bank of China (PBC) released the *Guidance on*

Microcredit Loans Management of RCCs for Rural Households (PBC 2001) which required RCCs to provide, and simplified the procedures for providing, microcredit loans to rural households across the country, bringing microfinance into formal financial institutions and vastly expanding the scope of the sector. RCCs operate on the township level and have the most extensive rural network in China; in 2000 there were already 37,624 RCCs with 169,092 credit stations. With the introduction of microcredit operations to RCCs the breadth of financial outreach in China was greatly expanded, however the RCCs have had a poor performance plagued by problems of government influence, inappropriate regulatory structures and weak management and governance; in 2001 the non-performing loan (NPL) ratio was 44%, 46% of RCCs were making losses, 53.3% had negative net worth and 27% were facing serious financial difficulties (Planet Finance 2005).

Since 2005 the Government has expanded the number of different institutions allowed to provide microloans. This fourth phase of microfinance development in China has been referred to as the normalization and institutionalization phase (He Guangwen et al 2009). In 2005, the People's Bank of China (PBC) piloted the credit only Microcredit Companies (MCCs) in five provinces and has since expanded this experiment to the whole country, promulgating a number of regulatory guidelines and reforms pertaining to them as they have proliferated. These MCCs are for-profit privately owned institutions and are a major step towards the development of a financially sustainable microfinance sector in China. In 2006 Village and Township Banks (VTBs), which are allowed to take deposits from and provide loans to the public, were established and the China Banking Regulatory Commission piloted a reform programme for Rural Mutual Credit Cooperatives (RMCCs). Neither of these types of

institutions has grown particular quickly mostly due to restrictive start-up and prudential requirements. In the same year the China Postal Savings Bank (CPSB) entered into microfinance operations, with 37,000 branches the CPSB has the potential for extensive outreach, recent estimates suggest that CPSB is now reaching 2.5m microcredit customers, however Geraci, Luan and Dixon (2010) point out that at an average loan size of RMB 50,000 and with less than 10-15% of loans below RMB 20,000 it is debatable whether much of this outreach should strictly be considered microcredit.

Despite this growth of the microfinance industry and the recent proliferation of different institutions that offer some form of microfinance services, there is a sense that the environment in which the microfinance sector has emerged has hindered its development both in terms of outreach and in terms of sustainability and that the overall size of the microfinance sector could and should be much greater given the extent of demand for credit amongst the rural poor. Of China's 900 million rural population the Central Bank estimates that only 25% of households have access to formal credit [Planet Finance 2004] whereas a 2005 survey of 502 rural households found that 89% or rural households expressed a demand for credit [[He Guangwen and Li Lilli 2005] cited in He Guangwen et al 2004]. A persistent and large informal financial sector is also evidence that credit demand is not being met by supply, with a 1998 study by the China Agricultural University finding than 61% of all loans accesses by rural households were from informal channels [He Guangwen 1999].

3.1.2. India

The Government of India's (GoI) main poverty alleviation plan through much of the 1980s and 1990s was the Integrated Rural Development Programme (IRDP). Bankers and Government

officials often referred to it as the "world's biggest microfinance programme" (Sinha and Patole 2002). It involved commercial banks in lending around Rs250bn to 55 million families in loans of under Rs15,000 over the course of almost 20 years. These loans were subsidized, however, at a rate of about 25-50% and were seen as politically motivated handouts by most of the bankers involved in the programme. Repayment rates were in the range of 25-33% and the result was the creation of a poor credit environment with a lack of credibility of microborrowers in the eyes of commercial banks (Sa-Dhan 2006).

The microfinance sector in earnest began in the late 1980s with the emergence of two types of institution. The Self Help Groups (SHGs) and the Grameen replicating NGO MFIs. The Self Help Groups began to form, often with the support of NGOs in the 1980s; they are formed of groups of 10 to 20 people who pool their resources in order to make small loans, with interest, to members of the group. As these proved successful and were replicated throughout the country, the National Bank for Agriculture and Rural Development (NABARD) in 1992 recognised their success and launched the SHG-Bank Linkage Programme which encouraged commercial banks to lend directly to SHGs. Soon after the RBI included the SHG-Bank Linkage programme as part of the priority sector lending requirement of commercial banks encouraging them to directly finance SHGs or groups of SHGs. Groups of SHGs began to cluster together and form SHG Federations made of around 15-50 SHGs which engage in inter group borrowing, sharing of costs and which garner advantages in dealing with commercial banks because of their scale (Reddy and Manak 2005).

Grameen, or similar, type NGO MFIs also began to appear en masse at the end of the 1980s and beginning of the 1990s originally being funded by donor support. Around 1994 these NGO-MFIs started to receive mass funding from development organizations such as NABARD and the Small Industries Development Bank of India (SIDBI). These NGOs were mostly registered under the societies acts or as trusts but as their operations grew substantially many of these companies began to transform into either Section 25 non-profit limited liability companies or as for-profit Non-Bank Financial Companies (NBFCs).

Over the course of the last decade the growth of both the SHG-Bank Linkage model and the NBFCs has been vast. The M-CRIL composite index of growth of microfinance institutions in India from a base of 100 in March 2002 had reached 7178 in 2008-09 (M-CRIL 2009). The number of borrowers served by Grameen-type institutions has increased from 44% in 2002 to 88% in 2009 and it is estimated that MFIs are reaching around 20 million borrowers (M-CRIL 2009), close to 30% of the estimated 60-70mn poor families in India (Sa-Dhan 2006). As well as easy access to debt from the priority sector lending of banks, the entrance of private equity companies into the sector in recent years funded a lot of the growth of the NBFCs with this trend towards commercial funding culminating in the IPO of SKS Microfinance at the end of July. With this growth there has arisen some concern about the lending practices and interest rates of NBFCs and political resentment is building up in some areas of heavy indebtedness.

3.2 Regulatory Structure

In comparing the regulatory structure for MFIs in the two countries it is necessary to be illustrative rather than comprehensive. I will first list a comprehensive set of the major

institutional types providing microfinance in each country and I will then go into detail on three of the major institutional types from each country and the regulatory environment faced by those. In order to best illustrate the differences between regulation in the two countries I will first compare the regulatory environment for NGO-MFIs in each country, then for the principle private for-profit MFIs in each country and then I will describe the principle Government-backed microfinance initiatives in each country.

3.2.1. China's MFIs

Microfinance suppliers in China can be broken down in to eleven different types of institutions [Du Xiaoshan 2008]:

1. NGO-MFIs established for public interest
2. Subsidized Poverty Alleviation microcredit projects of state-owned banks such as the Agricultural Bank of China (ABC) and the Agricultural Development Bank of China
3. Agricultural microcredit projects from Rural Credit Cooperatives (RCCs)
4. Urban Commercial Banks and Guarantee Companies' microcredit projects
5. Credit-only Microcredit Companies (MCCs)- pilot project of PBC
6. Village/Township Banks (VTBs)- pilot project of China Banking Regulatory Commission (CBRC)
7. Rural Mutual Credit Cooperatives (RMCCs)- pilot project of CBRC
8. Lending Companies established by commercial banks
9. Subsidized microcredit projects for poverty alleviation implemented by rural financial institutions
10. Microcredit Project of the China Postal Savings Bank

11. Microcredit Projects of Commercial Banks

The three types of institutions on which this analysis will focus are the NGO-MFIs, the MCCs and the RCCs. This is because these are some of the most important institutional types in the Chinese microfinance sector; they are representative of three different areas of microfinance in China, non-governmental socially oriented microfinance, commercial for profit microfinance and government promoted microfinance. Although the Government has implemented its own microfinance initiatives through the ABC, the scale of the programme of the RCCs and regulatory conditions imposed make RCCs more illustrative for the purposes of the analysis.

3.2.2. India's MFIs

In India the principal division of institutional types is constituted by which of a number of registration acts an institution decides to register under. Although the freedom to innovate at the grassroots level means there is a diverse range of institutions providing some sort of microfinance services, a cursory attempt to divide the major institutions might produce a list as follows:

1. NGO-MFIs registered under the Societies Registration Act 1860
2. NGO-MFIs registered under the Indian Trusts Act, 1882
3. NGO-MFIs registered under as non-profit organisations under Section 25 of The Companies Act , 1956
4. For-profit Non-Bank Financial Companies (NBFCs) registered under Section 45(1) of the Reserve Bank of India Act, 1934
5. Cooperative Banks registered under the Banking Regulation Act, 1949
6. Cooperative Societies registered under various state Mutually Aided Cooperative Society (MACS) acts
7. Producer Companies registered under Section 209 of the Companies Act, 1956

8. Self-Help Groups operating as unregistered organisations, groups of SHGs known as SHG Federations may register under the Societies Registration Act, the Indian Trusts Act, or MACS acts.

The three types of microfinance program I will examine closely in the Indian microfinance sector are the NGO-MFIs, the for-profit NBFCs and the SHGs in the context of the SHG-Bank Linkage Programme and the Government initiatives to support SHGs.

3.2.3 Socially Oriented NGO-MFIs

China: NGO-MFIs

The microfinance sector emerged in China in the early 1990s due to the pioneering efforts of NGO programs such as those set up by the UNDP and AUSAid. Despite the early successes of these programmes in demonstrating the viability of Grameen style microfinance in rural China, their lack of legal status and uncertain regulatory environment has led the NGO-MFI movement to fail to grow to any scale over the 15-20 years of its existence. A recent survey by the People's Bank of China (PBC) found that there were only around 100 MFIs operating as NGOs in China (PBC 2009). This number is remarkably small given the scale of microcredit demand in China.

The main regulatory roadblock for NGO-MFIs is that they have never been given any legal status as financial institutions. This means that the lending operations of these organizations are technically illegal whilst being implicitly tolerated. The Law on Banking and Regulation and Supervision 2003 (chapter 3, articles 18 and 19)(PBC 2003) also prohibits such organizations from taking deposits. They are not allowed to accept investments of either debt or equity and so must rely entirely on donor funding (Geraci et al 2010). Along with these restrictions the

regulatory environment has been particularly uncertain and changeable for NGO-MFIs. The uncertainty of the regulatory environment is epitomised by the story of the Association for Rural Development of Poor Areas in Sichuan (ARDPAS). In the year 2000 with over 35000 clients ARDPAS was the largest NGO microfinance program in China but in 2001 the Government mandated that the provincial government poverty alleviation funds that ARDPAS was funded by could not be used for onlending so ARDPAS's operations were shut down (Park et al 2003).

The uncertainty of the regulatory environment for NGO MFIs in China has resulted in difficulty in attracting substantial donor funds. This combined with their inability to mobilize deposits or to receive investment in the form of debt or equity has severely restricted their capacity to expand operations.

India: NGO-MFIs

In contrast to the NGO-MFI experience in China, these institutions have expanded rapidly since they started to appear in the early 1990s being funded by soft loans and donor funds. From around 1994 the development finance institutions such as NABARD and SIDBI as well as microfinance promotion organizations began to provide large scale funding to the NGOs allowing them to become a sort of intermediary between the public sector development financial institutions and groups of poor borrowers (Sa-Dhan 2006). Sinha and Patole (2002) estimated the number of NGO-MFIs operating in India at around 1000, in recent years the percentage of NGO-MFIs in the microfinance sector has been declining, between 2006-2009 the percentage of MFIs registered as Societies and Trusts or as Section 25 companies fell from 20.9% to 7.9% and from 5.7% to 3.6% respectively (M-CRIL 2009); this is mainly because many new NBFCs have entered and many former NGO-MFIs have transformed into NBFCs.

NGO-MFIs can register under the Societies Registration Act 1860, the Indian Trusts Act 1882 or under Section 25 of the Companies Act, 1956. Those NGO-MFIs which register as societies or trusts face much the same regulatory framework. They exist as unowned entities and as such cannot raise equity capital, nor are they allowed to mobilize deposits from the public. There are no restrictions however on debt financing and as part of the priority sector lending requirements of the commercial banks they have an abundant supply of debt. Section 11 of the income tax act exempts NGO-MFIs registered as societies and trusts from income tax under the exemption for 'charitable activities'; there has been some uncertainty over the ability of states to question whether microfinance comes under a definition of 'charitable activity' and therefore whether NGO-MFIs are in fact entitled to the income tax exemption. Societies and Trusts are not financially regulated and are therefore not subject to any prudential requirements, nor do the face any restrictions on the interest rate at which they lend.

Companies registered under Section 25 of the Companies Act are defined as non-profit institutions for the "promotion of commerce, science, art, religion, charity or any other useful object". The regulatory advantages they hold over societies and trusts are that as companies they have equity shareholders and can therefore raise funds in this way, they have exemption from income tax under Section 11 which is more certain than that for societies and trusts because of the term "other useful object" in the definition of charitable activities and because of their legal status as a company there is more legitimacy to their status which helps in accessing commercial funds. Like societies and trusts Section 25 Companies are not allowed to take deposits. Section 25 companies are not financially regulated so long as they only engage in microloans defined as being less that INR50,000 for non-housing purposes and INR125,000 for housing purposes. If their loan amounts are greater than this they must register with the RBI. The exemptions for Section 25 Companies were introduced in 2000 in an amendment to the laws on NBFCs made specifically for microfinancing activities in response to the recommendations of the NABARD Taskforce.

3.2.4. Commercially Oriented Private Institutions

China: Micro Credit Companies

Until 2005 no private MFIs were allowed in China, having started then as a pilot program in just 5 provinces, MCCs represent the fastest growing type of MFI in China with the PBC reporting that the number of MCCs operating China wide had increased from approximately 500 at the end of 2008 to around 1,334 at the end of 2009 (PBC 2009). As the first private, for-profit, microfinance specific institution to be allowed, the MCCs are seen by many as being a step forward toward the development of a sustainable microfinance sector in China. However, the reality is that the attempts by MCCs to become financially sustainable institutions have been hampered by overly stringent interest rate restrictions and prudential requirements, the number of new MCCs opening has been held back by overly burdensome minimum capital requirements and that their capacity to expand has been limited by rules on funding and by geographical restrictions.

Regulated by both the PBC and the CBRC, the main set of regulations for MCCs were set out in May 2008 in the Guidelines on Pilots of Micro Credit Companies 2008 (Rule 23). These set out prudential and non-prudential standards which were already stringent but set only as base rules, giving provinces the freedom to make these rules harsher if they wished. The minimum capital requirement for an MCC was set at RMB 5mn (US$740,000) for limited liability companies and RMB 10mn (US$1,475,000); the minimum capital requirement varies greatly though from 1x Base Rule in Inner Mongolia to 10x Base Rule (RMB100mn, US$14,750,000) in Beijing (Geraci et al 2010). The restrictions on capital formation given these requirements are prohibitive as MCCs are not allowed to mobilize deposits and must have a minimum of ten

shareholders each of whom cannot hold more than 10% of the share capital. Their capacity to leverage debt for expansion is severely limited as they may not receive financing from more than two banks and they must not exceed a debt to equity ratio of 0.5 (Guidelines on Pilot MCCs, Article 3). For those MCCs able to access funding for expansion, an MCC is limited to only lend in the jurisdiction in which it is registered (Guidelines on Pilots of Micro Credit Companies 2008, Section 1, 4, 5) so an MCC must apply for a new license in every jurisdiction in which it wishes to operate. Interest rates are only permitted to be in the band of 0.9x – 4x the PBC's base rate (Guidelines on Pilot MCCs, Section 4), at present this allows MCCs to charge interest rates of up to around 20%, whereas a survey by Park and Ren 2001 found that the maximum rate at which poor borrowers in China were willing to pay for a loan from the NGO programs was around 32%.

India: Non-Bank Financial Companies

The fastest growing institutions of recent years in the Indian microfinance sector, and currently in microfinance globally, are the for-profit Grameen replicating Non-Bank Financial Companies (NBFCs). The recent IPO of SKS Microfinance on the Bombay Stock Exchange is indicative, if the most extreme case, of the extraordinary growth of the large NBFCs. Started as a non-profit society in 1998 and converted into a NBFC in 2006, SKS has seen from March 2007 to September 2009 its number of branches grow from 276 to 1,627, its membership grow from 600,000 to 5.3mn, its portfolio outstanding grow from INR2.75bn (US$59mn) to INR32bn (US$692mn) and its profit after tax grow from INR37mn (US$800,000) to INR556mn (US$12mn) (www.sksindia.com). Huge lending by commercial banks as well as large amounts of equity investment at high valuations by private equity companies have made this growth possible.

NBFCs register as companies under the Companies Act 1956 and under Section 45(1) of the RBI Act, 1934. The vast majority of the growth amongst NBFCs has come from those that do not accept deposits from the public; this is because the RBI imposes stringent prudential requirements on those NBFCs which do. For NBFCs that do not accept deposits from the public the main regulations that impact their operation are a minimum capital requirement of RS20mn (US$432,500) for any NBFC started after April 21 1999 (Vide Notification no DNBS 132/CGM (VSNM)-99 dated 20th April 1999), Rs2.5mn (US$54,000) for those that started before, and a capital adequacy ratio requirement of 12%. The inflow of private equity into the industry has meant that most of the NBFCs have easily met the capital adequacy ratio, for example despite the huge growth rate of SKS they claim that they have maintained a capital adequacy ratio of 24.8% (www.sks.com). In order to be able to accept deposits NBFCs must have at least two years of operations and then obtain an investment grade credit rating, these companies will then be subject to a 15% capital adequacy requirement and to prudential regulations on the concentration of risk. NBFCs accepting public deposits must invest at least 15% of these in Government securities and bonds guaranteed by the government. NBFCs face no interest rate restrictions. One of the only really restrictive restrictions placed on NBFCs is that they can only accept FDI of over $0.5mn (INR23mn) and this cannot exceed 50% of the share capital in the company.

3.2.3 Government Backed Initiatives

China: Rural Credit Cooperatives

Established in 1950s during the rural cooperative movement, RCCs are the only formal financial institutions that directly supply financial services to rural, low income households and are the central financial institution of the rural economy. By the end of 2007 there were approximately 52,000 county level branches of RCCs in China, accounting for 41.5% of all county-level financial branches in China (He Guangwen et al 2009). In 1999 the PBC issued the *Provisional Method of*

Microcredit Loans Management of RCCs for Rural Households launching the provision of microcredit from RCCs in a few provinces. At the end of 2001 the PBC issued the *Guidance on Microcredit Loans Management of RCC's for Rural Households* extending the RCC microcredit experiment across the country, requiring that RCCs provide microcredit loans to rural households and setting out some guidelines on procedures based on the grameen joint liability methodology of the NGO-MFIs in the country (Du Xiaoshan 2005). However, the performance of the RCCS was terrible, by the end of 2001 RCCs had a non-performing loan ration of 44%, 46% were making losses and 53.3% had negative net worth (Planet Finance 2005). Acknowledging the poor state of the operations of the RCCs, in June 2003 the state council issued a policy directive to reform and restructure RCCs in a few provinces which was then expanded to 21 provinces by the CBRC and PBC in August 2004 before being extended to the whole country.

Until 1996 RCCs were functional units of the ABC when they were made independent and brought under the supervision of the PBC, since its inception in 2003, RCCs have been under the supervision of the CBRC. RCCs have a minimum capital requirement of $120,000, they must maintain an 8% capital adequacy ratio, the ratio of loans outstanding to deposits must not exceed 80% and the ration of current assets to current liabilities must be at least 25% (1997 Regulations for the Management of RCCs, Article 28). RCCs face a restrictive interest rate band of 0.9-2.3x the base rate, a ceiling which cannot conceivably allow for RCCs to become Financially Self Sufficient.

India: Self-Help Groups

The Self-Help Groups (SHGs) are groups of around 10-20 poor individuals, usually women from the same ethnic background and village, and form a savings and credit association where they pool their financial resources and start bank accounts in order to make small interest bearing loans to group members. In 1992 NABARD initiated the SHG-Bank Linkage programme in which commercial banks lend to SHG groups with the RBI encouraging them to do so as part of their directed lending. NABARD offers to 100% refinance the loans. The programme has been a huge success and is now known as the biggest microfinance programme in terms of outreach in the world, with the NABARD microfinance report 2009 reporting 6.1m savings linked SHGs and 4.2m credit linked SHGs in the programme covering 86mn poor households (NABARD 2009). Of the savings accounts 58% were with Public and Private Sector Banks, 26.6% were with Regional Rural Banks (RRBs) and 15.4% were with Cooperative Banks and of the loans given out 62.4% were with Public and Private Sector Commercial Banks, 25.2% with RRBs and 12.4% with cooperative banks (NABARD 2009), demonstrating that the majority of the formal sector financial institutions are involved in funding the programme. The Government merged many of its main credit programs in 1999 into Swarnajayanti Gram Swarojgar Yojana (SGSY) which provided subsidized credit to and supported the formation of SHGs. The program has grown to an enormous size with 24.6% of SHGs financed under the SGSY programme in the year 2008-2009 (NABARD 2009).

As grass roots community formed groups of savers, SHGs are entirely unregulated and are free to set the conditions of group membership and supervision for themselves. Groups of SHGs, usually about 15-50, in a particular area may cluster together to form an SHG Federation which in turn may register as societies, trust or mutually aided cooperative societies although they are not obligated to do so. These have the advantage of better leverage because of their scale and mitigation of the undiversified risk presented by single groups in the same village.

3.3 Key Regulatory Differences

Whilst the preceding comparative analysis may present quite a convoluted picture of a large number of institutions and regulations, there are certain differences that follow themes and there are a few differences which have been particularly significant in affecting the emergence of the microfinance sector. Though not by any means a comprehensive list, I follow here with a few of the key regulatory differences which have conditioned the emergence of the microfinance sectors in these two countries:

Interest Rate Controls

The most evident difference between the regulatory environments for microfinance in India and China is in interest rate controls. All institutions involved in the delivery of microfinance in China are subject to varying degrees of interest rate controls whereas none of the major types of MFI in India are. Microfinance in China will not be able to become a sustainable industry without some liberalization of interest rate controls. Given the small loan sizes in microcredit, the risk of uncollateralized loans and in particular the harsh geographical environment in rural China the cost per loan for MFIs are high. Without the ability to charge higher rates MFIs will not be able to become financially self-sufficient and particularly the commercially oriented MFIs will not be able to offer enough of a return to investors to attract capital for expansion.

At the same time that the pressure is building on China to liberalise interest rate controls on MFIs, culminating in an announcement by the PBC earlier this year suggesting without a firm commitment that they will be looking to loosen interest rate controls on MCCs and VTBs in the near future, there has been some backlash in India against what has been seen as excessive profit margins. Reductions in operating costs through economies of scale have been translated

into higher yields rather than lower interest rates which has led to some consternation that MFIs are drifting from their 'social mission'. State Governments in Kerala and Andhra Pradesh have forced NBFCs to register under state moneylending acts (respectively the Kerala Moneylending Act 1946 and the Andhra Pradesh Scheduled Area Moneylenders Regulations 1960) which force NBFCs to curtail their lending rates. Mounting political pressure following the movement towards public flotation of MFIs has seen other states begin to consider similar moves.

Funding Restrictions

In China NGO-MFIs have no access to either debt or equity funding and must therefore be funded entirely by donor support and operating surpluses. MCCs can only be funded by up to two banks, shareholders cannot hold more than 10% of the company, debt to equity ratios are under a prohibitive ceiling of 0.5 and at least 50% of shareholders must be Chinese citizens or enterprises. VTBs must be entirely funded by one bank. These funding restrictions have severely limited the capacity of any form of private MFI to expand, even as operational restrictions make them unattractive propositions for commercial investment, whilst RCCs and the Poverty Alleviation programs of the ABC have continued to receive substantial subsidized funding from the PBC forcing private MFIs to compete with subsidized interest rates from institutions that are unconcerned with achieving financial self-sufficiency.

In India, NGO-MFIs have been allowed to access debt when registered as societies or trusts and are able to access debt and equity if registered as Section 25 companies whilst facing no prudential requirements for debt to equity ratios or capital adequacy standards. This combined

with the fact that lending to the microfinance sector is counted as part of banks priority sector lending requirement means that there has been a huge inflow of debt into the sector. The M-CRIL India Microfinance Review 2007 found that the leverage ratio of leading MFIs in their sample was around 11.7:1 compared to the regional average of 6:1 (M-CRIL 2007). This has led many to fear that the sector is over leveraged, with a consequent fear that debt pressures may lead to questionable lending practices from the MFIs who need to expand their portfolios. For the NBFCs, since the entrance of private equity firms to the sector, leverage ratios have been decreasing as they have received an increased flow of equity financing; the companies also are prudentially regulated by the RBI and as such must maintain a capital-adequacy level of 15%. With the IPO of SKS it looks as though many large NBFCs will be looking to raise substantial equity from public flotations (Spandana, the second largest MFI has already announced its intention to follow suit); although this will no doubt allow these microfinance companies to supply substantially more of the unmet credit demand in India, there are concerns that remote shareholders may have little concern for the social mission of the microfinance companies.

Regulatory Uncertainty

After nearly 20 years of operation NGO-MFIs in China still have no legal status as financial institutions and continue to operate under an unofficial window of regulatory forbearance. The shutting down of the operations of ARDPAS in 2001 serves as a reminder to the industry of how fragile the continuation of this unofficial agreement is. This level of uncertainty has severely hampered the ability for NGO-MFIs to attract donor funds especially international funds on any extended basis and is the major cause of the failure of these MFIs to grow to any scale over the

last two decades. It was only in 2008 after three years of operation that the MCCs were legally recognized as formal institutions rather than as a pilot reform program which had created investor uncertainty. That all provinces are free to set standards stricter than the base rules also generates uncertainty for MCCs particularly with regards to their capacity to scale up through the country.

In India, a consistent regulatory environment for MFIs, as NGOs, NBFCs or SHGs, has existed for much of the past twenty years with the major changes being the hike in the minimum capital requirement for NBFCs from IRP2.5mn to IRP25mn in 1999 and the relaxation of restrictions on foreign funding in 2005. Regulatory uncertainty has begun to arise more recently as a result of the fast growth of the for-profit MFIs as state governments have begun to discuss imposing interest controls and resentment builds against aggressive moneylending practices.

3.4 Concluding Remarks

The value of such a comparative analysis lies not in the detail of the particular regulations faced by each of these institutions but hopefully in depicting a broader picture of the restrictive regulatory environment for microfinance in China versus the more conducive regulatory environment in India. In China non-governmental programmes are largely ignored by the government and face regulatory uncertainty after 20 years of operation, commercial for-profit institutions face a set of prudential standards and operating restrictions which make financial sustainability and expansion of operations near impossible and government support of microfinance consists either of fully government run microfinance projects or in mandating formal financial institutions to conduct microfinance operations for which they are ill structured

and incentivized. In India, NGO-MFIs are given a range of different options for formal registration none of which involves any prudential oversight, for-profit commercial institutions have boomed in an environment where they are able to access funding and to make sufficient profit to attract that funding and the principle government initiative in support of microfinance has involved funding and supporting the emergence of a grassroots, unregulated microfinance groups. In the following section I turn to the political and economic context of the two countries to try and explain why they have regulated microfinance so differently.

Chapter 4: Why do different countries regulate microfinance sectors differently?

On certain aspects of regulation there exists something of a notion of regulatory best practice for the construction of a framework conducive to the emergence of a scalable, efficient and sustainable microfinance sector. Numerous documents propagated by various practitioners and institutions, such as the Consultative Group to Assist the Poorest (CGAP), espouse the virtues of removing interest rate restrictions, only prudentially regulating those MFIs which accept deposits from the public, removal of restrictions on funding and allowing channels for socially formed organisations (such as NGOs) to attain legal status whilst leaving room for innovation at the grassroots level. Examples of successful microfinance sectors in countries such as Bolivia and Mexico, where private microfinance has been allowed to expand through operating on a for-profit basis and has therefore attracted substantial commercial funding extending outreach on a vast scale, set an example to those countries looking to achieve similar results. Examples of failures of Government loan programmes, such as the IRDP in India itself, and of the stagnation caused by excessive regulation serve as a reminder that demand for credit will not drive the emergence of a strong microfinance sector in itself.

Despite the emergence of this, admittedly incomplete, consensus on the type of regulatory framework and level of government intervention for a scalable, sustainable microfinance sector there is a vast degree of differentiation in regulatory frameworks internationally. Various governments have allowed microfinance vastly different levels of freedom to operate and have

held MFIs in their countries to very different standards. The question that this raises therefore is: why do governments in different countries regulate microfinance differently?

Decisions on how to regulate an emerging microfinance sector occur within the much broader political and economic context of the country in which they are made. Different Governments may have different goals for the microfinance sector which will not necessarily be for the emergence of a sustainable commercial industry; as financial institutions, the flexibility with which MFIs can be treated is firmly rooted in the broader financial regulatory structure; the level of state intervention in the microfinance sector will likely be determined more by the general level of state involvement in the economy rather than by any particular concern over microfinance mechanisms; and the integration of the microfinance sector into the economy and into legal and regulatory frameworks will be conditioned by the particular approach that the host government takes to reform in general.

India and China ostensibly share many characteristics that might lead one to expect the emergence of a microfinance sector to follow broadly the same pattern. They are the two most populous countries in the world and have both enjoyed extremely high economic growth rates over the past two decades during which they have both undergone extensive liberalizing market reforms. They both have a vast poor population, particularly amongst large rural populations, in which there is a huge unmet demand for credit which the governments of both countries have previously tried to rectify with subsidized loan programmes which have proved to be failures.

The two countries though are vastly different in a number of other dimensions. India is the world's largest functioning democracy and has been a democracy since its independence in 1947 whereas China has existed as a one party communist state under the authoritarian rule of the Communist Party of China (CCP) since the end of the Chinese Civil War in 1949. India is a far more ethnically and culturally heterogeneous society than the China which is dominated by the Han Chinese majority. Whilst both countries have grown rapidly over the past two decades, the drivers of growth in the two countries have been different with growth in China being fastest in manufacturing and growth in India being greatest in the services sector.

Why have these two countries, both with such vast demand for credit amongst the poor, taken such different regulatory paths with respect to the emergence of the microfinance sector?

The answers to this question are no doubt vast and complex and it is impossible to give any definitive or comprehensive solution. Political, institutional, economic, cultural, historical and international factors combine to impact the decision making processes of any government. The contribution I intend to make is to suggest two factors rooted in the particular context of political and economic reform in these countries which help to explain why they have treated microfinance so differently. In elaborating on these I will neither be able to be conclusive in the causal links nor will I pertain to being comprehensive in the explanation. These different hypotheses are intended to be complementary rather than exclusive and hopefully will contribute towards further exploration of explanators and closer inspection of those proposed. The two contributory factors I propose are as follows:

- Different Goals: Poverty Alleviation vs Economic Inclusion. Vast increases in inequality in China arising from broader liberalization have encouraged the Government to commandeer microfinance as part of its household focused Poverty Alleviation strategy with little regard for commercial sustainability. In India, where inequality has risen to a much lesser extent and the broader PA programme had been moving its emphasis from direct intervention to a more facilitative role, rhetoric surrounding microfinance has been about economic inclusion through self-employment leading to a more facilitative approach to government involvement.
- Financial Sector Reform: Whilst both countries have undergone financial sector reform in the past twenty years and both have still large amounts of state ownership in the banking system, I argue that financial sector reform has gone further in India and that this has given room for regulation conducive to microfinance particularly with regards to the role of private sector financial institutions, liberalized interest rates and access to commercial funding.

In the rest of this chapter I will elaborate and attempt to substantiate each of these hypotheses before drawing them together to try and illustrate a broader picture of the political and economic environment that has conditioned the regulatory framework for microfinance in these two countries.

4.1 Poverty Alleviation vs Economic Empowerment

In both India and China the economically liberalizing reforms of the past decades have led to high rates of economic growth that have lifted the per capita income within the countries by

unprecedented amounts. In both of these countries however the benefits of economic growth have been distributed unevenly and both intra and inter regional income inequality have increased. In particular, the rural-urban income divide has widened. This increase in income inequality, though, has been considerably more pronounced in China than in India over the same period. Over this same period the nature of the poverty alleviation strategies in both of the countries was changing; In China there was a move away from regional development and a move towards poverty alleviation at the household level, in India there was a move away from direct planning and implementation and towards a facilitative role.

I argue that these particular contexts shaped the goals of the governments for the emerging microfinance sectors and that these goals conditioned the regulatory approaches of the governments. In China, microfinance was commandeered as an effective tool for administering aid to the very poor. This led to the channelling of poverty alleviation funds through poorly structured and managed Government programmes and to burdensome restrictions on NGO-MFIs and private MFIs in the name of protecting the poor. In India, microfinance was seen as an effective channel for the economic empowerment of the poor through self-employment. This led the Government to adopt a facilitative and supportive role through the SGSY initiative and to pursue a conducive regulatory framework through consultations with committees consisting of practitioners, bankers and Government representatives.

4.1.1 Trends in Income Inequality

The increases in inequality of income and wealth that have accompanied the process of economic and political reform in China have been dramatic. The gini coefficient rose almost continuously over the period 1982-2002 from 0.30-0.52. Whilst the agricultural and land

reforms of the 1980s led to huge decreases in rural poverty, according to the world bank definition of poverty as those living on under US$1/day the percentage of those in poverty in China fell from 63.76% in 1981 to 28.36% in 1993, the divergence in income growth has been most stark between the urban and rural populations. Urban per capita income in 1990 was 824 yuan higher than rural income, in 1995 the gap was 1578 yuan, in 2000 it was 4027 yuan and in 2003 it was 5850 yuan, a six-fold increase in the absolute difference between urban and rural incomes (China Human Development Report 2005). After 1997, there was a steady decline in grain prices which saw the pace of this widening disparity increase even further leading China to have perhaps the highest urban-rural inequality despite having a lower Gini coefficient than some African and Latin American Countries.

In India the picture of trends in income inequality over the last twenty years is far less clear with economists continuing to disagree whether over the reform period income and consumption inequality rose (Pal and Ghosh 2007). Bhalla (2003) finds that over the period 1983-1999 the rural income gini coefficient fell in all states apart from Assam overall falling from 30.4 to 26.3, whilst the urban income gini coefficient for all India rose slightly from 33.9 to 34.7 leading to an overall decrease from 32.5 to 32. Jha (2004) finds the rural gini to have slightly increased over the reform period from 28.23 in 1989-1990 to 30.11 in 1997 and the urban gini to have increased from 33.95 to 36.12, suggesting that the liberalizing reforms did lead to a slight increase in income inequality. Most of these studies agree that in contrast to the Chinese experience rises in income inequality were worse in urban areas than those, if any, in rural areas.

4.1.2. Poverty Alleviation Programmes

The Chinese Government since the 1980s has implemented large scale, organized poverty alleviation campaigns. Holcombe and Xianmei (1996) separate the development of the style of these poverty alleviation campaigns into three phases up to 1996. The first period, in the early 1980s, was that of basic relief and financial subsidies, otherwise called the "money-grains-cotton" approach it involved the financial allocation of 40 billion yuan to poor areas over the period 1980-1985 (Holcombe and Xianmei 1996) for the provision of basic relief to poor people. The second period was the regional development approach from the mid-1980s to 1994. The government began to extend subsidized poverty alleviation loans through the Agricultural Bank of China to poor areas hoping to promote regional development projects and income generation amongst the poor. Unfortunately, as the funds were directed towards poor areas rather than directly to poor households the principal beneficiaries were local governments in poor areas, with most of the funds being taken by the politically connected or channelled into non poverty-alleviation rural enterprises. As broader liberalising reforms were underway in the economy, inequality, particularly urban-rural income inequality, was rising and the regional development approach was proving to not be effective in reaching the poor the government launched the third phase of poverty alleviation in the 8-7 (Ba-Qi) Poverty Alleviation Plan which shifted the focus from channelling funds to poor regions to supporting regional development and poverty reduction by focusing on the household.

In India the Governments Poverty Alleviation Programs can be broadly divided into four areas: Self-Employment Programmes, Wage Employment Programmes, Food Programmes and Social Security Programmes (Yesudian 2007). The largest of the Self-Employment programmes over

the 1980s and 90s was the Integrated Rural Development Programme (IRDP) which was initiated in 1979 and then expanded to the whole country in 1980. The principal component of this programme was to provide subsidized credit to the poor, in individual loans, in order to generate productive self-employment. Under this programme a number of subprogrammes were initiated, these were the Training of Youth for Self Employment (TRYSEM), the Development of Women and Children in Rural Areas (DWCRA), Supply of Improved Tool Kits to Rural Artisans (SITRA) and Ganga Kalyan Yojana (GKY). The credit programmes of IRDP suffered from low repayment rates as borrowers did not have the training to make returns on their loans and the loans were seen as grants rather than hard loans; the treatment of each of the subprogrammes as standalone projects also caused problems of overlap and poor integration. In response to these problems there was a meeting of the Planning Commission in 1997 to review the Self-Employment and Wage-Employment Programmes in which it was recommended that the focus move from individual based programmes to group lending and that the focus of government activity should be more on training and social mobilisation and less on direct lending. In 1999 the IRDP was merged with other projects into one integrated self-employment programme called the Swarnajayanthi Gram Swarozgar Yojana (SGSY) which was "conceived as a holistic programme for microenterprise development" (Planning Commission 10th Plan, p,293) focusing on SHG group formation, capacity building and infrastructure support in which the government provided a 30% subsidy to projects under the programme and left implementation to a network of agencies including District Rural Development Agencies (DRDAs), banks and NGOs.

4.1.3. Government Goals for Microfinance

In China it was in the context of rapidly increasing urban-rural inequality and of renewed strategies for poverty alleviation that the microfinance sector first began to emerge. International aid projects began to be implemented in China in direct response to the Governments policy for poverty alleviation and microfinance was introduced as a component in these poverty alleviation projects from organizations such as the World Bank, UNDP, UNICEF, UNFPA and UNWFP/IFAD in the UN system, bilateral organizations such as AusAid, CIDA and GTZ and international NGOs such as the Ford Foundation, World Vision and Oxfam Hong Kong (Ruomei Sun 2002). The Central Committee of the Chinese Communist Party and the State Council held a working conference on aiding the poor in September 1996 in which they emphasized the importance of effectively bringing aid to the poorest households. Chen Jusheng, a member of the State Council and leader of the Leading Group for the Poverty Alleviation and Development of the State Council, in a national forum of the State Council's Poverty Aid Office in February 1998 explicitly mentioned the effectiveness of microfinance for the goal of bringing aid to the poor. In October 1998 the "Resolution of the Central Committee of the CCP on some major problems of agriculture on rural work" was passed by the Third Plenum of the 15th Central Committee of the CCP which stated that for the goal of adequate food and clothing for the poor "effective methods of extending funds to households for aiding poverty, such as microfinance should be implemented". Microfinance for aid was again mentioned in the central committee working conference for developing aid and in the document Zhongfa 10/1999. Microfinance methodology was introduced to the governments poverty alleviation loans in the document "methods of the ABC for managing "microfinance" in bringing aid loans to households" in April 1999. In outlining its plans for development aid to the

poor for the years 2000-2010, it was again mentioned that "microfinance as aid to poor households should be actively and steadily extended". (Du Xiaoshan 2005)

In every policy pronouncement by the Government on microfinance, it was explicitly and exclusively referred to in terms of a means to channel aid to the poor and in terms of poverty alleviation. Even as the PBC mandated that the RCCs, as ostensibly commercial institutions, should be involved engage in microfinance, it was specifically directed in January 2000 and again in December 2001 that they were to engage in microfinance for the benefit of "peasant households". No mention is made as to the emergence of a commercially viable and sustainable microfinance sector.

In India it was in the context of the move towards a more facilitative rather than direct planning role for the government in development strategies that the microfinance sector was emerging. The emphasis of all consideration of microfinance was on financial inclusion and economic empowerment through self-organisation. In 1998 at the instance of the RBI a *Task Force on Supportive Policy and Regulatory Framework for Microfinance* was convened, comprising of a cross institutional group from the GoI, RBI, NABARD, banks and the CEO of prominent NGOs. In this taskforce, microfinance under national policy was referred to as "a useful tool in building the capacities of the poor in management of sustainable self-employment activities" and the national policy for microfinance envisioned by the group was:

"Five years hence, we are looking for a process of change leading to *empowerment* of 75 lakh poor households, and more particularly of the women from these households, through strong and *viable people's structure* like SHGs and MFIs which draw strength and support from the

banking system with *the message that banking with the poor is a profitable business opportunity* for both the poor and the banks" (NABARD 1999)

In an 18th February 2000 RBI circular letter the Government gave banks the freedom to choose their own model for offering microcredit with lending to SHGs to count as part of their priority sector lending; this was said to be for the purpose of 'mainstreaming' microfinance and to enhance the outreach of microfinance services (Bhattacharjee and Staschen 2004).

Since then the government and the RBI have frequently brought together working groups of experts to discuss legal and regulatory issues pertaining to microfinance and recommend policies to make the regulatory environment more "microfinance friendly". The stated goals of the Government and the committees consistently refer to financial inclusion and economic empowerment of the poor as the goals of the microfinance sector and never refer to microfinance as a form of aid.

4.2.4. Impact on the Regulatory Environment

In China, in the context of rapidly increasing inequality, a widening rural-urban income divide and the failure of the region based poverty alleviation programmes, the Government commandeered the emerging microfinance sector as part of its household focused 8-7 Poverty Alleviation Plan. The result of this was that regulation of the microfinance sector focused very narrowly on microfinance as a tool for administering aid, as a part of the poverty alleviation plan, with little consideration for eventual sustainability. As part of the poverty alleviation plan it channeled poverty alleviation funds through state-owned banks which were ill-structured and incentivized to deliver microfinance at the expense of NGO-MFIs which struggled to compete

with the subsidized rates of the Government Programmes. Poverty reduction goals were given much more significance than the long run sustainability of the industry and so measures which were thought to protect the poor at the expense of financial self-sufficiency, such as interest rate restrictions and restrictions on debt financing, stayed in place. These measures not only prevented MFIs from scaling up and reaching a greater part of the rural poor but also led MFIs to ration credit and lend larger amounts to less risky borrowers.

In India, in the context of approximately stable levels of inequality and at a time of fiscal retrenchment and reconsideration of the direct role of the Government in poverty alleviation programmes, the microfinance sector was seen as playing an important role in promoting economic inclusion of poor groups, with particular emphasis given to the role of self-organisation. In this context the Government subsidised and supported the SHGs through the SGSY programme, whilst convening task forces to discuss the most facilitative regulatory environment for the emergence of a sustainable microfinance sector. The recommendations of these task forces, which were made up of both practitioners and officials, formed the basis of Government Policy towards microfinance and thus a much greater understanding of the needs of sustainable microfinance was engendered in the regulation. The need for high interest rates for MFIs reaching the poor was understood, Section 25 companies were given favourable tax treatment and exemption from burdensome prudential regulation and commercial debt and equity was allowed to flow into the industry encouraging the scaling up of programmes as well as improving governance standards.

4.3 Financial Sector Reform

The financial sectors in China and India are both characterised by a high level of state involvement compared to the financial systems of advanced industrialised countries. Government ownership of banks was between 90-100% in both countries in 2005 and banks constitute a large part of the whole financial system at 72% of total assets in China and 43% in India (Farrel and Lund 2006). A huge amount of the credit extended by banks in both countries goes towards financing SOEs and Government expenditure is directed towards 'priority sectors' under Government targets and directives.

In both countries the financial systems have undergone a significant process of political and economic reform over the past two decades with increasing roles for private banks and the sale of equity in the public sector banks, increasing autonomy in the operations of public and private sector banks and liberalisation of interest rates and funding restrictions being implemented to differing degrees. It is widely considered, however, that India's reforms have gone further than those in China allowing for the freer play of market forces and more diversity of institutions and ownership (Dobson 2007).

The process of regulatory decision making for microfinance is complicated by the peculiar dual roles that MFIs play. They are both development and financial institutions, so whilst regulation may hope to achieve the goals of outreach, sustainability and impact of the sector, regulations can only be made within the confines of the broader financial regulatory structure. The regulatory structure of the broader financial system determines the feasible set of microfinance regulations.

I argue that the different timing and pace of financial sector reforms in China and India have conditioned the emerging regulatory environment for microfinance. In particular I argue that despite high levels of state control in both systems India has allowed a greater role for the private sector which in turn has allowed a greater role for private sector MFIs in the microfinance sector and that the much greater extent of interest rate liberalisation in India allowed more flexibility in interest rate regulation for MFIs.

4.3.1. Financial Sector Development

The Reserve Bank of India, as well as performing other central banking functions, has supervisory authority over the commercial banking sector and Cooperative banks in India, whilst the Securities and Exchange Board of India and the Forward Markets Commission have authority over the equity markets and forwards markets respectively. Within the commercial banking sector there exist 27 public sector banks, 29 private banks and 31 foreign banks holding around 75%, 18.2% and 6.5% of the total assets respectively with over 53,000 branches throughout the country. Besides the RBI there exist other apex banking institutions such as NABARD and the National Housing Bank and development finance institutions such as the Small Industries Development Bank of India (SIDBI). On a lower level there exist large networks of Regional Rural Banks and Cooperatives throughout the country.

At the time of independence in 1947 India had an established banking industry with over 600 commercial banks. The Government of India established the Bank of India in 1955 in order to make up for what was considered to be a bias in the commercial banks against lending to rural and poor sectors of the economy. Having decided that banks should play a more integral role in the development of the economy, two waves of nationalizations in 1969 and 1980 saw 92% of

the banking sectors assets under state ownership. Priority Sector lending requirements for banks were 40%, requirements on statutory liquidity ratios and cash reserve ratios were 38.5% and 15% respectively. Apart from some minor reforms in the 1980s the catalyst for the process of financial sector reform in India was a Balance of Payments Crisis in 1991 which necessitated an IMF bailout. The Narasimham Committee was appointed by the Government of India to examine all aspects of the financial system and make policy recommendations. The recommendations of the committee consisted of a shift in banking supervision from micro-level intervention on credit decisions to prudential regulation and supervision, a reduction of the statutory liquidity ratios and cash reserve requirements, interest rate and entry deregulation and adoption of prudential norms (Shirai 2002a). Since then a significant process of reform has been undertaken; public sector banks have extended equity stakes to the public, there has been a considerable increase in the number of private and foreign banks, there has been a comprehensive process of liberalisation particularly with regards to interest rate restrictions and reserve requirements and more recently tight controls on foreign investment have begun to be loosened.

The financial system in China lies under the supervisory purview of four regulatory institutions; the PBC, the China Banking Regulatory Commission, the China Insurance Regulatory Commission and the China Securities Regulatory Commission. The Banking system had $7.5trillion of assets in December 2007 (Du Xiaoshan 2008) and is composed three tiers (Huang et al 2005). The first tier consists of the three policy banks, the Agricultural Development Bank of China (ADBC), The Import and Export Bank of China and the China Development Bank (CDB), whose role is to conduct operations according to national policy objectives. The second tier is

made up of the four state-owned commercial banks, the Bank of China (BoC), the Industrial and Commercial Bank of China (ICBC), the China Construction Bank (CCB), and the ABC, who together make up the vast majority of the total assets in the financial system. In the third tier there are the 13 joint-stock commercial banks and a large number of smaller financial institutions such as the RCCs and the Urban Credit Cooperatives (UCCs).

From the declaration of the PRC in 1949, until the formation of the state commercial banks in 1979-84 the PBC existed at the centre of a mono-banking system with responsibility over central and commercial banking. In 1994, the major process of financial reform in China began with the separation of the commercial banking and the central banking functions of the PBC and with the establishment of the three policy banks. With the emergence of these policy banks, the operations of the state commercial banks were limited to commercial banking whilst the policy banks took control of meeting the policy objectives of the Government. The following years saw the introduction of a number of joint-stock commercial banks, the end of official mandated SOE lending for the state commercial banks and major efforts to 'clean up' the balance sheets of the state commercial banks of the high levels of Non-Performing Loans which had accrued over the years of directed lending. Since WTO accession was announced in 2001, many of the commercial banks have taken on minority investment from foreign banks and all four of the state-owned commercial banks have listed minority stakes on the stock exchange. According to the WTO rules, since 2006 restrictions on foreign banks operations in China have been lifted although in practice these banks still have a limited presence.

4.2.2. Major Regulatory Differences

Rather than go through an extensive comparative analysis of financial sector reforms in both countries I will compare the development of policy in a few areas pertinent to the microfinance sector.

Liberalisation of Interest Rates

India has undergone almost complete liberalisation of interest rate controls whereas China still operated tight restrictions which have only begun to slowly be liberalised in the last few years.

Prior to the reforms the RBI set both deposit and lending rates. In October 1994 the Government abolished restrictions on the lending rate for loans of greater than Rs 200,000 and at the same time mandated that banks should establish a prime lending rate. The rate on loans below Rs 200,000 was liberalised in April 1998 as long as it did not exceed the Prime Lending Rate. Priority sector lending rates were gradually liberalised. Deposit rates were gradually liberalised over the period 1992 to 1997 and as of 2005 the RBI only sets the deposit rate for non-resident Indian deposits and the savings deposit rate.

Liberalisation of both lending and deposit rates for banks in China has been markedly less pronounced than in India. Having partially liberalised rates in the 1980s, in 1993 the PBC reimposed lending restrictions of 0.9-1.2 times the base rate for commercial banks, of 0.9-1.3 times the base rate for Urban Credit Cooperatives and at 0.9-1.6 times the base rate for RCCs. This was further tightened in 1996 to 0.9-1.1 times the base rate for commercial banks and 0.9-1.4 for RCCs. In 1999, the ceiling for loans to SMEs was raised 0.9-1.3 (Shirai 2002b). In 2002 banks were allowed to charge borrowers 1.3 times the base rate, rising to 1.7 times the base rate in January 2004 whilst the RCCs were allowed to charge between 0.9-2.3x the base rate.

Whilst officially in 1994 the PBC abolished interest rate ceilings for commercial lending of banks, it was ruled illegal for the banks to charge more than four times the base rate.

The Role of the Private Sector

The extent to which the private sector has been allowed to engage in the financial sector has been much greater in India and a diverse range of institutions has been allowed.

From 1993 the Reserve Bank of India allowed the entry of new private banks into the banking sector as long as they were well capitalized and technologically advanced. By 2005 there were 28 domestic private banks and 28 foreign private banks which had entered the financial sector and had a total share of around 20% of total assets (Dobson 2007). Private banks are subjected to the same prudential standards as the public sector banks and some have grown to be amongst the largest in the Indian financial sector, the banks ICICI and HDFC are both in the top ten largest banks.

In China, from the mid-1990s the wholly State-Owned banks began to face competition from new joint-stock commercial banks such as Everbright Bank and the Shenzhen Development Bank; however the main shareholders in these were mainly local governments and SOEs. Huang et al (2004) point out that even the commercial banks supposedly most linked to the private sector have extremely strong ties to the state. They offer two examples to demonstrate this. The first involves Minsheng Bank, supposedly the first fully privately owned bank in India; the chairman of this ostensibly private bank was also the chairman of the All-China Federation of Industry and Commerce, the government organisation under whose jurisdiction the bank operates. The second involves the genuinely privately owned Urban Credit Cooperatives, which

in 1997 were forced to form shareholding ties with municipal governments leading to them immediately becoming the largest shareholders in the banks.

Reform of State Banks

In the process of financial sector reform neither country opted to privatise the major state owned banks but both have allowed for some diversification of ownership and have sought to increase the autonomy and the commercial viability of the banks.

In 1993 private shareholding in the State Bank of India was allowed in 1994 an amendment of the Banking Regulation act was enacted which allowed State Owned Banks to offer equity to the public up to 49%. The Public Sector Banks were then subjected to the same prudential regulations as the private sector banks and were given operational autonomy except for meeting priority sector lending targets common to both public and private sector banks. The private sector banks have consistently outperformed public sector banks over the course of the last decade, Banerjee, Cole and Duflo (2005) find that public sector banks are less aggressive as lenders, in getting depositors and in expanding branches than private sector banks. However there has been some evidence that the genuine competition from private sector banks has led to improvements in the performance of PSBs.

In China the privatisation of state banks only began in the last few years with the partial public flotations of the four state-owned commercial banks starting with the IPO of China Construction Bank in October 2005 and most recently with the IPO of the ABC in the August 2010. Foreign banks have taken stakes in many of the state commercial and second tier banks starting with HSBCs December 2001 purchase of an 8% stake in the Bank of Shanghai. The

major reform programme for the state commercial banks has involved the removal of distressed assets from the balance sheets of the banks through purchases by the newly formed Asset Management Companies to remove the burden of historical directed lending, however 0state banks continue to direct a huge amount of credit to SOEs in preference to private enterprise.

Whilst this description provides only a very partial picture of the financial sector reforms undergone in both countries, the intention is to demonstrate that whilst both countries have undergone reforms the State still plays a much more active role in the financial system in China and that there has been a much more limited role for private sector development.

4.3.2 Impacts on the microfinance regulatory environment

The broader context of the institutional and regulatory structure of the financial systems in China and India has conditioned the environment in which the regulatory structure for microfinance has been developed.

In the Indian financial sector interest rates broadly had been liberalised and the role of private sector financial institutions was rapidly advancing, in this context it was possible for microfinance to emerge within a more conducive regulatory structure. With interest rates in the broader financial sector liberalised, special exemptions would have had to be made to impose interest rate restrictions on MFIs and with the increasing role of private sector banks there was supervisory capacity and infrastructure in place for the emergence of private MFIs. In China, strict controls on interest rates for the existing financial institutions in the economy

would have made interest rate liberalisation in the microfinance sector politically unpalatable and would have potentially encouraged regulatory arbitrage.

Although the banking sectors in both countries are still predominantly state owned and experience considerable Government intervention, the Indian financial sector genuinely opened itself to competition from private sector institutions. Whilst private banks and different private financial institutions were entering the financial sector, Grameen type NGO-MFIs, SHG groups and various other forms of MFI were forming, as they moved to formalise as institutions there was regulatory infrastructure and a precedent of new, diverse private financial institutions entering the Indian financial sector. In China, despite some rhetoric of opening to private competitions, no genuinely private financial institutions had been allowed to exist outside of state control; in this environment not only did the Government not offer legal routes for MFIs to formalise their operations as private financial institutions but they forced the socially formed NGO-MFIs to partner with Government organisations in order to keep the growth of these financial institutions within state control. In this context the establishment of the private MCCs and VTBs is a big step and the cautious approach to their rollout is understandable.

4.4 Conclusions

The two explanators of microfinance regulation in China and India described here are not intended to be considered as comprehensive explanations of the factors that have affected the development of microfinance regulation but are intended instead to be indicative of a broader picture of the political and economic context in which regulatory decisions have been made.

The explanators can be separated into the goals for regulation and the feasible set of regulations. In China, rising inequality and the emergence of the household-focused poverty alleviation strategy led the government to commandeer microfinance for the singular goal of poverty alleviation. At the same time, the limited role of the private sector and the prevalence of tight controls in the financial sector limited the feasible set of regulations for microfinance. In India, the Government was moving away from direct intervention poverty alleviation strategies and towards facilitating the self-empowerment of the poor and so a socially organised, sustainable microfinance sector promoting financial and economic inclusion was a desirable goal for regulation, whilst the further progress of financial sector reform allowed made liberal policies with regard to the microfinance sector feasible.

Chapter 5: Conclusion

In this thesis I have undertaken a comprehensive comparative analysis of the regulatory frameworks for microfinance in China and India and I have demonstrated how this has affected the outcomes for the two sectors. Following that I have brought the discussion of the regulatory frameworks for microfinance away from a simple comparison with international consensus on best practice and into the broader political and economic context in which this regulation is formed. Rather than restate the results I have found earlier, I will conclude by first briefly discussing the future trajectory for microfinance and microfinance regulation in India and China and then by considering some of the broader implications and contributions of this work.

Whilst much of the analysis of the Chinese microfinance sector seemed to draw a gloomy picture of sector hobbled by a repressive and interventionist government the reality is that whilst excessive intervention has severely slowed the development of the sector, the reforms over the last few years have been moving in the right direction. He Guangwen et al (2009) point out that over the 6 years 2004-2009 domestic microfinance policies have been becoming increasingly liberal, with successive No.1 Documents stressing that microfinance development should be "supported under the premise of financial risk prevention, laying a policy foundation for the development of domestic microfinance industry and creating a relaxed policy environment" (p49), claiming that the dominant ideology of the latest phase has moved from a focus on poverty alleviation to one which combines poverty reduction with a focus on microenterprise development and sustainable provision of financial services for middle and low

income groups. Earlier this year the PBC announced that it will be looking to remove the interest rate restrictions and relax the capital adequacy requirements for MCCs which should drastically improve their chances of attaining commercial viability and scale. Steinfeld (2008) describes the process of 'experimental reform' in China whereby reforms are at first piloted, if successful they are expanded and only after establishing success at this level do they become officially legally recognised and formalised. Much of the development of the microfinance sector in China has followed this exact pattern, so within this framework it is possible to hold hope that the prospects of a conducive, formal regulatory framework for commercial and non-profit microfinance are good going forward and to therefore look forward to strong, efficient growth of the microfinance sector in the future.

In India, the pace of growth over the last five years has been astounding and with the major NBFCs looking, with great success so far, to the stock markets to fund their vast ambitions it is possible to imagine a growth trajectory which sees the expansion of microfinance services to a huge proportion of the currently unserved. However, uncertainty is building that the regulatory framework has allowed these companies to grow in an unsustainable way, with some concern arising that the high valuations paid by Private Equity companies and more recently by the public may be the beginnings of a microfinance bubble. If such a bubble were to burst, the impact on the poor could be devastating and no doubt the regulatory reaction would be swift to curtail the practices of the microfinance companies. Already a political backlash is arising at the state level, with politicians condemning usurious interest rates and aggressive lending practices. The Indian microfinance sector is on route to be the world leader in the provision of microfinance services and it has done so without charging interest rates nearly as high as many

other countries and whilst continuing to reach poorer borrowers than many other countries, however the major risk faced by the sector now is of a political backlash to the more unscrupulous actors in the business and a failure to bring these under control now could lead to the imposition of burdensome regulation for the whole sector in the future.

In the second substantive chapter I demonstrated how on two fronts the regulatory frameworks chosen by a government could be caused to veer away from regulatory best practice. These were if the goals the government had for the microfinance sector were different to the emergence of a sustainable, efficient sector and if the feasible set of regulations, according the political and economic context of the country and particularly of the financial sector, differed. The examples described were suggestive rather than comprehensive and the particular causal channels between the explanators and the actual regulatory outcomes would certainly warrant further research but the major contribution that I hope to make with this is to engender a further consideration in the microfinance literature of how the political and economic context conditions regulatory frameworks. Microfinance occupies an unusual space in policy because of its dual roles as a development tool and as a commercial finance industry and as such the decision making process of how to treat this sector is worthy of investigation.

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