Rural Credit Cooperatives in China

Background Information

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1.Background

1.1.Overview of Access to Financial Services in China

In recent years, an overwhelming emphasis on “access” has implied that governments and donor groups seek ways to extend (and reform) existing financial structures so that they may reach those whom have never enjoyed formal financial services before.

China represents 25% of the world’s population and the majority of this population lacks adequate access to financial services, particularly working capital credit. With its Reform and Opening (beginning 1979), and its recent ascension to the WTO, China also represents the fastest growing economy in the world – a region with vast demand for broad-based financial services. Unfortunately, the financial sector has been one of the slowest sectors to develop and adopt fully market-oriented principles of operation.

China’s banking sector is dominated by four major state-owned commercial banks. These banks are currently undergoing significant reform; the best are preparing for an IPO (China Construction Bank, Bank of China), while the less advanced (e.g. Agricultural Bank of China) is still working to reform those of its 40,000 branches that are failing; the ABC’s current NPL is currently still at 25%.[1] The Agricultural Bank of China is the only one of the “Big Four” that has ventured into small-scale microfinance services, and these have been offered at a subsidized interest rate with low recovery and low sustainability. The ABC is steadily withdrawing from the agricultural sector; in a number of years it may be much less “agricultural” than its original sector-specific name implies. Not to be confused with the ABC, the Agricultural Development Bank of China (ADBC) also operates in the rural areas of China, but serves for grain purchasing/distribution and has not yet taken on retail services to agricultural or nonfarm clients.

Ranked below the “Big Four” in size of assets and breadth of operations, China has 10 private stock-holding banks that operate on a commercial basis. These banks are largely interested in corporate banking; their retail portfolios are growing, but still small. These second tier banks are largely disinterested in incurring unnecessary risk and are subject to strict capital adequacy ratio regulations. While there may be opportunities for “downscaling” these banks, it will certainly prove a long and arduous process. Credit Guarantee Schemes have been set up (3000 nation-wide)[2] to try to induce these 2nd-tier commercial banks to offer financial services to riskier and smaller-scale borrowers, but these measures may not prove sustainable either. Access to SME finance is slim in small towns (population 50,000-100,000) and large cities (population 4-10 million). Small consumer loans are more readily available than in past years, but limited “access” still remains a problem.

Against this backdrop of a nationally troubled banking sector, it is estimated that up to 75% of rural residents in China do not have access to financial services. NGO financing (micro-credit and microfinance programs) represent insignificant scale and performance to be considered a widespread vehicle for broad-based pro-poor financial services at this point.

Rural Credit Cooperatives (RCCs) have been identified as a key vehicle for the delivery of financial services to the small-scale entrepreneur/consumer.

[1] General information on the reforming banking structure drawn from statements made by Banking Sector Specialist WANG Yi of McKinsey & Co., Beijing Office. March 23, 2005.

[2] This number drawn from a statement made by Wang Jun at the Micro and SME Finance Conference, Beijing April 15, 2005.

1.2.RCCs as a key means of pro-poor finance delivery

RCCs were established during the rural cooperative movement in the 1950s.[3] They account for 11.5% of deposits (CNY 2,233 billion), 10% of loans outstanding (CNY 1,618 billion) of the banking sector, and 85% of agriculture loans. China has 32,397 RCCs with some 628,000 employees, 2,441 RCC unions (RCCUs) at the county level, 65 RCCUs at the prefecture level, and 6 RCCUs at provincial level. Agriculture loans outstanding by RCCs in June 2003 amounted to CNY700 billion. Farmer loans amounted to CNY555 billion and microcredit loans amounted to CNY114 billion.

RCCs have long been influenced by various levels of government and suffered from problems such as unclear ownership structure, poor corporate governance, inadequate business scope and internal control, poor administrative and supervisory framework, problems with staff capacity, heavy historical burden, non-standard accounting practices poor asset quality, and dismal financial performance. By the end of 2001, the non-performing loan (NPL) ratio of the RCC system was 44%: 46% of RCCs were making losses; 58% had asset value less than liabilities, 53.3% had negative net worth (before counting NPLs written off), and 27% were facing serious financial difficulties.

RCCs have gone through several rounds of ineffective restructuring. RCCs were under the overall administrative umbrella of ABC from late 1970s to the mid-1990s and were under People's Bank of China (PBC) from the mid-1990s to the early 2000s. After the shift of the bank and RCC supervisory function from the PBC to the China Banking Regulatory Commission (CBRC) in April 2003, it was clear that neither PBC nor CBRC could administer RCCs while fulfilling their regulatory mandates.

In June 2003, the State Council issued a policy directive to commence a reform program aimed at fundamentally restructuring RCCs. The reform program had two objectives: (i) to clarify the ownership structure and strengthen corporate governance for RCCs, and (ii) to transfer the administrative responsibilities to provincial governments, as well as resolve historic financial burdens. Seven provinces and one municipality were selected as the first batch for pilot testing the reform. While this first round was not without problems, the experiment was deemed a success and thus a full-scale implementation of the reforms was announced by PBC and CBRC on 30 August 2004 for 21 additional provinces. In effect, RCC reform is now underway across the country.

1.3.Current state of RCC Reform

Overall, the outcomes of the pilot have been:

- the transformation of RCCs into agriculture commercial banks (ACBs), agriculture cooperative banks (ACOBs), county-level consolidated structures made up of multiple township-level RCCs, or township-level institutions with a clear ownership structure.

[3] Information on RCCs gathered from online resources, particularly an Asian Development Bank document entitled TECHNICAL ASSISTANCE (Financed by the Poverty Reduction Cooperation Fund) TO THE PEOPLE'S REPUBLIC OF CHINA FOR RURAL FINANCE REFORMS AND DEVELOPMENT OF MICROFINANCE INSTITUTIONS. November 2004.

- RCCs with serious financial problems could be liquidated.
- In order to transfer RCCs' administrative responsibility to provincial governments and resolve balance-sheet issues, mainly in the form of nonperforming loans (NPLs), provincial RCC unions (RCCUs) were formed and provided financial incentives such as (i) partial compensation of losses from policy-driven subsidized loans, (ii) reduction of RCC corporate tax by 50–100%, (iii) provision of special PBC refinancing loans, and (iv) provision of PBC notes redeemable upon meeting certain financial and operational criteria.[9] Loan interest rates, now at 200% of the base-lending rate prescribed by PBC, are more flexible.

Problems in the process of reform continue to exist. Such problems include:
- Wrongly placed incentive structures due to the top-down approach by the central government;
- Lack of participation by farmer-owners in the reform process and decreased participation in restructured RCCs;
- Unclear objectives and conflicts of interest at the provincial RCCUs;
- Lack of progress in interest rate liberalization;
- Poor corporate governance and human resource development;
- Continued capital outflow from rural areas (for example, RCCs were unable to attract more deposits as compared to postal savings and banks.
- Incomplete supervision and regulatory framework

In light of the role that RCCs have to play broadening access to financial services among the rural (and now urbanizing) regions of China, in light of the on-going reform, authorities and stakeholder groups would do well to adopt a broader view of the national strategy for regulation and supervision.

1.4.Importance of Regulatory and Supervision Strategy

Once new systems are in place, once experiments have been allowed to stabilize and standardize across the provinces, how will regulators set frameworks for regulation and supervision? The CBRC currently employs little over 3,000 people nation-wide (including national, provincial, and county-level staff). Each local supervisor is therefore asked to supervise more than 10 RCCs each on average. The job of supervising RCCs across this vast and varied land is the work of an army; inconsistencies and non-standardization in the system make this job all the more impossible. There is a need to be very efficient in sculpting a national strategy for regulation and supervision for the "next generation" of RCCs. Efficiencies can be obtained by:
- Drawing fully upon experience (particularly failure and success cases) from other countries
- Integrating the experience of the last three years of RCC reform
- Encouraging high participation among key stakeholders at the CBRC's Rural Cooperative Finance department.
- Aiming quickly toward a working strategy paper that can be worked upon internally by supervisors and other stakeholders.

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