Public Disclosure Authorized

Public Disclosure Authorized

RCC Policy Note
(Revised Draft: 12 June/2009)

70358

THE REFORM OF CHINA'S RURAL CREDIT UNIONS[1]

POLICY NOTE

1: Executive Summary

The reform of the Rural Credit Unions (RCUs) currently faces a number of major inter-related challenges. These must be resolved if China is to create a 'modern rural financial system'. The key issues facing policy-makers are:

- Consolidating independent shareholder ownership in order to realize effective corporate governance and create sustainable commercial financial institutions;
- Reshaping the relationship between provincial governments and the RCU system in order to bring to an end direct government administrative intervention in RCU management;
- Preventing government subsidies and special policies, which are intended to ensure that RCUs meet policy goals to support the rural economy, from generating rent-seeking behavior and moral hazards that undermine commercial sustainability; and
- Enabling the growth of a diverse range of rural financial institutions that would create competition and force greater efficiencies in rural financial markets.

Policy reforms since 2003 have sought to address these issues, but they have yet to achieve their goal. The need for more change is widely recognized, and the authorities now have the opportunity to implement further reforms in order to create a flexible, diverse, efficient and responsive rural financial market that is both vibrant and disciplined.

Despite the development of shareholder ownership since 2003 and the widespread establishment of shareholder meetings, boards of directors and supervisory boards, RCU shareholders are not able to realize their control rights and responsibilities and cannot exercise independent management. On the one hand, this is the result of direct intervention by provincial governments, which continue to exercise administrative

[1] In this policy note, the term Rural Credit Unions (RCUs) is used to refer to the Rural Credit Cooperative (RCC) system as a whole. This reflects the reality that, since 2003, the RCC system has been reorganized as a two-level legal person structure consisting of Provincial RCUs (PRCUs: in some provinces now reorganized as Rural Commercial Banks or Rural Cooperative Banks) and County RCUs (CRCUs), with subordinate cooperative branches at township level. In some provinces (cities), this change has been taken further by the establishment of a single-level unified system at provincial level.

controls over the RCU system and take the key decisions on personnel appointments, strategic direction and financial management. On the other hand, it reflects policy concerns that independent investors would neglect rural finance and seek maximum profits by focusing on urban and non-agricultural business. Regulations are therefore designed to prevent the emergence of powerful large shareholders with the authority to take strategic decisions. Since they do not have the right to control the RCUs nor the responsibilities that go with that right but simply collect their dividends that are guaranteed by government, the incentives for shareholders to promote good corporate governance and management are absent. Shareholders are not able to run the RCUs in ways that reflect the risks of private ownership under market discipline and in ways that lead to efficient, sustainable and profitable financial enterprises. The solution requires both ensuring that shareholders are able to play their full role as owners and creating an environment where rural finance is profitable.

Provincial government administrative intervention in RCU management is widespread. Intervention is realized through personnel appointments, supervision of operations, and decisions over strategic management and policies. This situation is predictable, given the responsibility that provincial governments have to guarantee the RCU system against financial losses, together with the perception that the RCCs as a whole are weak and inefficient, as demonstrated by their legacy of bad debts and poor performance. Inevitably, government intervention results in the appointment of people in senior positions for their administrative and policy experience rather than for their ability and experience in managing a sustainable and efficient financial institution, and it also results in pressures to provide loans for government priorities. This situation not only undermines shareholder property rights but also introduces risks and inefficiencies in financial management. While government will always have a role as regulator, ultimately the shareholders of the RCUs/RCCs should bear responsibility for their economic performance.

The requirement that RCUs support farmers, agriculture and the local rural economy has been accompanied by a set of special policies that limit their development as commercial entities and provide special subsidies and supports to compensate them for their assigned role. Given the large number of rural households and the dispersed nature of the rural economy, rural financial services are high cost and high risk. Government policy requires the RCUs to serve the rural market using low interest rates. In compensation, the RCUs have been given a series of special subsidies and supports, including low-interest on-lending funds from the People's Bank of China (PBC), reductions in business tax, exemptions from income tax, and direct subsidies from the PBC and local governments to help write-off accumulated bad loans and losses. While these policies have helped RCUs to improve their financial performance since 2003, they also undermine commercial operations. RCU managers have opportunities to disguise losses that are the result of poor management or bad loan decisions as ‘policy-induced’. The results are low incentives to strengthen risk management and efficiency, reliance on government support, and the encouragement of rent-seeking behavior. The removal of interest rate controls so that RCUs can charge rates that reflect the costs and risks of their loans, together with the removal of government guarantees to cover the losses of badly-managed RCUs so that shareholder owners bear the full risks of bankruptcy if they fail would provide immediate incentives to improve performance. In addition, mechanisms are needed to ensure that government support for rural development does not create negative incentive structures for financial institutions. These include categorizing the types of rural lending attracting government support more precisely; making subsidies and tax incentives available to all financial institutions so that there is competition to provide the rural services; directing government support through government agencies rather than through financial institutions; and targeting support directly to rural households.

These problems in the RCU system are further intensified by the lack of diversity in rural financial institutions and the absence of a competitive environment. Although the regulatory environment is changing, and recent years have seen the rapid emergence of new kinds of community-level village banks, farmer financial cooperatives and micro-loan companies, these experiments are still limited and small in scale. In addition, although the Postal Savings Bank (PSB) and the Agricultural Bank of China (ABC) are both developing their rural business and are poised to grow rapidly, their rural lending remains small relative to the RCUs. As a result, the RCU system retains a dominant role in rural finance, accounting for 80 percent of all agricultural loans, for 90 percent of rural household loans and some 35 percent of all rural-related loans from the formal banking sector. This lack of competition acts as a constraint on efficiency and innovation. The absence of alternatives institutions also leads to a predominant focus among policy-makers on solving the problems of the RCUs, rather than on solving the broader problems of developing a sustainable rural financial system. It is necessary to intensify efforts to build greater diversity in the rural financial market in order to promote the healthy development of the RCUs and to reduce the risks of reliance on a single institution. Policies that make the entry threshold for registered capital too high, that limit the role of key shareholders and that require existing banks and financial institutions to be the key investors need to be further relaxed to allow easier market entry for investors wanting to establish new local community financial institutions. A related issue is that in areas where there are no alternative service providers, there are pressures on government to ensure that RCUs and RCCs continue to operate, no matter how poorly managed and inefficient. The development of alternative institutions would also make it easier to allow such RCUs and RCCs to close.

All of the above challenges are closely related. They therefore require an integrated package of reforms to resolve. The subordinate relationship between shareholders and local governments means that shareholders cannot exercise their rights to control the institutions that they own. At the same time, since they rely on government support to ensure that the RCUs do not go bankrupt and that they receive dividends, they do not face any real risks for their capital investment. This failure to create responsible independent shareholders means that, even if the formal structure of corporate governance expressed through the establishment of shareholder meetings, boards of directors, supervisory boards and management rules are established, there are low incentives to create efficient institutions with strong corporate cultures and behavior. This lack of incentives is further reinforced by the fact that policy goals and government subsidies mean that RCUs receive support regardless of their performance. In reality, the worse the RCU is, the more support it receives. The relationship between management authority and economic responsibility is broken, poor management of risks and operational losses can be blamed on policy, and government continues to underwrite the system. This interaction between lack of shareholder authority and responsibilities, the focus on policy goals, and the use of government subsidies combine to create poor system incentives, inefficient institutions and weak corporate culture and behavior. In addition, the lack of a strong competitive environment constrains product innovations and service quality and makes it difficult to close weak RCUs, since there is a lack of alternative service providers. The issues are all closely inter-linked, and there is thus a need to introduce a set of related reform measures that, implemented together, would create a new momentum in RCU reform. While the core issue of ensuring that shareholders rights and responsibilities is fundamental, the related policy and competitive environment challenges also need to be addressed. Introduced as a package, these reforms would reinforce and complement each other and reduce the risks that might arise.

The solution to these problems, a solution which simultaneously addresses a number of the interlinked problems of ownership, management and corporate culture, is the development of truly independent, private shareholder-owned rural commercial banks. This would clarify ownership and responsibility and create the internal incentives to improve management, reduce risks and achieve profitability. Accompanied by complementary changes in the role of provincial governments and the regulatory authorities, in the operation of policy supports and subsidies, in the development of competitors like the PSB and the ABC, and in the role of alternative forms of cooperative banking and microfinance that can contribute to greater diversity and vitality in rural financial markets, this change would transform the RCU system. However, regional disparities in local economies and in RCU capacity also mean that there should be diversity in the type of institutional change.

In some cases, a revitalized cooperative structure might also be appropriate. This reform might be suitable in areas where the local economy is less urbanized and less industrialized. However, such cooperatives should be truly independent and run by their members, so that they also face real financial risks. They should not continue the current 'quasi-official' cooperative structure.

2. Issues and Problems

China's Rural Credit Cooperatives (RCCs) occupy a unique position in China's financial system. This is the result of four key legacies dating back to the 1950s. *First*, the RCCs originated as cooperatives. Although they were never truly voluntary and independent and by the late 1950s had already been absorbed by the collective economy and subordinated to the state banking system, they have retained the notion of belonging to their members. Because they were seen as cooperatives and not corporate institutions, reform of the RCC property rights structure was constrained by the belief that RCCs should have a special relationship with local farmers and should maximize member benefits rather than maximize profits. *Second*, they were required to operate within a defined geographical or administrative area. They were local institutions nested within a hierarchical structure of territorial administrative structures. Their mission was to act as the financial service provider to the local community. They were expected to ensure that local rural savings were used to support agriculture and the local economy. *Third*, they were expected to play the primary role in supporting rural development through lending to farmer households and rural producers for agricultural production, for processing and marketing agricultural products and for other countryside-based economic activities. *Finally*, either as a subordinate part of the ABC or as an independent institution, the RCCs until the past few years had a virtual monopoly in the provision of saving and lending services in rural areas. These legacies made it impossible to conceive of the RCCs as commercially-oriented and profitable rural financial institutions. They also dominated reform policies for the RCCs from 1978 to 2003 and led to the emphasis on rebuilding the RCCs as 'true' cooperatives, after separation from the Agricultural Bank of China (ABC) in 1996.

Despite the view that the RCCs should be local rural cooperatives, the reality has been that the RCCs have always been subordinate to the state banking system and to the local authorities. The members of the cooperatives were never able exercise voluntary participation and independent management. The RCCs were always closely integrated with the formal banking system, and at various times were directly subordinate to the ABC. There was also always a close relationship between RCCs and local level governments at township (formerly people's communes) and county levels, which were able to intervene directly in RCC operations. From 1996 to 2003, the RCCs were even placed under the management of the PBC, the central bank. The result was that, whatever their levels of performance, the RCCs were guaranteed state support and operated under 'soft budget constraints'. By 2003, the historical burdens of system losses and non-performing loans (NPLs) affected as much as half of all cooperatives.

The reforms of 2003 marked a step away from this approach. The need to clarify property rights was recognized. The consolidation of the provincial and county-level rural credit unions (PRCUs and CRCUs) resulted in a decisive shift away from the old model of a local cooperative organization at the township level towards a two-level legal person model, with shareholder property rights and a formal corporate internal management structure consisting of a shareholder meeting, a board of directors, a supervisory board and a set of subordinate management structures (the so-called 'three committees and one management layer). This process also led to the transformation of some RCUs at either provincial or county levels into shareholder cooperative banks (by March 2009 there were 172 of these) and commercial banks (25), and to a growing emphasis on the role of investor shareholders. Alongside that, the assertion of administrative controls by provincial governments encouraged the introduction of strict managements systems, with a focus on better risk management improved services, and the introduction of standardized procedures. The provision of government support through the PBC on-lending funds supplied since 1997, the PBC special bills introduced in 2003, and business and income tax relief also helped improve RCU financial performance and enabled some of the historical burden of negative equity and NPLs to be resolved. In addition, experiments with rural lending by the PSB and with village banks, microcredit companies and new local farmer cooperatives initiated a process of institutional diversification in the rural financial market. Finally, computerization and the related staff turnover, with the employment of growing numbers of better-trained managers and agents, also contributed to better financial performance.

Despite these gains, however, the reforms have only been a partial success. Shareholders still face constraints on the exercise of ownership rights and responsibilities. The sense of cooperative ownership is sustained through the existence of 'member shares'. The power of governments at provincial level to intervene has been strengthened because of their role as the ultimate guarantor of the system. The policy requirements to serve rural development and the local community and to prevent capital from flowing outside remain supported by policy interventions that conflict with commercial sustainability. Government guarantees mean that the soft budget constraints remain in place, and the volume of NPLs continues to be very large. In addition, efforts to promote a more dynamic and competitive environment remain limited. The continued existence of these challenges has led to the general conclusion that the effort in 2003 to 'spend money for mechanism' has not succeeded and that a further round of reform is needed. The following sections outline the key issues.

2.1. Ownership Reform

Although the development of shareholding systems has promoted a change in the nature of ownership, it is widely acknowledged that the new shareholders are not able to exercise their property rights. This outcome was foreseen by many observers at the time of the 2003 reforms (e.g. Xie Ping, 2003). Small farmer member shares (*zige gu*) are a remnant of the old cooperative model and are held in small amounts by a dispersed community. Investor shares (*touzi gu*) are classified into several categories (legal person, natural person and employees), and there are strict limits on the number of shares that can be owned by each category. These rules are often expressed as a concern to prevent the emergence of large shareholders and to protect the interests of small shareholders. The result, however, is to weaken the influence of the shareholders as a whole. It is not possible for large shareholders with an interest in the long-term development of the RCUs to emerge, and most small shareholders focus on short-term interests, such as access to loans in return for their investment or payment of dividends. They do not address long-term goals, such as developing RCU asset strength and capital adequacy ratios.

The establishment of shareholder meetings, boards of directors and supervisory boards is intended to represent the interests of shareholder owners. However, the constraints on share ownership volumes and the dispersed nature of many small shareholders have tended to undermine the capacity of shareholders play a coherent role. The strong intervention by provincial governments, discussed below, has also meant that key decisions about membership of the board of directors and the supervisory committee are taken by government officials rather than by the shareholders themselves. The net result is that property rights remain constrained. Shareholders do not have the incentives or capacity to develop strong governance and management practices to control risks, improve efficiency and achieve commercial sustainability.

Apart from the risks to provincial governments because of their current role as system guarantors, another major reason for the incomplete ownership reform is the belief that the emergence of large shareholders seeking to maximize profits would lead to an abandonment of local community services and a shift to non-rural services. This reflects the legacy of the values of the cooperative model, which aims to maximize member benefits. It also assumes that rural business is not profitable in the current economic environment, in which urbanization and industrialization are the key sources of growth and development. As a result, it is believed that commercial financial institutions would tend to focus on high profit, urban business only. In reality, rural financial services can be profitable, if they can be supplied at a price which covers cost and risk. Rather than constrain commercial ownership, alternative approaches such as higher interest rates, agricultural insurance, and improved collateral and loan guarantees, all of which would reduce risk and encourage profitability in rural operations, can address these issues and ensure that the RCUs focus on their area of comparative advantage, which is their rural client base.

In clarifying share ownership, it is also necessary to consider how to establish a system for trading in RCU shares. In theory, the value of the shares reflects the quality of the enterprise. The price should send a clear signal to shareholders, board and management about their performance. Currently shares can be traded through various types of private or internal mechanisms which risk distortions and manipulation. The fact that it is generally assumed that government will guarantee losses and prevent bankruptcy also means that it is difficult to determine the market value of shares. Experiments are needed with the development of an RCU share trading system, through which transparent and open transfers can take place within a designated framework. This would provide a mechanism for changes in shareholder investments, for raising capital in successful RCUs and for enabling mergers and acquisitions to take place within the RCU system.

While the development of formal shareholder ownership through the formation of rural commercial banks at both provincial and county levels would help the emergence of a sustainable RCU system, in some parts of China it may be appropriate to retain a cooperative model. If so, it would be important to ensure that the institutions are real cooperatives, with voluntary entry and withdrawal, effective cooperative governance by their members, complete responsibility for their own profits and losses, and fully independent operation. In places where the nature of the local economy and its level of urbanization and industrialization may not require the full range of services of a commercial bank, this result could also be achieved either by reorganizing existing RCUs in this way or by allowing the emergence of entirely new independent cooperatives at community level. As in other parts of the world, such cooperatives should be able to operate sustainably. They may also eventually make a transition to becoming a commercial structure. Such a choice should, however, depend on the wishes of the membership and the changing capacity of the institution over time.

A significant challenge facing the above changes is the fact that many poorly-managed RCUs/RCCs still carry a burden of historical losses and NPLs that makes it unlikely that new shareholders in rural commercial banks or cooperative members in reorganized cooperatives would be willing to invest in poor assets dominated by old debts. This raises the question of whether a further round of recapitalization with government support should be considered. Doing so has the obvious risks of a further round of rent-seeking and special interest bargaining. On the other hand, transitional arrangements such as those provided to the ABC to help with its capital restructuring through a current injection of funds to be recouped gradually from future earnings might be considered. However, any recapitalization should be considered on the basis of an independent audit of each RCU. Those that have failed, have no demonstrated improvement since the last round of government funding, or are incapable of revival can be closed down, and their place can be taken by competition from more successful RCUs or from other types of rural financial institutions. Those which can demonstrate future profitability can be considered for recapitalization. However, this should not be solely the responsibility of government, and the new shareholders should also contribute so that they have the incentive to ensure that the new institution becomes profitable. Furthermore, a condition of any government contribution should be that shareholders take on clear contractual obligations for all future profits and losses and accept that failure will result in bankruptcy. In future, all RCUs should carry full responsibility for their own survival.

Finally, independent RCUs/RCCs at provincial, county and local levels should have greater flexibility to compete across administrative borders and to carry out mergers and acquisitions. Provided it is based on commercial principles, this would promote a more diverse and competitive financial environment.

The comparative advantage of RCUs lies in their local knowledge and their client base, and this will drive their development. The establishment of province-wide rural commercial banks managed as single legal person entities might also eventually take place, though this should also be the result of normal commercial development and not of administrative decision.

2.2. The Role of Provincial Governments

The establishment of PRCUs in 2003 led to the assertion of strong provincial government control of the RCU system. This situation has also largely characterized the management of the new shareholder cooperative or commercial banks established in recent years. In part because of the responsibility they acquired for RCU financial risks and in part because of their perception of RCC management as weak, provincial governments have introduced firm controls of all the key personnel, financial and material decisions. This authority is exercised downwards from the government, through the PRCUs to the CRCUs and is expressly embodied in the establishment of special missions or observers assigned by provincial governments to sit in the PRCUs and rural commercial banks to monitor activities and supervise operational behavior. Management of the system is thus implemented as an administrative process, rather than as an enterprise management process. In other words, the long-term reform goal of separating government and enterprises (*zheng qi fenkai*) has not been realized in this case. In fact, developments in the RCUs since 2003 have tended to re-emphasize the role of government management. This reality is recognized within the PRCU systems (Xiao Siru, 2007) and by the CBRC (Jiang Dingzhi, 2008). It is an obstacle to the healthy development of RCUs and to the emergence of strong rural financial institutions.

This situation also creates a conflict of interests and competing incentives among the various government stakeholders in the existing rural financial system. Provincial governments are concerned to reduce their financial risks, to maintain RCU stability and to promote local economic development. County and lower level governments are influenced by their local policy priorities and by the need to obtain funds to support local development. RCC employees have incentives to maximize benefits and to offset management risks by reliance on government support. Moreover, the principal-agent problems inherent in state interventions in economic units mean that the information asymmetry between state administrators and RCU managers makes effective controls from outside difficult.

As discussed above, most of these problems can be resolved if shareholders are given full responsibility for their investments and bear the risks of failure themselves. In such a situation, the role of government should focus primarily on issues of macro-economic management, improving the legal environment, monitoring compliance with rules and regulations, implementing complementary policies on such things as insurance, rural subsidies and state investments that help the rural economy, and ensuring a stable regulatory framework.

2.3. The Regulatory Framework

The reform of 2003, removed the RCC system from management by the PBC, thus resolving an anomalous role for the central bank. The overall regulation of RCUs/RCCs was then placed under the China Banking Regulatory Commission (CBRC), which has responsibility to monitor the performance of the system. The primary task of the CBRC is thus to ensure that financial institutions comply with the regulatory requirements. However, its capacity to intervene in provincial decision-making is constrained, so that, even if it is aware that a particular RCU is operating outside of the regulatory requirements for capital adequacy ratio or asset/liability levels, it is not in a position to demand changes. While the CBRC needs to play a strategic role in policy discussion of the development and reform of the system which it regulates, it is important to ensure that, particularly at the local level, it does not take on any direct roles in RCU operation that might interfere with its capacity to carry out its key function.

The regulatory framework is also complex and continuously changing. Both the PBC and the CBRC issue many regulations and decisions each year. These are often supplemented by implementing regulations at the local level, which modify aspects of the general policy to suit local conditions. In addition, the regulations are not always consistent. In respect of the experiments to promote new forms of basic-level financial services as competition for the RCUs, for example, the PBC issued regulations in 2005 to permit the formation of a number of experimental microfinance loan companies. These were not endorsed by the CBRC, which issued alternative proposals in December 2006 for village banks, farmer cooperatives and loan companies. It was not until May 2008 that these competing models were reconciled through a joint document. Currently, the CBRC is arguing for a further round of government recapitalization to solve the on-going problems of NPLs in RCUs, while the PBC is opposed. This leads rural financial institutions to focus on the next round of policy changes as a solution to their problems, rather than on the stable development of their organizations. Since they may obtain further support, there is low incentive to solve problems themselves.

2.4. Policy Constraints and Subsidies

Like rural financial institutions in many developing countries, the RCUs are expected to play a major role in rural development by serving the key policy goals of supporting agriculture, farmers and the local rural economy and by ensuring that local savings and capital are used for local development. The result is government policies to limit interest rates on rural loans, to restrict capital flows, and to direct a fixed proportion of loans to particular types of rural investment. These policies create constraints on the choices for RCU system reform and tend to conflict with the goal of achieving profitability and commercial sustainability. They also generate the need for government support and operational subsidies to ensure that the policy goals are met. Furthermore, since RCU managers do not face bankruptcy and are allowed to continue to operate despite failing to meet normal operational requirements, RCU losses and bad debts can be high, and the integrity of the regulatory system is undermined. The consequence is that government becomes the ultimate guarantor of the RCUs and has to fund any system losses. One of the ironies of this situation is that the weaker an RCU is, the greater is the level of support it obtains. The net effect is that weak RCUs get most benefit, and strong RCUs have no rewards or incentives.

What is more, despite the policy support and the efforts by governments to ensure that RCU financial services focus on rural development, the results have consistently been poor. Numerous studies have underlined that most farmers are unable to get access to RCU credit, that small rural enterprises are unable to get the loans they seek, and that a significant proportion of RCU funds tend to leak outside their local area into non-rural investments. Although the reserve deposit ratios for RCUs is lower than for banks in order to encourage them to make more funds available for local lending, the ratio of loans to savings is low, and many RCUs invest in government bonds or deposits elsewhere.

Furthermore, the existence of the special policies and subsidies also encourage rent-seeking behavior and create moral hazards. Poor operational management and bad loans can be hidden as policy losses. RCU managers can wait for the next round to government support to deal with NPLs, rather than strengthening risk management. The nature of 'rural loans' is also hard to define, especially in the richer areas, with high levels of urbanization and industrialization and close integration between the rural and urban economies. As a result, non-rural loans might be disguised as rural loans. These kinds of problems become an obstacle to good corporate governance and to the emergence of sustainable financial institutions.

The net result of this situation has been the accumulation of NPLs within the system, often disguised by loan agents rolling loans over. In addition, large numbers of RCUs/RCCs have always operated at a loss, with liabilities greater than their assets. The opportunity cost of seeking to ensure that policy goals are met, therefore, is the creation of substantial problems of management and incentives within the RCU system.

By the end of 2002, the uncovered liabilities in the RCC system were estimated to be around Rmb 330 billion, and NPLs were reported as Rmb 514.7 billion, the equivalent of 36.93 percent of 2002 year-end outstanding loans (Renmin Yinhang, 2008). During the 2003 round of reforms, it was decided that these NPLs should be resolved, half through the use of PBC special bills and the other half to be covered by provincial government funds. By March 2009, after a long process of verifying claims and assessing management improvements, some Rmb 159.9 billion of the PBC special bills had been cashed, or 93 percent of the total issued, and the policy required the balance to be funded by provincial governments.

Despite some improvement in the ratio of NPLs, however, the underlying causes that gave rise to them in the first place remain present. The continued existence of soft budget constraints and government subsidies mean that system risks remain high. The CBRC estimates that NPLs are now around 15.9 percent of loans (interview 16 March 2009). Given the overall growth in deposits and loans, however, the improvement in the ratio of NPLs is not reflected in a decline in the actual amount, and the total value is now substantially higher than that acknowledged during the 2003 reforms. As noted above, at the end of 2002, NPLs were Rmb 514.7 billion or 36.93 percent of year-end outstanding loans. At the end of 2008, the NPLs were 15.9 percent of the year-end outstanding loans of Rmb 3.7 trillion, or Rmb 593.9 billion.

The evidence indicates that the special support policies for rural finance do not achieve their goals and that they introduce substantial distortions and risks into the operation of the RCUs. The opportunity costs of the policies are therefore very high.

2.5. Governance and Management

The reforms since 2003 have helped improve management capacity within the RCU system. Studies of experience in a number of provincial examples, such as the Jiangsu PRCU and the Ningxia Yellow River Commercial Bank, have underlined the improvements in performance that have resulted. To a considerable extent, these gains have been driven by external pressures from the PBC which required RCUs to meet improved management standards in order to qualify for issuing PBC special bills and for receiving the cash payments. They have also been driven provincial governments, which have been keen to realize the special bill payments and to reduce the risks they face in guaranteeing the local RCU system. In future, it will be important to internalize these changes as part of the transformation of corporate culture that would result from independent legal person status under shareholder ownership. It is therefore necessary to analyze and document the lessons that have been learned since 2003 and to generalize them through professional training and staff appointments. The following discussion lists the key areas for attention.

A fundamental issue is the development of a strong ***enterprise culture*** that focuses on professional management, risk controls, efficiency and service delivery. Each RCU needs to clearly define its mission as a provider of community finance in rural areas and to develop the appropriate management and supervisory systems that enable it to achieve its goals efficiently and profitably, with minimum risk. These values and procedures need to be part of staff appointment, training and evaluation.

The enterprise culture is also the basis for a ***transparent corporate structure*** that incorporates the key principles for management of a financial enterprise. The establishment of truly independent RCUs should be reflected in a clear division of rights and responsibilities between the owners (shareholders), decision-makers (the board), the supervisors (supervisory board) and the operators (managers and staff). On that basis, the development of professional management controls, the allocation of duties for risk management, evaluation, quality control, and service innovation, and the mechanisms to ensure that duties are properly implemented can also be established. In addition, the corporate structure also needs to articulate corporate social responsibility and the obligations of the enterprise to its employees, to its community and to society as a whole.

On the basis of the corporate structure, the full range of ***professional management processes*** necessary for the sustainable development of financial services can be developed. Good practices adopted in a number of current RCUs and rural commercial banks include:

- Separation of functions
- Procedures and controls for risk management
- Separation of loan assessment and approval
- Use of auditing and evaluation teams to review performance
- Effective staff performance and evaluation procedures with appropriate rewards and punishments
- Emphasis on staff quality and training
- Strong market research and client relations in order to anticipate market needs, reduce risk and promote product innovation
- Efficient systems for loan loss provision and NPL management and
- Independent auditing and accounting systems to support all management functions.

These processes need to be promoted widely across the RCU system.

A further important aspect is the development of ***strong computerization and IT management***. This not only provides the foundation for effective control of information and management decisions, but also supports improvements in product innovation and services. For example, the use of ATMs, internet banking, and smart cards can introduce flexibility in services, improve security, and reduce costs. It can also make the provision of services to remote and scattered populations easier.

Product innovation is also the key to better services and better competitiveness. The development of microcredit to farmers using the on-lending funds is has been broadly successful in improving RCU performance. Experiments with the use of smart cards and ATMs to provide these microcredit services suggest that there are further improvements in services that can be developed. There are also demands for other services such as agricultural and loan insurance, remittances, credit services to migrant workers, and helping returned migrant workers establish small businesses. If the corporate culture focuses on innovation and service quality, a sustainable financial institution can be developed.

In sum, one of the major goals of establishing clear property rights is the incentive to develop reliable and effective management practices such as those listed above. While many of these practices can be introduced through administrative controls, they will not become internalized unless the institution is fully responsible for its own survival.

2.6. Complementary Reforms

While the establishment of rural commercial banks with effective corporate governance and management systems would provide a strong foundation for the development of sustainable rural financial institutions, it is also necessary to introduce additional and complementary policy reforms that are important to ensure that the RCUs can operate effectively.

A key issue is ***rural interest rate reform***. Limits on interest rates mean that the costs and risks of rural loans are not compensated. While the state must act to prevent predatory lending and interest rates, both international experience in micro-finance and China's own experience with informal lending indicate that farmers and small producers are willing to take loans at higher cost where profitable activities can be developed. The controls over rural interest rates should be removed, and the authorities should focus on monitoring market rates and using macro-economic policies to influence them. This change would also mean that the funds allocated for state subsidies to compensate the RCUs for using low rates might be used for more direct investments in rural development or for targeted support for poor farmers.

A related issue is the role of ***mortgages and collateral***. The role of these is to impose discipline on borrowers when loans are taken. By risking something of value, the borrower has strong incentives to meet the terms of the loan. Currently, land cannot be mortgaged because land is not privately owned. In addition, land contracts remain the ultimate basis of social security for farmers, and rural people do not have access to strong social insurance and social welfare schemes. In such a situation, the risks for farmers who lose their land are high. Furthermore, since housing land is also collectively owned, the market in rural housing is limited and houses are also difficult to mortgage. Experiments with expanding the role of land contracts and housing as mortgage collateral for loans thus have to be seen in the context of the provision of better rural social security schemes and linked to changes in the land laws. Such changes will take time. Nevertheless, as part of the effort to reduce risk in rural lending, it is important to improve systems for loan collateral and guarantees. Current experience with such things as mortgages against land cooperative contracts, loans against purchase orders and futures orders, use of large machinery as collateral, group guarantees, joint guarantees by cooperatives and small enterprises and individual farmers should be analyzed and improved. Where possible, experiments in the use of land contracts as collateral should be allowed. In addition, the risks to borrowers might be reduced by expansion of current

loan and agricultural insurance schemes. While these are additional costs to borrowers, they would help protect them against unforeseen problems and such things as crop failure. This would make it easier for them to risk key assets when taking loans.

A complementary development to help reduce risk to both lenders and borrowers is the development of ***credit bureaus and credit information systems***. Since these systems can provide information on the previous record and capacity of borrowers to manage credit, they make analysis of loan applications easier. These systems can also record information by townships, villages and individuals, so that both the general local economic context and the capacity of applicants can be matched. To some extent, this knowledge is the responsibility of the individual rural financial institutions in managing their own client base. However, the development of some shared databases would also strengthen the credit environment. It is necessary, however, to develop clear regulatory requirements for such systems in order to prevent misuse and to protect privacy.

Some observers argue that the development of ***deposit insurance*** is important to protect the deposits of small farmers. In effect, current government guarantees for RCU operation do provide a form of deposit insurance. The recent global credit crisis has also seen an extension of deposit insurance by governments worldwide. However, experience in many countries also indicates that such schemes can introduce substantial moral hazards and risks (Garcia, 2000). They tend to undermine the incentives for prudential management by banks and can result in large costs to government, such as the experience in Turkey. Given the track record of RCUs, however, without a clear and well-established regulatory and legal environment, the risks for extending deposit insurance will be high.

Alongside reforms aiming to promote the development of a sustainable rural financial system, policies for ***direct state support for rural development*** should also be strengthened. In poor areas where environmental constraints, distance from markets and lack of human resources mean that access to credit is not the key constraint, the potential for rural finance and access to credit to solve the problems of development is limited. In such contexts, direct state investment in rural infrastructure, agricultural technology, welfare and education and in policies to help people move to more sustainable locations would be more productive. What is more, funds that are saved by a reduction in the government supports and subsidies given to the RCU system might also be directed towards targeted support for poor areas and poor farmers.

A further innovation that would encourage greater competition and efficiency would be to ***allow RCUs to operate across county borders***. This should be done by permitting mergers and acquisitions and by allowing RCUs to open branches outside their current areas. Strong RCUs with good management and resources should be able to expand their services into other areas as part of the process of strengthening rural finance. At the same time, this would mean that there would be an exit mechanism for poorly managed RCUs and a way of ensuring that good practices spread across the system

2.7. Competitive Environment

A further important element in strengthening RCU performance is the ***encouragement of greater diversity and competition***. The current virtual monopoly of the RCU system is a disincentive to efficiency and product innovation. It also results in the major emphasis on support for the RCUs, since they can be seen as 'too big to fail' and irreplaceable because there are no alternatives. The competitive environment can be improved in three ways: a) encouragement for the formal banks to develop more rural business; b) support for local community level institutions and services; and c) greater legitimacy for informal credit systems.

Over the past two years, the ***formal banking system*** has begun to develop more rural services through both the ABC and the Postal Savings Bank (PSB). The ABC was originally an important service provider for rural finance, but it reduced its rural services and closed down many of its rural branches after 1996, when became a commercial bank. The government is now encouraging it to take on more rural lending and to expand its services to the rural economy. The challenge it faces is whether these policy-led roles might undermine its commercial priorities. It will also take time to rebuild its rural network in a context where the RCUs have an established advantage in knowledge and clients.

The Post Office Savings Department has long played an important role in providing remittance services for migrant workers. The national network of Post Office branches and their capacity to make transactions in any of their 36,000 national locations gave it a considerable competitive advantage in this role. The establishment of the PSB in March 2007 and the expansion of its role to include deposits, loans and other banking services have enabled it to begin to take on a growing role in rural finance. Although separated from the Post Office itself, the PSB continues to enjoy the network advantage that the Post Office system offers. Currently, its main rural service is the provision of microcredit loans, which reached about Rmb 30 billion in 2008 and is planned to increase to Rmb 55 billion in 2009. Compared with total RCU loans of Rmb 3.7 trillion around half of which are in rural areas, the volume of service is still small. However, the combination of its branch network, remittance services and local community knowledge implies that over the long term it has the potential to develop as a competitor to the RCUs.

While the scale and level of rural services by the ABC and the PSB are still small in comparison to the RCUs, their potential to develop as competitors and to promote the emergence of new services (for example, the Huilong Credit Card for farmers being introduced by the ABC) should be encouraged. In addition, the government should also consider allowing any special subsidies and supports that are given to the RCUs in return for providing rural services to be made available to other banks and financial institutions that provide the same service. This would strengthen competition and gradually reduce dependence on the RCUs. It would be necessary, however, to make sure that there is strict monitoring of the services and subsidies in an effort to reduce rent-seeking and moral hazards.

Currently, there are only around 500 or so ***local community-level financial institutions*** established under the PBC and CBRC experimental regulations. These include microcredit loan companies, village banks and farmer cooperatives. The regulations limit the extent of investment from outside areas and give a preference to investment from existing registered financial institutions. As yet, however, the role of these innovations in rural finance is limited. Their scale is small, and they are not allowed to take deposits. The requirements for registered capital are relatively high, which raises the threshold for entry. Once established, they primarily rely on the turnover of existing capital, and there are limits on their ability to expand. For the moment, therefore, their capacity to develop services and to compete with the RCCs at the local level is limited. Their role could be enhanced by further liberalization of the rules for registration and operation. Overall, these small organizations can play important roles at the community level, where local knowledge and ownership by local communities can reduce risks and complement services offered from formal institutions. Furthermore, the risks of their operation are borne by their owners and operators.

In addition, there are a number of micro-finance institutions that have been supported by international donors and international microfinance organizations. Studies of these experiments have underlined that the constraints on their operations, their lack of a clear legal and regulatory framework and their reliance on donor support has prevented them from achieving sustainability and scale. In addition, many of them take a welfare approach and focus on community development and the provision of services and support beyond credit. Nevertheless, their experience has provided some useful lessons for the development of microcredit methodologies and of community support for the poorest farmers in ways that create social capital, as well as providing financial support. There is a need to develop a better regulatory framework to allow such organizations to continue to play both a social and a financial role. International experience and expertise to support this expansion is readily available through CGAP and the large, international microfinance organizations.

A final aspect of promoting the competitive environment is recognition of the role of informal credit and allowing it to operate more openly. The PSB has been reviewing this situation for some time and has been considering mechanisms to allow it to operate more openly. While this may not require formal registration and licensing, it should involve some monitoring of the practices in order to prevent abuses.

While these various developments will take time to develop and achieve scale, the growth of greater diversity and competition in rural financial services is an important mechanism for stimulating improvements in RCU management and performance.

3. Recommendations

The overall goal of China's rural financial reform is the creation of a 'modern rural financial system'. The urgency of this broad vision was underlined by the Decision of the Third Plenum of the 17th Central Committee in October 2008 and by the State Council Document No 1 in February 2009. By examining the lessons from the current reforms, this policy note has clarified the obstacles to the realization of this goal. It has also identified a range of policy options for RCU reform that can help transform it into a sustainable and profitable system. The key recommendations are:

Ownership, Corporate Governance and Management

3.1 ***Where conditions permit, truly independent rural commercial shareholding banks should be established at both the PRCU and CRCU levels***. This requires:

i. Converting all shares into investor shares and phasing out 'member shares';
ii. Changing the limits on the proportion of shares that can be owned by natural persons and legal persons so that a number of large shareholders with a long-term interest in the healthy development of the enterprise can emerge;
iii. The development of properly managed mechanism to trade in shares, so that property rights can be traded and share prices can reflect enterprise value;
iv. The establishment and proper operation of shareholder meetings, independent boards of directors and independent supervisory boards; and

v. The appointment of managers with financial expertise and responsible to the board for performance.

3.2 ***Where conditions do not permit the introduction of shareholder commercial banks, the cooperative model should be stabilized and improved***. This work should draw on international experience, such as that of the Rabobank, to improve cooperative operation as a sustainable financial institution. It should also allow the establishment of entirely new cooperatives, free from the historical burdens of the existing system. This would require:

i. Reorganizing cooperative shareholder ownership so that members are true investors with a stake in success of the institution;
ii. Ensuring that the cooperatives are true cooperatives run by and on behalf of their members and not 'official cooperatives' under government control;
iii. Establishing governance systems that ensure the full expression of members' views and the appointment of professional staff responsive to the requirements of the cooperative owners;
iv. Ensuring that the CRCUs operate as autonomous independent cooperative unions, where necessary investing in a PRCU to provide a range of management and service inputs to support the system as a whole.
v. The PRCU not act as a top-down manager and should provide services required by members, such as support for linked computer networks and IT management, support and training for the introduction of sound governance structures, and effective management systems and risk controls, account clearing, and staff training.

3.3 ***There should be continued strengthening of corporate governance and risk management systems***. Apart from the incentives for better corporate management created by giving shareholders and cooperative members full responsibility for managing the risks they face, it is also necessary to assess and extend the experience of current management innovations in institutions such as the Jiangxi PRCU, the Ningxia Yellow River Rural Commercial Bank and others. These experiences include separation of loan assessment and approval, risk management systems, NPL management systems, employee incentive systems, information management procedures and so forth. These lessons can be widely publicized and incorporated into training manuals and institutional development materials circulated through the system.

3.4 ***Experiments with exit strategies for failing RCUs/RCCs should be allowed***. Rules should be relaxed to enable weak institutions to be taken over and reorganized. This could include such things as merger and acquisition by more successful neighboring RCUs and allowing successful RCUs to operate outside of their immediate borders. These experiments should follow the internal logic of sustainable financial development of the institutions, rather than administrative boundary requirements. This would also encourage greater competition and innovation within the system.

The role of government and regulation

3.5 ***The role of provincial government in direct management should be ended***. Provincial governments should focus on broad regulatory issues and appropriate support and mitigation policies that reduce the risks for depositors and encourage the development of community-level services.

3.6 ***It is important to ensure that the CBRC system is able to play its primary role as regulator***. The above innovations encourage greater independence for RCUs and greater diversity and flexibility in rural financial markets and institutions. This, in turn, requires strengthening CBRC capacity to ensure that the new RCUs operate within the regulatory framework. CBRC staffing and resources at local levels should be improved, so that it can monitor rural financial conditions, identify emerging problems and recommend appropriate steps for mitigation.

Policy Support

3.7 ***Subsidies and special policies provided for the RCUs to encourage them to serve rural policy goals (tax incentives and on-lending funds for example) should be extended to all financial institutions providing the same rural services***. These policies should be aligned by the service, rather than by the institution. This would enable competition between institutions in the efficiency of providing the service. This innovation will require strict monitoring and evaluation of the services to ensure that they meet the required standards and goals and are not used as a mechanism to disguise poor management.

3.8 ***Controls over interest rates for rural loans should be abolished***. On the one hand, these controls mean that the higher costs and higher risks of rural financial services are not rewarded, making it difficult for commercial or cooperative institutions to operate in a sustainable way. On the other hand, international experience in micro-finance programs and informal credit demonstrates that where profitable rural activities are possible, borrowers are able to pay higher interest rates.

3.9 ***Current policies to support micro-credit through on-lending funds should be expanded***. The evidence suggests that these services have been successful in strengthening RCU services and in delivering small loans to a large number of small farmers and that the demand is greater than the current supply.

3.10 ***The stable development of the rural financial institutions also requires the introduction of complementary services to reduce risk and to improve the environment for rural finance***. These include experiments with agricultural insurance to reduce the risks of loan default through external shocks or disasters, and better systems of credit assessment and pooling of information. In addition, the quality of auditing and accounting services in rural areas also needs development.

3.11 ***Extend experiments with the use of mortgages, loan collateral and guarantees***. To ensure financial discipline, it is vital that borrowers face risks if they default on repaying loans. While the development of insurance can help protect borrowers against external shocks and disasters, current experience with such things as using group guarantees, moveable assets, and other innovations should be extended. In addition, recent experiments with using cooperative land contracts as collateral should be evaluated and experiments with mortgaging individual land contracts or farmers' houses should be allowed. It is recognized that there are concerns that there are risks for individual farmers in such arrangements, and appropriate loan insurance should be introduced to offset the risks.

Competitive Environment

3.12 ***The competitive environment for RCUs/RCCs should also be improved by encouraging the more rapid development of alternative local level community financial services***. The lessons of the current experiments with microfinance institutions, loan companies, village banks and farmer cooperatives in recent years should be summarized, and the successful models should be expanded. The entry thresholds for these services should be suitably reduced. These institutions can offer competitive credit services and encourage innovation in the system as a whole. In addition, the Postal Savings Bank (PSB) and Agricultural Bank of China (ABC) should also be encouraged to continue expanding their rural services, by gaining access to the same policy supports as the RCUs for doing so.

3.13 ***The role of informal credit in rural areas should be recognized, and it should be allowed to operate more openly in ways that enable it to be monitored for problems***. Many studies have demonstrated that informal rural finance plays a major role in the provision of credit for small farmers. Moreover, the interest rates charged, while above the official rates are commonly not excessive. Although it is tolerated, it is not legal. This sector should be acknowledged and brought more into the open so that potential risks can be monitored and controlled.

Annex 1: List of Interviews

<u>Date</u>	**<u>Interview</u>**
14 March 2009	International Workshop on Rural Financial Reform in China
16 March 2009	Mr. Tian Jianhua, Deputy DG, Cooperative Finance Supervision Division, CBRC.
	Mr. Jiang Yonghua, Division Chief, Department of Rural Financial Reform, CBRC.
	Mr. Cheng Enjiang, China Project Manager, Accion International.
17 March 2009	Mr. Xu Zhong, Finance Research Institute, PBC.
	Mr. Shen Minggao, Chief Economist, *Caijing* magazine.
	Ms Ren Lin, Investment Office, IFC, Beijing
18 March 2009	Professor Du Xiaoshan, Rural Development Institute, Chinese Academy of Social Sciences.
19 March 2009	Professor He Guangwen, Chinese Agricultural University
3-5 May 2009	Yellow River Rural Commercial Bank, Ningxia
6 May 2009	Professor Zhang Yuanhong, Rural Development Institute, Chinese Academy of Social Sciences
7 May 2009	Mr. Han Jun, Director Rural Work Department, Development Research Center, State Council
	Ms Dai Hui, Representative, Rabobank, Beijing

Annex 2: References

Asian Development Bank, *Establishing a Framework for Sustainable Rural* Finance, April 2005.

Chen Jianbo, 'Chongjian nongcun jinrong tixi xuyao pojie de nanti', *Nongye Jingji Wenti*, 2004, No. 11.

Findlay, Christopher, Andrew Watson, Cheng Enjiang and Zhu Gang (eds), *Rural Financial Markets in China*, (Asia Pacific Press, The Australian National University, Canberra, 2003), 152 pp.

Garcia, Gillian, *Deposit Insurance Actual and Good Practices*, International Monetary Fund 2000

Han Jun, Luo Dan, Cheng Yu, 'Nongcun jinrong xiankuang diaocha', *Nongcun Jinrong Yanjiu*, 2007, No. 9, pp.9-20

Jiang Dingzhi, 'Tanxun nongcun xinyongshe gaige fazhan zhi lu'. *Zhongguo Jinrong*, 1 October 2008.

Jiang Dingzhi, 'Nongcun xinyongshe gaige hexin zai chanquan', Xinhuashe, 18 July 2008.

Renmin Yinhang Nongcun Jinrong Fuwu Yanjiu Xiaozu, ' Zhongguo nongcun jinrong fuwu baogao', September 2008.

Renmin Yinhang Xiao'e Xindai Zhuantizu, *Xiao'e Xindai Tongxun,* No 10, January 2009.

Wang Shaoguang, 'Nongcun xinyongshe gaige 30 nian', *Zhongguo Jingji Shibao*, 9 May 2008.

Watson, Andrew, 'Financing Farmers: The Reform of the Rural Credit Cooperative and the Provision of Financial Services to Farmers', in Christopher Findlay, Andrew Watson, Cheng Enjiang and Zhu Gang (eds) *Rural Financial Markets in China*, (Asia Pacific Press, The Australian National University, Canberra, 2003)

World Bank, *China Rural Finance Policy Note*, January 2007.

World Bank, *Zhongguo: Jianli zonghe xietiao de nongcun jinrong zhanlue zhengce baogao*, 15 January 2007

World Bank, 'Note on Restructuring Zhejiang Provincial Rural Credit Cooperative', internal undated manuscript.

Xiao Siru, 'Nongcun xinyongshe gaige fazhan ruogan wenti tantao', 2007

Xie Ping, 'Reforms of China's rural credit cooperatives and policy options'. *China Economic Review*, 14 (2003) pp. 434-442.

Xu Zhong, Zhang Xuechun, Shen Minggao, Cheng Enjiang, *Zhongguo Pinkun Diqu Nongcun Jinrong Fazhan Yanjiu* (Zhongguo Jinrong Chubanshe Yanjiu, 2009)

Xinhuashe, 'Nongcun xinyongshe gaige de hexin zai chanquan – Yin Jian Hui Fuzhuxi Jiang Dingzhi tan nongcun hezuo jinrong gaige', 18 July 2008.

Zhong-Gong Zhongyang, *Guanyu Tuijin Nongcun Gaige Fazhan Ruogan Zhongda Wenti de Jueding* (Xinhua, 19 October 2008)

Zhuang Suilin, Xie Qiong, Wang Yapeng, 'Nongcun xinyongshe gaige moshi bijian yanjiu, *Nongye Jingji Wenti*, 2007, No. 7, pp. 27-32.