

ASIAN DEVELOPMENT BANK

TAR: PRC 35412

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

CURRENCY EQUIVALENTS

(as of 31 October 2004)

Currency Unit	–	yuan (CNY)
CNY1.00	=	\$0.1208
\$1.00	=	CNY8.2765

ABBREVIATIONS

ABC	–	Agricultural Bank of China
ACB	–	agriculture commercial bank
ACOB		agriculture cooperative bank
ADB	–	Asian Development Bank
CBRC	–	China Banking Regulatory Commission
EA	–	Executing Agency
IMAR	–	Inner Mongolia Autonomous Region
MFI	–	microfinance institution
NGO		nongovernment organization
NPL	–	nonperforming loan
PBC	–	People's Bank of China
PRC	–	People's Republic of China
RCC	–	rural credit cooperative
RCCU	–	rural credit cooperatives union
TA	–	technical assistance

TA CLASSIFICATION

Targeting Classification	:	General intervention
Sector	:	Financial
Subsector	:	Financial sector development and reforms
Theme	:	Sustainable economic growth
Subtheme	:	Rural development

NOTE

In this report, "\$" refers to US dollars.

This report was prepared by Ying Qian and B. Wilkinson, Governance, Finance and Trade Division, East and Central Asia Department.

I. INTRODUCTION

1. Strengthening financial services to the agriculture sector¹ and to rural nonfarm activities has become a major policy objective of the Government of the People's Republic of China (PRC). Accordingly, the Government requested the Asian Development Bank (ADB) during the 2004 country programming meetings to provide advisory support for rural finance reforms and the development of microfinance institutions (MFIs) in Inner Mongolia Autonomous Region (IMAR) and Guizhou Province. A fact-finding mission² visited Beijing, IMAR, and Guizhou on 30 August–10 September 2004 and reached agreement with the Government on the objectives, scope, and implementation arrangements for the technical assistance (TA).³ The TA logical framework is in Appendix 1.

II. ISSUES

2. The rural financial system comprises the rural credit cooperatives (RCCs), Agricultural Bank of China (ABC), and Agricultural Development Bank of China (ADBC). ADBC focuses only on commercial grain and cotton production. ABC, with a mandate to operate as a purely commercial bank, has been retreating from rural finance service provision. Thus, in many localities, RCCs are the only financial institution serving rural areas.⁴

3. RCCs were established during the rural cooperative movement in the 1950s. They account for 11.5% of deposits (CNY2,233 billion), 10% of loans outstanding (CNY1,618 billion) of the banking sector, and 85% of agriculture loans.⁵ 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, poor asset quality, and dismal financial performance.⁶ RCCs have gone through several rounds of ineffective restructuring.⁷

4. After the shift of the bank and RCC supervisory function from the People's Bank of China (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

¹ i.e., rural economy, rural communities, and farmers.

² The mission had two teams. The Inner Mongolia Autonomous Region (IMAR) team comprised Y. Qian, principal financial economist; and C. Oh, governance specialist. The Guizhou team comprised B. Wilkinson, microfinance specialist; L. Shen, financial economist; and T. Nguyen, economist. Both teams are from the Governance, Finance and Trade Division of the East and Central Asia Department.

³ The TA first appeared in *ADB Business Opportunities* (Internet edition) on 31 July 2004.

⁴ ABC is closing its township and county branches. County branches can only take deposits and not sanction loans, with the exception of policy-driven poverty reduction lending.

⁵ The PRC 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.

⁶ By the end of 2001, the nonperforming 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.

⁷ RCCs were under the overall administrative umbrella of ABC from late 1970s to the mid-1990s and were under PBC from the mid-1990s to the early 2000s.

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, including Guizhou Province.⁸

5. The reform allowed 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. 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), Government policy recommended establishing provincial RCC unions (RCCUs) 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.

6. Results of the 2003 RCC reform have been generally positive.¹⁰ Thus, a full-scale implementation of the reforms was announced by PBC and CBRC on 30 August 2004 for 21 additional provinces, including IMAR.¹¹ During this second phase, a number of problems experienced in the first batch of pilot projects will need careful attention. These include (i) wrongly placed incentive structures due to the top-down approach by the central government; (ii) lack of participation by farmer-owners in the reform process and decreased participation in restructured RCCs; (iii) unclear objectives and conflicts of interest at the provincial RCCUs; (iv) lack of progress in interest rate liberalization; (v) poor corporate governance and human resource development; (vi) continued capital outflow from rural areas;¹² and (vii) lack of alternative forms of rural finance other than RCCs; particularly in serving the poor.

7. Given the importance of market competition and the need to service poor areas, policymakers are contemplating alternative forms of financing, primarily MFIs. No policy or regulatory framework allows MFI operations, although numerous pilot programs have been implemented in the past 10 years, providing CNY3 billion in microfinance loans. Outstanding microfinance pilot project loans amount to CNY300 million. Interest rates range from the subsidized rates of 3% per annum for Government-operated schemes to 16% per annum for MFIs that seek financial sustainability. MFIs have long been regarded as informal financial institutions by the Government and are being restricted for fear of financial market instability. In

⁸ Guizhou, Jiangsu, Jiangxi, Jilin, Shanxi, Shandong, and Zhejiang provinces, and Chongqing municipality.

⁹ The amount of People's Bank of China (PBC) special refinancing loans and redeemable notes is based on 50% of actual asset-liability balance after taking into account actual nonperforming asset (NPA) losses. The definition is carried over losses (due to interest subsidies to depositors) + actual NPA losses – shareholders' equity – special provisions. The actual NPA losses are calculated as 100% of bad loans + 40% of nonaccrual loans + 10% past due loans + 10% invested assets + 50% of loan collaterals. PBC refinancing loan will have a 3-, 5-, or 8-year term, and an interest rate half of reserve deposit rate. PBC redeemable notes will be for 2 years, with an interest no less than reserve deposit rate. The preliminary estimate indicates that the actual asset-liability balance of rural credit cooperatives (RCCs) nationwide should be in the range of negative CNY200–250 billion, which means central Government financial support will be at least CNY100–125 billion.

¹⁰ These include (i) commercialization of RCCs and establishment of agriculture commercial and cooperative banks in economically advanced areas, (ii) streamlined provincial administration of RCCs, (iii) expansion of capital bases, (iv) reduction of historical burdens and future risks through NPL resolution, and (v) strengthened financial performance.

¹¹ Except for Tibet Autonomous Region, which does not have an RCC, and Hainan Province.

¹² RCCs were unable to attract more deposits as compared to postal savings and banks.

most localities, only RCCs maintain a regular but limited microcredit program.¹³ However, the Government has started to encourage microfinance.¹⁴

8. IMAR is one of the PRC's largest provinces and autonomous regions with a total area of about 1.18 million square km and a population of 20 million. Agriculture is a key sector. Rural households comprise 64% of the total population. Close to 10% of the total population is poor, and about half of 40 rural counties are classified as either national or regional poverty counties. Guizhou is a mountainous agricultural province in the upstream Yangtze River basin in southwestern PRC. Guizhou's total population is 38 million, of which 87% is in rural areas. It is the poorest province in the PRC with poverty incidence estimated at 9.5%. Low-income households comprise 30% of the population. IMAR and Guizhou households that have managed to cross the subsistence line remain vulnerable, and many have fallen back into poverty due to natural disasters or diseases.

9. RCCs and microfinance pilots have been significant in IMAR and Guizhou. The RCC system is the largest financial institution in IMAR, with the most branch networks and number of employees.¹⁵ With 2,142 offices covering all townships and counties in Guizhou, RCCs remain the main provider of rural financial services. RCC reform has completed its first phase.¹⁶ In IMAR, the microfinance project implemented by the local women's association in Chifeng City is funded by the United Nations Development Program (UNDP). In Guizhou, five pilot MFIs operate with small client groups with varying degrees of success. Their successes and problems are similar to those faced by the MFIs in Chifeng: limited capital bases and no new source of funds to lend, lack of access to regular training and skills improvement, insufficient accounting systems to deal with expansion, lack of institutional licensing, and interest rate limitations.

10. Several factors encourage RCC reform and microfinance support in the provinces concerned:

- (i) **Strong government support.** The IMAR and Guizhou governments have placed utmost importance on a successful rural finance reform program. The IMAR's Financial Office has assumed the responsibility of directing and managing the

¹³ Most RCCs operate a microcredit program similar to credit card operations, in which creditworthy farmers or herders are given a credit ceiling to draw from. The mission was told the default rate of the microcredit program is the lowest, but RCCs operate it on a very limited scale,

¹⁴ Based on a study of 158 microfinance pilots, PBC concluded that (i) MFIs should be encouraged in the central and western regions, targeting the poor with income-generating capacity, and nonbanking MFIs should not be allowed to take deposits; (ii) modalities and loan sizes should be made more flexible, including group lending and guarantees; (iii) interest rate bands should be widened depending on costs and risks; (iv) tax concessions should be given to MFIs; (v) MFIs can be self-regulated through an association; and (vi) optional minimum of operation for MFIs should be around CNY5 million, including CNY1.5 million for operations and training, and CNY3.5 million for loan funds to finance operations for 4,000 low-income households.

¹⁵ By the end of 2003, the total assets of the IMAR RCC system amounted to CNY40.5 billion while loans outstanding was CNY17.4 billion. Total liabilities of the RCC system amounted to CNY39.6 billion, of which CNY25.5 billion was in deposits, which, in turn, accounted for 12.2% of total deposits among all financial institutions. Loans extended by RCCs comprised 9% of loans extended in IMAR by financial institutions and 95% of increases in agriculture loans. NPLs amounted to CNY7.87 billion, or 45.2% of total assets. Some 1,050 RCCs were making money with a total profit of CNY73 million but 226 RCCs were making losses amounting to CNY65 million. As of 2003, total cumulative loss of the RCCs amounted to CNY880 million and the actual asset-liability balance of IMAR RCCs is calculated at negative CNY2.4 billion. IMAR government estimates that the loss can be resolved in 5 years, assuming IMAR receives the mentioned special incentives from the central Government.

¹⁶ Guizhou RCCs have about CNY20 billion in deposits and CNY18 billion in outstanding loans, of which CNY13 billion is in agricultural lending. It is estimated that RCCs reach 30–40% of rural clients. Last year, 26% of RCCs in Guizhou were in the red.

RCC reform process.¹⁷ Jiangkou County in Guizhou has actively sought to be included in the model MFI program, while the Assistant Governor's Office directs and manages the RCC and related microfinance reform processes. The Guizhou provincial government is considering allocating poverty reduction funds for this cause.

- (ii) **Rapid growth of nonagricultural sectors.** IMAR and Guizhou have registered rapid economic growth in last 3–4 years, primarily fueled by resource-intensive industries, small and medium-sized enterprises, and tourism.
- (iii) **Addressing poverty.** The IMAR and Guizhou governments recognize the importance of MFIs in reaching the poor and have committed to establishing a focused microfinance program.

11. However, the following concerns need to be addressed:

- (i) **Geographic distance and economic disparity.** IMAR's large size and the long stretch from east to west, and Guizhou's mountainous environment with low population density and poor infrastructure, require heavy administrative and supervisory costs for RCCs and MFIs. Disparity in operational conditions for RCCs and MFIs require flexible policies.¹⁸
- (ii) **Limited operational scale, poor financial performance, and weak institutional capability.** Given the vast areas of service and the small population, many RCCs operate on a limited scale and perform poorly.¹⁹ Most RCCs have poor bookkeeping methods²⁰ and lack qualified staff, more critically in Guizhou Province as reform progresses;
- (iii) **Policy constraints.** RCCs are subject to many policy constraints that further undermine their profitability and financial safety.²¹ RCCs also face strong local government interference.²² MFIs are not formally licensed and cannot take deposits.
- (iv) **Poor corporate governance.** RCCs and RCCUs have complicated and unclear ownership structures. Original RCC members such as farmers and herders hardly participate in key policy issues.²³ RCCUs are usually established based on

¹⁷ The IMAR Financial Office has identified RCC reform as an integral part of the overall financial market development in IMAR. The Financial Office is developing a small and medium-sized enterprise credit guarantee system, an agriculture insurance scheme, and a credit information system.

¹⁸ For example, Manzhouli RCCU has never been operated as a traditional rural financial institution, and the best option is to restructure it into an urban credit cooperative or city commercial bank. Such an option, however, is not covered under the policy.

¹⁹ Most RCCs registered a very low loan-to-deposit ratio, and even lower for agriculture loans. RCCs often seek perceived safer investments but lack risk management capabilities. Many investments thus resulted in losses. RCCs barely break even despite heavy subsidies. Eight out of 13 RCCs within the Otog RCCU had less than CNY10 million in deposits. The capital adequacy ratio of Hohhot RCCU is only 6%. For Baotou RCCU, it is only 4%.

²⁰ The rural credit cooperative unions (RCCUs) that the mission visited reported an NPL ratio of 15–17% and a recovery ratio of 20% although the IMAR-wide estimate is above 45%. The NPL recovery ratio of ABC is only 10%.

²¹ For example, the restricted interest rate structure essentially leaves no profit margin. It is estimated that an RCC can break even at central bank base rate plus 37% upward float. RCCs provide loans to their members at the central bank rate plus 45% upward float, leaving an 8% upward float margin. Many local government fiscal agencies do not allow fiscal funds to be deposited in RCCs.

²² The implementation strategies of the RCC reform initiatives reflect the local governments' wishes rather than a carefully considered strategy reflecting wishes of RCC members and financial sustainability.

²³ Many are not even aware that they are members of the RCC. Some RCCs treat depositors as members of the RCC and recognize their deposits as shares without informing them.

administrative boundaries, not on economic necessity. The Government appoints senior officials at RCCUs.

12. **ADB's Operations and Strategy.** The overall aim of ADB's operation in the PRC is to promote pro-poor economic growth. The rural sector, to which most of the poor belong, is important in poverty reduction. ADB's financial sector operations will support this strategic objective by (i) helping restructure rural financial institutions and strengthening their institutional capabilities; (ii) strengthening the legal, regulatory, and supervisory framework, and encouraging rural financial institutions to adopt sound corporate governance standards; and (iii) enhancing competition and efficiency in financial services to the rural poor.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

13. The TA goal is to expand sustainable financial services to the rural poor in underdeveloped areas of Guizhou and IMAR. The TA will (i) ensure the adoption of suitable RCC institutional and supervisory frameworks, resulting in institutional restructuring strategies for various types of RCCs as well as appropriate regulatory and supervision systems for restructured RCCs; and (ii) develop a sound policy and institutional framework for microfinance and MFIs, resulting in enhanced awareness of policymakers and the public about the importance and feasibility of microfinance, and development of microfinance mechanisms and the licensing of institutions.

B. Methodology and Key Activities

14. The TA has two components, each responsive to the particular needs of the concerned province and its unique timing of RCC reforms. Component A in IMAR will (i) assess the performance of RCCs in IMAR and, after thorough consultation with all stakeholders, identify and help implement a comprehensive strategy for RCC policy and institutional reforms in IMAR;²⁴ (ii) prepare pilot RCCs and RCCUs with commercial potential for restructuring into ACBs or ACOBs; and (iii) establish a conducive policy framework for microfinance development. Component B in Guizhou will (i) build capacity for RCC staff in Guizhou to improve loan operations in the post-restructuring period; (ii) develop Guizhou provincial and related county governments' understanding of and capacity for support to microfinance policy, regulatory, and institutional development; and (iii) develop and implement a competitive bidding process to establish a licensed model MFI in Jiangkou and adjacent counties.

C. Cost and Financing

15. The total cost of the TA is estimated at \$1,440,000 equivalent, comprising \$445,000 in foreign exchange and \$995,000 equivalent in local currency costs. It is proposed that ADB finance \$1,000,000 equivalent, consisting of the entire foreign exchange costs and \$555,000 equivalent in local costs. The TA will be financed on a grant basis by the Poverty Reduction Cooperation Fund. The Government will contribute \$440,000 equivalent in kind for office space,

²⁴ This will include restructuring, administrative framework, financial and institutional and operational strengthening, and a sound policy, regulatory, and supervisory and institutional framework for the healthy development of the local financial market in IMAR. The reform process will be monitored in pilot areas and best practices disseminated to other localities in IMAR.

counterpart staff, transportation, and other services. Details of the cost estimates for the TA are in Appendix 2.

D. Implementation Arrangements

16. The IMAR Financial Office will be the Executing Agency (EA) for component A. A leading group will be set up comprising top officials of IMAR, finance bureau, Financial Office senior management, PBC Hohhot branch, and CBRC Hohhot Branch; and heads of RCCs and RCCUs. The vice governor of IMAR in charge of financial sector issues will chair the leading group. The Guizhou Provincial RCC Reform Office will be the EA for component B. The Guizhou provincial RCCU and selected county government offices will be the implementing agencies.²⁵

17. The TA will engage five international consultants for 10 person-months and nine domestic consultants for 24 person-months.²⁶ Separate budgets are provided to engage resource persons to participate in seminars and conferences and to cover specific technical areas. The terms of reference for consultants are in Appendix 3. The consultants will be selected and engaged on an individual basis in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB on the selection and engagement of domestic consultants. Equipment (notebook computers, facsimile machines, and photocopiers) will be procured by the EAs in accordance with ADB's *Guidelines for Procurement*. The advance payment facility procedure will be adopted to facilitate timely organization of training, seminars, and conference activities. For both components, the consultants will submit (i) inception reports 1 week after their services start, (ii) interim progress reports at appropriate stages of TA implementation, (iii) draft final reports before the conclusion of the contract, and (iv) final reports 2 weeks after incorporating the EAs' and ADB's comments.²⁷ Both TA components will commence in November 2004 and will be completed in November 2005.

IV. THE PRESIDENT'S DECISION

18. The President, acting under the authority delegated by the Board, has approved ADB administering technical assistance not exceeding the equivalent of \$1,000,000 to the Government of the People's Republic of China to be financed on a grant basis by the Poverty Reduction Cooperation Fund for Rural Finance Reforms and Development of Microfinance Institutions, and hereby reports this action to the Board.

²⁵ The executing and implementing agencies of the two components will provide office space, counterpart staff, transportation, and other services to the consultants and will arrange their appointments with relevant agencies and organizations

²⁶ The three international consultants for component A will include a rural finance restructuring specialist (4 person-months), an agriculture banking specialist (2 person-months), and a microfinance development specialist (2 person-months). The two international consultants for component B will include a microfinance institution development specialist (1 person-month) and a microfinance licensing specialist (1 person-month). The five domestic consultants for component A will include a rural finance reform strategy specialist (3 person-months), an agriculture banking specialist (3 person-months), a microfinance development specialist (3 person-months), an RCC legal and regulatory specialist (3 person-months), and an RCC accounting specialist (3 person-months). The four domestic consultants for component B will include a financial institutions training specialist (2 person-months), a microfinance applied research specialist (4 person-months), a rural credit demand analyst (2 person-months), and a bidding specialist (1 person-month).

²⁷ All reports must be submitted in English and Chinese. National workshops and conferences will be organized to disseminate lessons learned from IMAR and Guizhou and seek feedback from high-level policymakers.

TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>Goal</p> <p>Affordable and sustainable financial services to the rural sector and the poor in Guizhou Province and Inner Mongolia Autonomous Region (IMAR).</p>	<p>Expansion of rural loan and savings services in project areas by 30% by mid-2008.</p>		
<p>Purpose</p> <p>Establishment of rural and microfinance system in Guizhou Province and IMAR with prudent administration and supervisory framework.</p>	<p>Completion of rural credit cooperative (RCC) restructuring in IMAR and Guizhou by end-2005.</p> <p>Establishment of provincial RCC administration and supervision system by the end of 2005.</p> <p>Finalization of policy for microfinance institution licensing and supervision in IMAR and Guizhou by the end of 2005.</p>	<p>Government documents on RCC restructuring.</p> <p>Reports by financial market regulators.</p> <p>Client and beneficiary surveys.</p>	<p>Assumption</p> <p>The Government places high priority on rural finance reforms.</p>
<p>Outputs</p> <p>Institutional restructuring and strengthening strategies for RCCs.</p> <p>Regulatory and supervision systems for restructured RCCs.</p> <p>Conducive policy framework for microfinance.</p>	<p>IMAR RCC restructuring recommendations by early 2005.</p> <p>Guizhou Province RCC training needs assessment (TNA) by mid-2005.</p> <p>Completion of IMAR RCC restructuring by end-2005.</p> <p>Provincial policy on microfinance established and promulgated in both areas by end-2005.</p> <p>Licensed model microfinance institution (MFI) providing credit to households in Guizhou and IMAR by end-2005.</p>	<p>Progress reports by consultants and respective executing agencies (EAs).</p> <p>Supervision by review missions.</p>	<p>Assumptions</p> <p>Sound recommendations are accepted and implemented.</p> <p>Related government agencies coordinate closely.</p>
<p>Activities</p> <p>Component A in IMAR:</p> <p>Assess performance of RCCs in IMAR.</p> <p>Design comprehensive strategy for RCC policy and institutional reforms in IMAR with stakeholders'</p>	<p>Completed reviews showing best options for RCC restructuring and microfinance growth.</p> <p>Report with range of restructuring options for RCCs,</p>	<p>For all activities:</p> <p>Progress reports by consultants and respective executing agencies (EAs).</p>	<p>Assumption</p> <p>High quality expected of preparatory work of the EAs.</p>

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>consultation.</p> <p>Prepare pilot RCCs and rural credit cooperatives unions (RCCUs) with commercial potential for restructuring.</p> <p>Reform policies for microfinance development.</p> <p>Institutional development for RCCs and Government officials.</p>	<p>and recommendations for regulation and supervision of RCCs and microfinance institutions (MFIs) at provincial level.</p> <p>Restructured RCC pilots.</p> <p>Draft policy documents and regulation and supervision suggestions.</p> <p>Training reports based on previous activities findings.</p>	<p>agencies (EAs).</p> <p>Supervision by review missions.</p>	<p>Risks</p> <p>High quality expected of technical assistance (TA) implementation of the EAs.</p> <p>High quality expected of the TA consultants' services.</p>
<p>Component B in Guizhou:</p> <p>Assessment of existing RCC field staff training needs.</p> <p>Design and delivery of appropriate training to county-level RCC staff.</p> <p>Provide key officials with summary of microfinance lessons learned, study tours, and a leading advisory team in the People's Republic of China (PRC).</p> <p>Establishment of a special license for the MFI.</p> <p>Development and implementation of bidding process for MFI.</p> <p>Institutional capacity-building support for the licensed MFI.</p>	<p>TNA report.</p> <p>Training reports based on TNA.</p> <p>Summary reports on official recommendations for MFI policy.</p> <p>License requirements materials.</p> <p>Bid award documents.</p> <p>MFI startup in selected location.</p>		
<p>Inputs</p> <p>Five international consultants for a total of 11 person-months, and nine domestic consultants for a total of 24 person-months.</p> <p>Funding support for institutional strengthening and capacity-building activities.</p> <p>Three review missions including the inception mission.</p>	<p>On time fielding of consultants and implementation of various tasks.</p> <p>High-quality training programs within budget.</p> <p>Back-to-office reports</p>	<p>Progress reports by consultants and respective EAs.</p>	<p>Assumption</p> <p>Counterpart support is available.</p>

COST ESTIMATES AND FINANCING PLAN
Table A2.1: Cost Estimates and Financing Plan, Component A
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Poverty Reduction Cooperation Fund Financing^a			
1. Consultants			
a. Remuneration and Per Diem			
i. International Consultants ^b	170.0	0.0	170.0
ii. Domestic Consultants ^c	0.0	70.0	70.0
b. International and Local Travel	30.0	10.0	40.0
c. Reports and Communications	0.0	10.0	10.0
2. Equipment ^d	40.0	0.0	40.0
3. Training, Seminars, and Conference			
a. Facilitators (interpreters and translators)	0.0	10.0	10.0
b. Domestic Training	0.0	45.0	45.0
c. Overseas Training	45.0	0.0	45.0
4. Miscellaneous Administration and Support Costs	5.0	0.0	5.0
5. Contingencies	40.0	25.0	65.0
Subtotal (A)	330.0	170.0	500.0
B. Counterpart Financing			
1. Office Accommodation and Transport	0.0	90.0	90.0
2. Remuneration and Per Diem of Counterpart Staff	0.0	90.0	90.0
3. Contingencies	0.0	40.0	40.0
Subtotal (B)	0.0	220.0	220.0
Total	330.0	390.0	720.0

^a Administered by the Asian Development Bank.

^b Around \$20,000 is earmarked for additional international specialists and will be identified during technical assistance (TA) implementation as the need arises.

^c Around \$105,000 is earmarked for additional domestic specialists and will be identified during TA implementation as the need arises.

^d Equipments to be purchased include notebook computers, facsimile machines, and photocopiers.

Source: Asian Development Bank staff estimates.

Table A2.2: Cost Estimates and Financing Plan, Component B
(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Poverty Reduction Cooperation Fund Financing^a			
1. International Consultants			
a. Remuneration and Per Diem			
i. International Consultants ^b	85.0	0.0	85.0
ii. Domestic Consultants	0.0	41.0	41.0
b. International and Local Travel	10.0	5.0	15.0
c. Reports and Communications	0.0	12.0	12.0
2. Equipment ^c	5.0	45.0	50.0
3. Training, Seminars, and Conferences			
a. Facilitators/Resource Persons	0.0	32.0	32.0
b. Domestic Training/Workshops ^d	0.0	175.0	175.0
c. Overseas Study Tour	0.0	20.0	20.0
4. Miscellaneous Administration and Support Costs	0.0	10.0	10.0
5. Contingencies ^e	15.0	45.0	60.0
Subtotal (A)	115.0	385.0	500.0
B. Government Financing			
1. Office Accommodation and Transport	0.0	90.0	90.0
2. Remuneration and Per Diem of Counterpart Staff	0.0	90.0	90.0
3. Contingencies	0.0	40.0	40.0
Subtotal (B)	0.0	220.0	220.0
Total	115.0	605.0	720.0

^a Administered by the Asian Development Bank.

^b \$20,000 is earmarked for additional international specialists and will be identified during technical assistance (TA) implementation as the need arises.

^c \$45,000 in local currency is earmarked for start-up support for office space, equipment, supplies, and materials of microfinance institutions (MFIs).

^d \$50,000 in local currency is earmarked for MFI staff training.

^e \$35,000 in local currency included for undesignated possible initial support for MFI startup.

Source: Asian Development Bank staff estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

A. Component A: Inner Mongolia Autonomous Region

1. International Consultants (8 person-months)

a. Team Leader and Rural Finance Restructuring Specialist (4 person-months)¹

1. The specialist, who is expected to possess sufficient professional experience in rural financial sector development in countries similar to the People's Republic of China (PRC), will perform the following tasks:

- (i) Formulate a strategy for rural finance reform in Inner Mongolia Autonomous Region (IMAR) through (a) evaluation of experiences learned from eight pilot areas;² (b) review of policy, institutional, legal, and regulatory conditions for rural credit cooperative (RCC) reform; (c) international comparative studies; (d) asset evaluation and due diligence for IMAR RCCs, preparation of survey questionnaires and reporting formats, and categorization and ranking of RCCs based on operational and financial performance indicators; and (g) organization of workshops to seek feedback from all stakeholders, particularly farmers and RCC members.
- (ii) Establish a suitable RCC administration framework by (a) identifying the most appropriate leading agency to administer RCCs,³ (b) estimating additional financial and human resources for the leading agency, (c) recommending legislation to allow the leading agency to assume administrative responsibilities, and (d) establishing procedures and coordination mechanisms with regulatory and fiscal agencies.
- (iii) Evaluate the existing regulatory and supervisory system for RCCs and microfinance institutions (MFIs)⁴ and identify inconsistencies with the existing RCC reform process.⁵
- (iv) Improve the policy environment for rural finance by covering key areas such as interest rate liberalization,⁶ payment and settlement system, risk management, new and diversified financial products, credit guarantees, agriculture insurance, credit rating, and credit information bureaus.

¹ As the team leader, the consultant will be responsible for the overall technical assistance (TA) implementation, timely delivery of quality interim and final reports, identification and management of resource persons for various technical tasks, and organization of conference and training activities. The rural finance reform strategy specialist should take the lead in tasks relating to deliberation and identification of the most proper rural financial system strategies for IMAR, and establishment of the administration mechanism at the autonomous region level.

² Deliberation for applicability of restructuring modalities prescribed by the central Government.

³ Evaluating pros and cons of establishing the rural credit cooperatives union (RCCU) at either the autonomous region or the prefecture level, and examining alternative forms of organization that can represent and organize RCCs and provide value-added services.

⁴ Including those by the Government auditor general, external auditors, credit-rating agencies, and other regulatory and supervisory agencies. With specific focus on (i) minimum capital requirements, (ii) fit-and-proper tests, (iii) feasible business plans, (iv) minimum requirements regarding corporate governance, and (v) licensing authorities' capability.

⁵ Including licensing requirement for various forms of rural finance institutions and accounting and audit rules that apply to RCCs and MFIs to meet the need for information disclosure, financial and risk management, and supervisory activities.

⁶ Recommending remedies in the absence of full interest rate liberalization, including significantly increasing float margins on central bank base interest rates.

- (v) Recommend reforms for those RCCs and rural credit cooperatives unions (RCCUs) that will not be transformed into an agriculture commercial bank (ACB) or an agriculture cooperative bank (ACOB).⁷
- (vi) Develop a policy framework for RCCs to be significantly involved in microfinance, and recommend a policy for the establishment, financing, operation, regulation, and supervision of MFIs.
- (vii) Develop a system to monitor and evaluate the rural finance reform process and staff training programs for RCC, RCCU, and the local China Banking Regulatory Commission (CBRC) staff.⁸

b. Agriculture Banking Specialist (2 person-months)

2. The specialist is expected to possess sufficient experience in banking sector management and regulatory issues in the PRC and exposure in developed countries with an advanced banking industry. The consultant will do the following:

- (i) Prepare pilot RCCs and RCCUs with commercial potential for restructuring into ACBs and ACOBs by (a) conducting due diligence⁹ and identifying operational, financial, and management constraints; (b) identifying restructuring options; (c) estimating proper valuation of shares; (d) identifying proper ownership, capital structure, and management structure;¹⁰ and (e) drafting proposals to banking supervisors.
- (ii) Assist the newly established ACBs and ACOBs in areas of (a) corporate governance, (b) business plans, (c) accounting and internal control system to ensure accountability to shareholders, (d) operational procedures, (e) human resource guidelines, and (f) training programs.¹¹
- (iii) Recommend nonperforming loan (NPL) resolution strategies, and estimate potential external funding needs to support NPL resolution and new businesses for ACBs and ACOBs by (a) analyzing financial data to assess viability and adequacy of the funding plan,¹² (b) calculating the financial internal rate of return (FIRR),¹³ and (c) calculating the economic internal rate of return for external funding.¹⁴

⁷ Aimed at strengthening corporate governance standard and financial, institutional, and operational capacities through (i) identifying restructuring options and a suitable nonperforming loan (NPL) resolution strategy; (ii) recommending proper ownership, capital, and corporate governance and management structure; (iii) recommending improvements for accounting and internal control; (iv) improving operational guidelines; and (e) instituting proper human resource policy and staff incentive schemes.

⁸ Training on modules will be provided for RCC managers, credit officers, accountants, and administrative staff.

⁹ Against internationally and nationally accepted standards, with particular attention to past and projected operational and financial performance in terms of solvency, liquidity, profitability, portfolio quality, operational efficiency, credit appraisal capabilities, and corporate governance practices.

¹⁰ Including recommending adequate operational, financial, and human resource policies, and suggesting necessary improvement to office facilities and risk control mechanisms.

¹¹ With special emphasis on risk assessment, rating, pricing, and management concepts. Training courses will use case studies relevant to their own operations and appropriate to local conditions.

¹² Advising application of conditions, or covenants that should be required as conditions.

¹³ Forecasting for a period covering the duration of the funding program up to at least the end of the fifth year. The financial internal rate of return is measured as the discount rate that equalizes the present value of investment cash outflows associated with the Project to the present value of the Project's net operating cash inflows.

¹⁴ To ensure adequate incentive for all stakeholders and fair distribution of benefits, and forecasting demand for rural finance services.

c. **Microfinance Development Specialist** (2 person-months)

3. The specialist is expected to possess sufficient experience in microfinance development and exposure in other countries at a similar development stage. The consultant will do the following:

- (i) Raise awareness of policymakers and the public about the importance and feasibility of microfinance by (a) surveying existing MFIs and microfinance services provided by RCCs, (b) conducting focus group meetings with beneficiaries, (c) analyzing microfinance demand and estimating the supply gap, and (d) organizing training activities.
- (ii) Develop microfinance mechanisms for the poor and assist in the institutional building process, covering areas of (a) ownership and management structure; (b) risk management system that is consistent with serving poor households; (c) accounting, fund disbursements, and collection, etc.; and (d) alternative financial products such as credit lending, group lending, savings and loans, and group funds.
- (iii) Establish a conducive policy framework for microfinance covering areas of (a) supporting infrastructure such as credit guarantees, agriculture insurance, and credit information sharing; (b) development of nongovernment organizations (NGOs) such as women's associations; (c) rules and regulations on microfinance; and (d) market-based mechanisms aimed at improving financial sustainability.¹⁵

2. **Domestic Consultants** (15 person-months)¹⁶

4. The domestic consultants are expected to possess sufficient experience in their fields, and will include the following:

- (i) **Rural finance reform strategy specialist** (3 person-months). He or she will help the team leader¹⁷ and other consultants (a) review experiences in the eight pilot areas, (b) conduct an international comparative study and organize training activities, (c) organize asset evaluation and due diligence, (d) formulate operational procedures for RCC administration, and (e) develop a monitoring and evaluation system for rural finance reform and disseminate best practices to other localities.
- (ii) **Agriculture banking specialist** (3 person-months). He or she will (a) conduct due diligence for selected pilot RCCs and RCCUs for restructuring into ACBs and ACOBs, (b) identify an NPL resolution strategy and estimate proper valuation of shares, (c) improve office facilities and risk control mechanisms, (d) prepare business plans, (e) improve the payment and settlement system aimed at better risk management, (f) develop new and diversified financial products for RCCs, and (g) implement a staff training program.

¹⁵ Such as liberalization of microfinance interest rates and engagement with other financial institutions to provide services in critical areas like payment and settlement systems.

¹⁶ The domestic consultants will have extensive in-depth country and sector knowledge and good contacts with the Government and financial institutions. The domestic consultants will help the international consultants quickly become familiar with their tasks by translating various documents into English; researching and compiling the set of Government policies, regulations, and procedures adopted; and ensuring that the international consultants' output is appropriate.

¹⁷ In overall TA management, timely delivery of quality interim and final reports, and recruitment and management of resource persons in various technical tasks.

- (iii) **Microfinance development specialist** (3 person-months). He or she will (a) survey existing MFIs that have proven to be successful, (b) analyze demand for microfinance services, (c) identify institutional strengthening requirements for MFIs, and (d) organize training activities on various policy and operational aspects of microfinance.
- (iv) **RCC legal and regulatory specialist** (3 person-months). He or she will (a) review and identify legal and regulatory impediments for RCC reform, (b) evaluate the existing regulatory and supervisory system for RCCs and MFIs and identify areas of inconsistency, and (c) review procedures and authorities of licensing the various forms of rural finance institutions.
- (v) **RCC accounting specialist** (3 person-months). He or she will (a) evaluate the adequacy of accounting and audit rules that apply to RCCs and MFIs;¹⁸ (b) for those RCCs being restructured into ACBs and ACOBs, recommend improvements in the accounting and internal control system to ensure accountability to shareholders; and (c) evaluate staff incentive schemes on the cost-effectiveness of operations and overall financial results.

B. Component B: Guizhou Province

5. The consulting services will help enhance RCC training effectiveness and the setup of the microfinance model project. The consultants will carry out the following tasks in support of and in close coordination with, as relevant, the national and provincial CBRC and People's Bank of China (PBC) the Guizhou provincial government, the provincial RCC Union, and the county governments in the selected target area of Jiangkou county and, possibly, surrounding counties.

1. International Consultants

a. Microfinance Institution Development Specialist¹⁹ (2 person-months)

6. The specialist will

- (i) based on the desk studies,²⁰ identify key issues to be addressed in the startup and operations of the microfinance model, including identification of competition issues, appropriate management and accounting structures, products, and loan delivery and recovery mechanisms;
- (ii) provide training to Guizhou government officials at all levels on international best practices in microfinance and the actual workings of MFIs, including a training and on-site review and analysis of a Guizhou MFI; and
- (iii) help complete the final set of materials for requesting proposals along with the bid analysis instructions to ensure applicability of the MFI program to client needs.

¹⁸ To meet the needs for information disclosure, financial and risk management, and need for supervisory activities.

¹⁹ The MFI development specialist will have at least 10 years' experience in microfinance service development, including work with MFIs providing rural finance. He or she will have completed bid proposals for ADB and be familiar with ADB bidding processes for grants. Experience in direct design, management, or evaluation of a microfinance project in the PRC is highly desirable.

²⁰ Undertaken by the microfinance applied research specialist. The demand study will be undertaken by the rural credit analyst.

b. Microfinance Regulatory Specialist²¹ (1 person-month)

7. The specialist will

- (i) provide summary information to PBC and CBRC and the Guizhou government on licensing and registration standards for non-depository MFIs in various countries;
- (ii) after consideration of PBC administrative orders for MFIs, suggest options for a special NGO-MFI license that will help meet Government goals for the MFI, while ensuring that it will be attractive to strong local NGOs (and possibly international and local NGO partners) to bid for;
- (iii) support relevant Government institutions in their deliberations on this topic; and
- (iv) provide information on options for oversight and reporting of the MFI.

2. Domestic Consultants²²

a. Microfinance Applied Research Specialist (4 person-months)

8. The specialist will

- (i) carry out a detailed national and international desk review of relevant MFI materials in Chinese and English and present the results at a workshop of key officials to discuss microfinance options for Guizhou Province;
- (ii) select and set up study tours for key officials in Guizhou provincial and local governments, and accompany them to facilitate learning;
- (iii) facilitate the establishment of a small in-country panel of microfinance experts to support the work of the Guizhou government in selecting the MFI model;
- (iv) set up and run the workshop to disseminate lessons, and use the advisory panel and others to help establish a set of bid selection criteria;
- (vi) provide feedback on the bid development and selection criteria; and
- (v) arrange and oversee the microfinance model bidding and evaluation process.

b. Rural Credit Demand Analyst (2 person-months)

9. With the full facilitation of the Guizhou government and relevant agencies, the specialist will

- (i) locate and analyze village household data for Jiangkou and all adjoining counties on financial circumstances, based on the 60-household detailed household survey data in Jiangkou county, but may include field surveys;
- (ii) extrapolate numbers of client households likely to access financial services in each county, and types of financial services they desire, as baseline technical assistance (TA) data;

²¹ The expert will have a strong background in all aspects of MFI regulation and supervision issues, and will have at least 5 years' experience in developing regulatory and supervisory framework for MFIs. He or she will be a qualified legal counsel with prior experience in developing countries and international publications on this topic. Relevant experience in the PRC is desirable.

²² Domestic consultants will have at least 5 years' experience working on applied research, training, and program implementation regarding MFIs in the PRC. An advanced degree in economics or relevant field is required. Field experience in reviews of MFIs or in MFI operations, particularly in Guizhou, is highly desirable. Fluency in English is required.

- (iii) based on RCC county data and other client data to be accessed through PBC, determine the level of client demand already supplied and justify the assumptions;
- (iv) determine the level of effective client demand as yet unmet, particularly for low-income and poverty households, comment on likely mechanisms for meeting this demand, and approximate funds that are needed to address this gap; and
- (v) present these findings to the Guizhou government and ADB to facilitate selection of an effective catchment area for the MFI model.

c. Financial Institutions Training Specialist (2 person-months),

10. With the Guizhou provincial RCC and the Guiyang Finance Institution (a training tertiary institute), the specialist will

- (i) discuss in detail with the provincial RCCs their existing training needs assessment system and training program, how to meet staff needs, and how to enhance them under the TA;
- (ii) assess a subset of county and provincial RCC staff to determine their training needs to meet the new circumstances, and give advice on the type of training deemed crucial in loan product development, credit marketing, portfolio operations, and delinquency management;
- (iii) determine services to be offered under the training services contract in order to meet the key needs most effectively, supplementing existing RCC training, and ensure that the TA-funded training will use modern training tools such as role-play, case studies, and other forms of experiential learning;
- (iv) review the capacities of RCC-designated trainers working in association with the Guiyang-based finance institution, and comment on their training as trainers; and
- (v) 6 months after the training is completed, assess its effectiveness in the county RCCs, training replication by financial intermediaries, and improvements needed.

d. Bidding Specialist (1 person-month)

11. The specialist will perform the following tasks:

- (i) Discuss with the Government and ADB their existing processes for providing grants to NGOs for such operations, and what they will need to apply this process.
- (ii) Develop bid documents for the applicants to establish an institution for microfinance services in the designated area in Tongren Prefecture. The bid documents will include a description of the circumstances and the needs, expected services to be provided, ownership and management, loan funds, and operational and reporting needs. Government relationships will be clearly spelled out. Financial documents will be included so that applicants can show how much of their own resources they will provide, how much they are requesting for lending and for operations support to reach self-sufficiency, and the timing of their growth and operations.
- (iii) Develop bidding procedures, bid analysis processes, selection criteria, and mechanisms for the bid process, consistent with Government and ADB practices.
- (iv) Finalize all documentation and advertising processes, facilitate translation into English and Chinese, and ensure that all relevant persons are familiar with the processes and can complete them.