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# **The Chinese Regulatory Framework for Inclusive Finance in the Context of International Best Practices**

**Bachelor Thesis**  
in Banking and Finance

Submitted to the  
Department of Banking and Finance  
University of Zurich

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Submission                28 October 2011

## Executive Summary

During the last ten years an increasing number of policy makers, donors, practitioners and academics around the world have become aware of the **essential role regulation and supervision** plays for the sustainability, outreach and impact of the whole microfinance industry. Due to different motivations, backgrounds and emphases of the authors writing about microfinance regulation, the existing literature on this topic is very heterogeneous. The **first part of this thesis** thus provides a **structured overview** of both **existing approaches** to microfinance regulation and supervision and **specific principles** guiding microfinance regulation in the context of international best practice. Based on the thorough review of the conceptual literature the following statements can be formulated:

1. Based on the principal-agent theory, **main rationales for the regulation and supervision** of financial intermediation are to ensure consumer protection and systemic stability and to prudentially concern about the liquidity and riskiness of financial institutions.
2. Due to the distinctive features of their business model, microfinance institutions (**MFIs**) **have an unique risk profile**, which microfinance regulation and supervision has to address.
3. However, not all types of MFIs share the same **level of risk exposure**. That's why many authors see an explicit need for the regulation and supervision only of deposit-taking MFIs due to their potential to cause systemic risk, while others argue that in the self-interest of MFIs, due to potential borrower runs and in order to ensure consumer protection, also credit-only MFIs should be subject to clear regulation and supervision.
4. In the past, different **approaches to the regulation and supervision of MFIs** were examined: Some countries' regulatory authorities have so far ignored the existence of MFIs. In such a case, MFIs in their own interest should install a system of self-regulation and supervision. Governments engaged in MFI regulation have either adapted and expanded their existing banking regulation or opened a special regulatory window for MFIs.
5. The typical ownership structure of (smaller) MFIs reduces the feasibility and effectiveness of the most powerful **tools of a supervisory authority**, which is further challenged by the high level of effort and cost of MFI supervision.
6. Considerable areas of consensus exist on the level of guiding principles for **non-prudential** and **prudential regulation of microfinance** mainly formulated by CGAP and BIS. Minimum capital requirements, capital adequacy requirements and liquidity ratios amongst others represent powerful tools to prudentially regulate MFIs.

Pioneered by NGOs in the 1980s, the microfinance industry in China developed in four stages and today still does not live up to its full potential. Many authors claim that this is due to the regulative environment for microfinance in China. The **second part of this thesis** therefore examines the market for microfinance in China with a special focus on the current regulatory environment. The results can be summed up as follows:

1. The analysis of the market for microfinance in China shows that the **demand side** is affected by a substantial rise in living standards of the poor population during the last thirty years. Instead of poverty alleviation, today **financial access** can be seen as **the first objective** of microfinance in China. On the **supply side** in the literature a classical set of institutions is considered as typical microfinance providers. Although most institutions are addressed frequently in the literature, concrete microfinance activities in many cases are hard to pin down and in many cases average loan sizes are above the defined level for microcredit. As a consequence the regulatory examination in this thesis is limited on NGO-MFIs, Microcredit Companies (MCCs) and Village and Township Banks (VTBs). The latter two institutions were introduced in 2006, developed successfully and offer the (only) possibility for foreign investors to engage in the Chinese microfinance market.
2. **NGO-MFIs** so far operate without a legal basis and their most severe **challenges** therefore are the actual **lack of legal status** and the **source of funding**, as they today solely rely on donations.
3. **VTBs** are allowed to conduct almost all activities as other **formally licensed banks** and as such experience tight regulation and supervision. The VTB regulation imposes major challenges **on foreign investors** through the relatively **high shareholder requirements**. Limitations in terms of geographic scale reduce the exploitation of economies of scale and threaten profitability. Current regulations regarding to the **transformation of a MCC into a VTB** are **unattractive** for all affected parties.
4. Based on a provided translation of **MCC regulation** on provincial level, regulation concerning this type of MFI could be analysed in most detail. Although the CBRC defined relevant MCC regulation, rules on provincial level in general set substantially stricter requirements. This leads to a **very complex, opaque and heterogeneous regulatory environment**. The greatest regulatory **obstacles** are the maximum allowed **debt/equity ratio of 50%** and the **high entrance barriers**.
5. Based on the insights gained in the first part of the thesis, finally a set of **recommendations** is formulated and a suggestion for a phased **integrative framework** for the regulation of NGO-MFIs, MCCs and VTBs presented. Key recommendations are the establishment of a **new regulatory and monitoring body** responsible for NGO-MFIs and MCCs and the **introduction of a new type of MCCs**, the so-called **MCC+D**, which is also allowed to accept deposits from the public.