

Pilot Scheme to Deepen Reform of Rural Credit Cooperatives

State Council
3 July 2003

Guidelines and General Principles

The main requirements are to clarify ownership structures, intensify checks and balances, with a view to improving RCCs' service functions. The state shall provide reasonable support and delegate responsibility to local governments. The objective is to accelerate reforms in RCC management and in ownership transformation in order for RCCs to become true community financial institutions providing services to *san nong* (rural areas, agricultural production, farming households).¹⁹

The principles to be observed in further deepening RCC reform are as follows.

- Improve corporate governance and operations through ownership transformation, based on market principles, with the objective of enabling RCCs to become autonomous, disciplined market participants responsible for their own losses and developments.
- Improve service functions and service quality to agricultural production and farming households in rural areas.
- Explore all possible ownership structures and organizational forms including shareholding, cooperative shareholding, and cooperatives, taking local circumstances into consideration. The objective is to establish organizational forms and operating mechanisms that are compatible with local conditions.
- Give full play to initiatives from all parties involved in accordance with the principle of matching responsibilities with rights and interests, and clarify the managerial and supervisory systems of RCCs. The responsibilities to prevent undue risks assumed by RCCs and to resolve problem RCCs should also be clarified.

¹⁹ *San nong* (三农) literally means three "nong". The word "nong" in Chinese is combined with other words to form phrases such as *nongcun* (rural villages or rural areas), *nongmin* (farmers or peasants), *nongye* (agriculture or agricultural industry).

Pilot Details

There are two main issues to be dealt with in further deepening RCC reform. One is ownership transformation to improve corporate governance through various ownership structures; the other is to restructure the managerial regime with the objective of handing RCC management to local governments.

Ownership transformation will occur in each RCC with legal entity status.

In order to clarify ownership structure, there is a need to appropriately deal with historical losses. In the case of those RCCs with positive net worth, the surplus will first be distributed as dividends and will fulfill obligations including unpaid interest payments and various insurance premiums. The remainder shall be set-aside as loan loss provisions (100% for lost loans; 50% for doubtful loans; 20% for overdue loans, and 1% for normal loans), which shall be counted as subsidiary capital. Any remaining amount shall be added to the original value of equity. In the case of RCCs that are insolvent yet difficult to close, their retained earnings shall be used to write off accumulated losses. The remaining losses shall be delegated as part of managerial responsibilities to be absorbed gradually through improved incentives and management as well as policy support.

Build new ownership structures to improve corporate governance. The pilot scheme shall allow various ownership structures based on local circumstances. In localities where conditions permit, RCCs shall be transformed into shareholding banks; in those localities where conditions are not adequate, cooperative shareholding²⁰ shall be tested; in those localities where conditions are appropriate for cooperatives but not for shareholding, then cooperatives shall be tried. In parallel with ownership transformation, organizational forms shall also be determined.

First, in advanced localities with a high degree of urbanization, shareholding banks shall be established based in the RCCs if they are sufficiently large and commercially oriented. Specific criteria are: (a) management is strong; (b) total assets exceed 1 billion RMB; (c) NPL ratio is below 15 %; (d) initial capital after restructuring exceeds 50 million RMB, and capital adequacy reaches 8%.

Second, in densely populated localities or prefectures/municipalities/counties designated as grain or cotton production bases, RCCs and RCC unions shall be consolidated into a unified legal entity. Specific criteria are: (a) positive net worth on consolidated basis; (b) consent by grass-roots level RCCs; (c) relatively strong management at the RCC union; (d) capital after ownership consolidation exceeds 10 million RMB, and capital adequacy reaches specified ratios.

²⁰ In this hybrid structure, decision-making in the RCC will be by one member one vote thereby preserving the cooperative nature. In the contract, dividends will be paid out according to shares held by members. As an experiment, a rural cooperative bank was recently created in Ningbo by merging the RCCs.

Third, in other localities, the current two-tier system where RCCs and RCC unions are both legal entities shall be continued to make them better cooperatives.

Fourth, effective measures shall be adopted to accelerate resolution of distressed and highly risky RCCs (no definition given), through mergers and acquisition. Those deeply insolvent RCCs that are located in urban or peri-urban areas shall be closed according to the *Regulations on Withdrawal of Financial Institutions*.

No matter what ownership structure is adopted, due diligence should be conducted to verify assets and to expand equity participation with the objective to inviting local residents, individual entrepreneurs, and economic organizations to participate. Corporate governance and internal checks and balances shall be effected in accordance with the requirements to establish modern enterprise systems. The new regional financial institutions (RFIs) shall adhere to the orientation serving *san nong*.

The management of RCCs shall be handed over to local governments.

The provincial government shall assume the following responsibilities over RCC management.

- (1) It will make sure the RCCs observe financial policies and guidelines set by the state and will guide their operations in the direction of serving *san nong*. Local party committees shall step up their leadership over RCC party membership and ideological work.
- (2) It will provide guidance to RCCs in accordance with laws and regulations to strengthen their self-discipline and supervise the election and appointment of RCC senior managers in accordance with laws and regulations.
- (3) It will take leadership in preventing and resolving financial risks of RCCs in its jurisdiction. The central bank shall provide temporary support in failure resolution, and fiscal authorities shall withhold future transfer payment to the provincial government should it fail to repay the central bank loans.
- (4) The provincial government will assist the RCCs in collecting old loans and in fighting willful default, in investigating and punishing fraud, and in creating a healthy credit culture and maintaining order and stability in rural finance.

In pilot areas where conditions are appropriate, an RCC union shall be established at the provincial level through which the provincial government can manage, guide, coordinate, and serve the RCCs. The provincial government shall adhere to the principle of separating government from enterprise and refrain from interfering in the business activities and operations of the RCCs. The managerial power shall not be delegated to lower levels of government, and no RCC union or other forms of independent managerial units shall be established at the prefecture/municipality level.

The China Banking Regulatory Commission shall assume regulation and supervision of the RCCs. Responsibilities include:

- (1) formulating regulations over RCCs in accordance with state laws and regulations;
- (2) authorizing the establishment, change and suspension of (rural finance) institutions as well approving their business scope;
- (3) conducting on-site examinations and off-site surveillance, collecting statistical information and conducting risk evaluation as well as investigating and penalizing violations of laws and regulations;
- (4) conducting fit-and-proper tests of senior managers;
- (5) providing regulatory data and relevant information to provincial governments and early-warnings on risky institutions and assisting provincial governments in dealing with risks;
- (6) providing training to specialized managerial staff designated by provincial governments; and
- (7) evaluating performance of provincial governments in managing RCCs and reporting findings to the state council.

In order to facilitate absorption of losses from the past and to pave the way for smooth implementation of the pilot, the central government, mindful of the need to avoid moral hazard, shall provide the following support.

- (1) Losses from indexed deposits during 1994–97 shall be verified and reimbursed in stages by the fiscal authorities.
- (2) From January 1, 2003 to December 31, 2005, income tax shall be exempted for all participating RCCs in the western region; it shall be halved for participating RCCs in other areas. Business tax shall be levied at 3% for all participating RCCs in all pilot areas.
- (3) Two options of financial support shall be provided to participating RCCs. One is for the central bank to set up a special facility to fund 50% of the negative net worth based on end-2002 data at half of the interest rate applied to required reserves with maturities ranging from 3, 5, and 8 years depending on specific local circumstances. Insolvency data shall be calculated based on each individual RCC and consolidated at the provincial level. The central bank facility shall be accessible only to provincial governments which will assume repayment responsibilities. The formula for

calculating negative net worth is: cumulative losses plus actual asset loss minus owner's equity minus loan loss reserves, of which actual asset loss is calculated by applying 40% to the sum of lost loans and doubtful loans, 10% to overdue loans, 10% to investments, and 50% to foreclosed assets.

The other option is for the central bank to issue special 2-year notes in exchange of the non-performing loans of RCCs at interest rates no lower than those on required reserves. The special notes shall not be tradable, endorsable, or used as collateral, but can be redeemed ahead of maturity with conditions attached. The disbursement of central bank notes shall be conditioned upon improvement in RCC reforms and shall be verified based on performance of individual RCCs at the county (municipal) level. The criteria set for disbursement include: clear ownership structure, paid-up capital, corporate governance in place, etc. Monitoring of performance criteria shall be conducted by local offices of PBC and CBRC as well as local governments. Participating localities shall be free to choose between the two options, details of which shall be specified by the PBC.

- (4) In those areas where informal finance is active, more flexible interest rates shall be applied. Lending rates shall be floated within a range of 1 to 2 times of the regulated rates; lending rates for micro loans to farmers shall not float upwards except in rare cases of high risk but then no more than 1.2 times regulated rates. In areas plagued with natural disasters, lending rates to farming households shall be floated downward as appropriate.

Implementation

Organization and leadership

The pilot to deepen RCC reform shall be organized and implemented by CBRC. Provincial/municipal governments can apply to participate in the pilot on voluntary basis. CBRC shall screen the applications and submit a short list to the state council for approval. The pilot starting in 2003 shall select 3-5 provinces from the eastern, middle, and western parts of China. Selected provinces shall formulate their own implementation plans for consideration by CBRC and final approval by the state council.

Timing

The pilot shall start in the second half of 2003, and efforts shall be made to strive for completion of the experimentation on managerial regime change. In the pilot areas, managerial functions

shall be handed over to the local government, and committed supportive policies shall be put in place. Ownership transformation tests shall be summarized and replicated throughout the whole country.

Issues for attention

- Avoid opportunistic behaviors to squander money, extend loans, and hire staff by taking advantage of the shifts in regime.
- Participating areas shall strictly observe the requirements set in this pilot scheme, and information exchange shall be maintained between central government agencies and local governments. Major problems during the pilot shall be reported promptly.
- Appropriate balance shall be maintained between pilot and non-pilot areas. In the areas not participating in the pilot, CBRC and its local offices shall continue to regulate and supervise the RCCs vigilantly to make sure services to san nong are maintained.
- Attention should be paid to avoiding payment risks. Local governments, PBC, and CBRC shall study mechanisms to deal with disruptive payment risks.