Rural Credit Cooperative Pilot Programs and Evaluation

Rural Credit Cooperatives in Guizhou: Status and Pilot Programs

The eight-province RCC pilot program initiated in the later half of 2003 is a milestone in the financial reform of the PRC. Compared with previous reforms, the pilot programs have (i) money for robust mechanisms and (ii) power for the provincial governments. The government is paying to get rid of the historical burdens of the RCCs and is delegating the power to implement reforms to provincial governments. This bottom-up approach marks a fundamental change from the top-down approach in previous financial sector reforms. If successfully implemented, future RCCs will better suit local economic development, the degree of penetration of markets, geographical location, effective financial demand and supply, and the performance of financial institutions. The objectives are to reform the RCCs while at the same time searching for financial innovations and to provide credit support to rural areas while ensuring financial sustainability.

Guizhou province is one of the eight pilot provinces. By the end of 2002, the total assets of RCCs in Guizhou reached CNY24.11 billion including outstanding loans of CNY12.55 billion and total liabilities of CNY24.1 billion including CNY14.35 billion in outstanding deposits. In addition, accumulated aggregate loss reached CNY910 million with a loss of CNY4 million in 2002. NPLs were CNY3.49 billion, accounting for 27.8% of total loans outstanding. Of all the NPLs outstanding, CNY150 million or 4.29% were bad loans, and CNY2.8 billion or 80.23% were idle (loans overdue for more than 6 months). With an overall capital adequacy ratio of -0.9%, 969 RCCs, or 17.2%, had negative equities. In this round of reform, the central bank has granted CNY719 million in central bank notes to Guizhou (see Table 24). According to central government regulations, RCCs need to pay only 3% of business taxes, and income taxes were exempted starting 1 January 2003. The Ministry of Finance approved CNY38.67 million in interest subsidies to RCCs that paid interest on indexed deposits for the period 1994-1997.

Under the pilot program, 84 county RCCUs in Guizhou (39 of them insolvent) were consolidated with RCCs into new legal entities in accordance with Document 15 of the State Council (see Appendix) following the principle of “taking into consideration the institutional capability, piloting in different batches, and accomplishing within a specific period.” Three RCCUs, Yunye District Credit Cooperative Union in suburban Guiyang, Huaxi District Credit Cooperative Union in the outskirts of Guiyang, and Meitan County Credit Cooperative Union of Zhunyi City (a national commodity grain production base), were selected to pilot rural cooperative banks. By the end of June 2004, the paid-in capital from

Table 24. Rural Credit Cooperatives in Guizhou: An Overview

(In CNY100 million unless otherwise specified)

Total Assets as of End 2003	298.84	Outstanding Non-Performing Loans as of End 2002	34.87
Total Liability as of End 2003	279.43	Aggregate Loss as of End 2002	9.13
Total Deposits as of End 2003	177.96	Capital Adequacy Ratio as of End 2002	-0.4%
Total Loans as of End 2003	148.58	Central Bank Note under the Pilot Program (2003-2004)	7.19
Number of Employees (In 10,000)	1.19	Ministry of Finance Subsidy for Interest Loss from Indexed Savings (2003-2004)	0.3867
Average Expenses per Employee in 2003	76,600	Estimated Income Tax Exemption and Reduction (2004)	0.13
		Business Tax Exemption and Reduction (2004)	0.3
Outstanding Agriculture On-Lending as of 2003	24	Additional Capital Required to Qualify for PBC Note	0.4127
Outstanding Loans Extended to Peasant Households as of 2003	7.6527	Additional Capital Required to Qualify for Cashing PBC Note	0.9382

member shareholders of all RCCs in the province reached CNY1.124 billion, CNY754 million more than that in 2002. The capital adequacy ratio was 3%, up from -0.9% before the structural reform (excluding the PBC notes factor).

Even under tight budget constraints, the governments at all levels in Guizhou strengthened their support for RCCs. Relevant measures include the following.

(i) **Establishing RCC Development and Support Funds:** Under the funds, the provincial finance department allocates CNY8 million per year from 2003 to 2007 to support development and risk management in RCCs. Statistics show that such funds have been established in 20 counties, cities, and districts.

(ii) **Supplementing Capital**: Twenty counties, cities, and districts have provided land, buildings, and budgetary support to supplement RCC capital.

(iii) **Arranging Budget Allocations:** In some counties, cities, and districts, allocations subsidize RCC business taxes, real estate taxes, tenure taxes, and stamp duties from 2004 to 2010.

(iv) **Promoting Operations of RCCs:** The provincial government has decided to entrust the management of microfinance poverty alleviation loans (formerly managed by ABC) to qualified RCCs. To implement the “Urgent Notice from the State Council on Improving Grain Production and Supply” (State Council Circular [2004] No. 9) and measures of the provincial government, the provincial RCCU issued a circular together with the provincial agricultural department and the provincial finance department to authorize

RCCs to handle business related to agriculture tax exemption of farmers and reductions and direct subsidies for hybrid fine rice production.

(v) **Strengthening RCCs' Deposit Base:** Most counties, if applicable, have deposited agriculture-related funds, education funds, off-budget funds of government agents, and special agriculture funds from the central government into RCCs.

(vi) **Exempting or Reducing Certain Fees or Charges:** This is done in coordination with relevant regulations of government authorities such as the Industry and Commerce Administration Bureau.

The provincial RCCU was established on 30 December 2003, and its affiliates in nine districts, prefectures, or cities were also set up and began operations upon approval of the provincial government. This signified the completion of the initial phase of RCC administrative reform in Guizhou. As Table 25 illustrates, in three counties or cities, rural cooperative banks have been chartered, and RCCUs in the other 84 counties have merged into county cooperative unions, with one for each county. The total paid-in capital of the provincial RCCUs reached CNY972 million, with CNY327 million in newly added capital in 2004 from fundraising and from issuing shares.

One key component of this round of the RCC pilot program is administrative reform, i.e., to transfer administration to the provincial government. However, as the provincial RCCU is inclined to maximize its own interests, the hidden danger is that the provincial RCCU will emphasize its operations while neglecting RCC sector management. This means measures are needed to minimize the role of the provincial RCCU and to limit its management responsibilities while improving RCCs at the grass-roots level. The key to resolving conflicts between respecting shareholders' rights and strengthening self-regulation is the power of senior management: the shareholder should extend a helping hand, not a controlling hand. In this respect and in line with the implementation of Document No.1 (2004) of the central government, the provincial authorities have:

(i) issued "Guizhou Provincial RCCU's Opinion on Supporting the Agricultural Sector, Rural Areas and Farmers" which emphasized that after the RCC pilot programs, better services should be provided to san nong by rural financial institutions irrespective of ownership and organizational structure;

Table 25. Rural Credit Cooperative Pilot Programs in Guizhou

	Amount (CNY100 Million)
Total Paid-In Capital	9.72
Newly Added Capital to RCC in 2004	3.27
	No.
Structure	
(i) Number of Rural Commercial Banks	0
(ii) Number of Rural Cooperative Banks	3
(iii) Number of County Level RCCU / Bank (After Merger)	84
(iv) Number of 2-Level RCCU	0

(ii) guided the provincial RCCU to draft "Guizhou Provincial RCCU Operation Objectives and Business Development Plan (2004-2006)," and signed "Commitment to Attaining Comprehensive Objectives for 2004" with county, city, and district RCCs;

(iii) guided the provincial RCCU in drafting and implementing over 40 sector-specific rules and regulatory documents, including "Rules on Financial Management for RCCs in Guizhou Province" and "Temporary Management Rules for Employees of RCCs in Guizhou Province";

(iv) issued "Contingency Plan for Risk Prevention and Disposal for RCC Pilot Programs" which defined the responsibilities of government authorities at all levels on risk prevention and mitigation;

(v) issued "Opinions on Assisting RCC to Collect Loan Repayment and to Punish Debt Evasion and Abrogation" which required that government authorities at all levels take effective legal, economic, and administrative measures to collect NPLs and to punish debt evasion and abrogation (with the government's efforts, the RCCs had collected NPLs up to CNY350 million by the end of June 2004); and

(vi) normalized the relationship between city and county governments and RCCs. The administrative power of the RCC has been vested in the provincial government that has to motivate the county and city governments to support RCCs without delegating power to them. For this, the provincial government has clearly defined the duties of the county and city governments. These include, among others, (a) to take practical measures to support the RCC, create a credit culture, and prevent and mitigate risks in a timely fashion, (b) not to intervene in RCC operations and human resource management, and (c) not to use RCCs for direct lending. These will support RCC development within their respective administrative areas and effectively prevent excessive intervention. The provincial government is drafting "Administrative Regulations for RCCs in Guizhou Province" to regulate the relationship between governments at all levels and RCCs.

Financial Innovations

RCCs in Guizhou have experimented with numerous low-cost financial innovations. Whether such innovations can be adopted in the pilot programs would be important for the success of reform.

Market-Based Risk Disposal Mechanism

Establishing a market-based risk disposal system can enable risk sharing among various players. Aquaculture businesses in Guizhou have huge market potential thanks to the province's unique natural conditions, distinctive seasons, and low pollution levels. To turn potential benefits into material gains requires a supportive environment in which credit support is the key. However, huge risks beyond the scope of credit such as natural calamities, plagues, and the adoption of new technology need to be addressed. Under the fixed interest rate regime, such risks are beyond RCCs' capacities. Without a proper risk sharing mechanism, an RCC can only avoid risks through credit rationing under which even farmers with profitable projects are unable to obtain credit. Without financial support, these farmers have to miss opportunities.

In some areas in Guizhou (e.g., Danzhai County), the risk-sharing mechanism established by local governments, insurance companies, rural households, and financial institutions has contributed to overcoming excessive risks in agricultural loans. This has also reduced the risks of RCC loans which enabled their relatively low interest rates to cover their costs. More importantly, this mechanism has facilitated agricultural specialization and has helped form a reliable credit clientele. Under this win-win arrangement, farmers' incomes have increased, and RCCs have cultivated a high-quality customer base. The operation of the mechanism is simple. First, the local governments need to allocate part of their budgets or fiscal funds for poverty alleviation to subsidize rural households' insurance premiums with insurance companies. Then insurance companies need to introduce special agricultural insurance products. With insurance coverage, RCCs can lend to insured borrowers without collateral or with the insured products (e.g., livestock) as collateral.

Information and Risk Sharing with Local Institutions

Making use of local institutional resources such as Farmer Professional Associations and Production Cooperatives can increase lending quality and improve client relationships. In the days of the collective economy, RCCs made loans backed by the goodwill of the village or by collectively owned enterprises. The adoption of the household responsibility system with remuneration linked to outputs has forced RCCs to deal with individual households based on their own credit worthiness. This has increased credit risk and the cost of collecting credit information. With some farmers leaving their land and with increased agricultural specialization, scattered farmers have begun to organize themselves. It will be important for RCCs to deal with a variety of farmers' organizations. Through these specialized organizations, RCCs can gather useful, accurate information on farmers. Some RCCs in Guizhou have coordinated with local farmers' professional associations or production cooperatives and have successfully used their information to improve loan quality.

In some towns in Meitan County, RCCs have taken advantage of the presence of local aquaculture businesses to sign feed procurement and sales contracts with suppliers on their behalf. This links rural household loans directly with feed supply assuring the loans are put to good use and that valuable information is collection. At the same time, RCCs have established lending risk funds that use wholesale and retail price differences to enable sharing of credit risks. RCCs have also established a risk sharing mechanism with local quarantine authorities. In some places, RCCs, local quarantine authorities, and village officials have established an accountability mechanism. Under this mechanism, if livestock die of disease, the local quarantine authority will bear 50% of the loss, village officials 10%, and rural households the remainder.

Group Guarantees and Microfinance Lending

Group guarantees and microfinance lending can help resolve issues of credit rationing caused by asymmetric information and can expand credit coverage. The bottleneck of rural finance is the asymmetry between returns to and the costs and risks of RCCs. If the costs and risks of RCC loans can be reduced by group guarantees or credit ratings, the RCC model can become commercially sustainable even under a relatively low interest rate scenario. Of course, feasibility depends on local tradition, culture, and individual relationships. In Fenggang County, group guarantees among hog raisers have been frequent because of the close cooperation among hog raisers, quarantine authorities, and RCCs.

Collateral Substitutes

Lack of effective collateral is the prime obstacle for rural households in obtaining loans. Property such as land and houses cannot be used for collateral, and agricultural production is seasonal. These factors have increased lending risks for RCCs. Moreover, group guarantees and microfinance are applicable only to rural households with small demands. To overcome such difficulties, some RCCs have begun to introduce effective collateral substitutes (those not legally recognized but that can serve as collateral) such as bills of lading, plant harvest rights, and livestock. More RCCs have gathered information on clients through direct involvement in production and sales activities of local quarantine stations and leading enterprises which is another substitute for collateral. Nevertheless, due to the lack of a legal base, the development of this type of operation is limited. A possible future direction can be that when made-to-order farming emerges, orders can serve as a form of collateral. Furthermore, loans can be made against credit ratings of individual guarantors.

Government Interest-Subsidized Loans

These loans can also diversify credit risks of rural households. In Guizhou, some local governments have introduced a variety of special interest-subsidized loans for raw silk production, hog raising, tea production, and the like. Some local governments share 50% of the interest, and some discount the interest rate to the level of ordinary RCC loans which makes the effective interest rate for rural households 2.4‰ per month. These special interest-subsidized loans have reduced the default ratio of rural households without affecting effective resource distribution and have turned the implicit demand of rural households into effective demand.

Informal Finance

Informal finance has two advantages over formal finance: low information and collateral requirements. First, informal finance can effectively utilize informal information to identify the effective financial demand of rural households through local networks. Second, informal finance can discover substitutes for collateral such as a wide array of social relationships among individuals, business ties, and other informal relationships to ensure timely repayment of loans. However, the status of informal finance is not normally recognized because of the traditional financial management system. Some financial institutions tend to treat informal finance providers as competitors and brand them as usurers. In fact, the scarcer the RCC funds and the higher the NPL ratios are, the more insistent the efforts to discourage informal financiers become.

Informal finance has become an important supplement to formal finance. On the one hand, the borrowers of informal finances are those formal financial institutions are prejudiced against. These clients have small financial demands but require flexible timing and are associated with high risks. The growth of informal finance can help these borrowers. On the other hand, informal finance can support profitable projects, the success of which can help rural households to become quality clients of RCCs. It may be useful to issue local regulations to allow informal finance to exist under certain conditions and to compete with financial institutions. In addition, the criminal code should be amended to address the crimes of illegal fundraising and the offenses of disrupting financial order. These crimes or offenses should be addressed by laws and regulations cracking down on usury. For example, regulations can be issued to set interest rates and lending ceilings for informal finance according to the local situation. Through these, informal finance can be developed to supplement formal finance. In some places, informal finance can even become the major player in rural finance. India's experience in combining formal and informal finance can serve as an example. In India, an average of 10 to 20 rural households form self-help groups which can engage in lending activities through formal financial institutions. Financial institutions provide loans to the self-help groups according to their credit records, and disbursements are based on a positive incentive principle. The initial amount is small but increases with timely repayments.

Target Moderately Poor Rural Households

The demand of rural households for funds can be categorized into commercial demand and social welfare demand. The former may be met by formal or informal financial service providers and the latter by government agencies. Some local governments (e.g., Taijiang County) and RCCs have realized that loan support should be mainly provided to moderately poor rural households with effective demands for funds that they are capable of repaying. These households will then be able to help relieve destitute farmers by offering employment opportunities. This can partially reduce the pressure on RCCs to provide loans to the agricultural sector.

Evaluation of Rural Credit Cooperative Pilot Programs

The RCC pilot programs initiated in the second half of 2003 in eight provinces are important experiments to correct the serious mismatch between rural realities and financial sector reform and development in the past two decades. The main objectives of the reforms are to encourage financial innovations that suit local economic development and to establish a modern rural finance system to meet the financial demands of localities, industries, and households with varying income levels. Different economic and market structures have resulted in a variety of demands for financial services from different regions of the PRC. In the eastern region, demand for rural finance mainly comes from the non-agricultural sector while in the central region it comes from aquaculture. In the west, most financial demand is for protecting livelihoods generated by uncertainties in agricultural production. Different regions have different *san nong* problems. The main issue to resolve rural financial problems in the eastern region is with rural areas, in the central region, with the agricultural sector, and in the west, with farmers.

One key to successful RCC reform lies to a great extent in eliminating the RCC monopoly in rural financial markets. Monopolies, a by-product of the planned economy, are by nature rigid in the face of changing demand and have to be abolished in order to establish an efficient and sustainable market with a variety of useful products. In other words, the RCC pilot programs should adopt different approaches in different provinces. That is, different types of financial institutions or service providers that suit local socio-economic and geographical situation should be adopted. Unfortunately, the design and progress of pilot programs in Guizhou do not seem to have addressed this core issue.

Moral Hazards in the Rural Credit Cooperative System Remain to be Addressed

An efficient system should balance rights and responsibilities, efforts and incentives, and investment returns and risks. In the present system, county RCCUs (the managers) need to expand their capital bases to meet capital adequacy requirements, but they do not need to report to their shareholders. The shareholders, deprived of their rights as principals, want to pursue high short-term returns with minimum risks. Each provincial RCCU has the right to appoint the director of a county RCCU (one director per county), but it is not responsible for the county RCCU's performance.

The RCC pilot programs heavily emphasized merging and changing titles of institutions but ignored much-needed reforms of mechanisms. When an RCC director was asked about the differences before and after reform, he replied that the two-level legal entity system had become a unified legal entity at the county level and that the regulator had changed from PBC to the provincial RCCU. Although some RCCs have expanded their capital bases and have introduced membership and investment shares, the directors of RCCs and county RCCUs are still appointed by the regulatory authorities. The shareholders do not have the right to appoint senior management, and the shareholders' meeting and the supervisory board are still rubber stamps. The asymmetry between shareholders' rights and responsibilities has created stocks of time deposits with high interest rates, as the main objectives of the shareholders have turned out to be convenient borrowing and preferential interest rates.

The pilot programs have not addressed operational issues such as incentives, supervision, and exit mechanisms of RCCs. The moral hazard problem has not been resolved as RCCs still use credit support for *san nong* as an excuse for their losses. This deviates from the intended objective of "money for better mechanisms" of the pilot programs. In addition, the RCC model is still the only model in operation, RCCs still have a monopoly in the market, and their operational environments remain the same. Simply put, the pilot programs continued to follow a top-down approach that is not in line with the guiding principles advocated in Document 15 of the State Council. With the same RCC system and staff, it is hard to discern the changes the pilot programs have made.

Loans for Supporting Agriculture Incur High Costs that Undermine their Sustainability

The organizational structure and weak corporate governance of RCCs have resulted in high average costs per employee, a high NPL ratio, and low rural household coverage making it too costly for poverty-stricken areas. The reasons for NPLs include moral hazards, government interventions, and agricultural risks. Because of asymmetric information, it is difficult to differentiate risks from natural cause from risks due to human causes. In fact, loans classified as supporting agriculture have become an excuse for moral risks. Although RCCs cannot avoid losses from natural calamities, people responsible for losses do not take responsibility because the losses were made to support farmers. More importantly, no one seems to be concerned about the huge amount of NPLs of RCCs. Credit support for *san nong* needs a new approach, i.e., efficiency should come first, and support should be market based. Otherwise, it would be like draining the pond to catch a fish.

Much of the PBC's On-Lending is Used to Benefit Rural Credit Cooperative Employees before it Benefits San Nong

The objective of rural finance reform is not limited to protecting benefits for RCC employees. Without a proper governance structure, RCC development cannot go hand in hand with support for *san nong*. In many areas of Guizhou, the average annual expenses for an RCC employee are CNY60,000-80,000, higher than those in the eastern region. This indicates that preferential policy treatment and PBC on-lending have failed to achieve their intended objectives, i.e., on-lending was used to benefit RCC employees rather than *san nong*.

Reforming Finance and Nationalizing Risks

On one hand, Guizhou suffers from inadequate social security and cooperative medical systems in rural areas. Some medical expenses that are covered by RCC loans should have been covered by fiscal expenditures. When RCC funds are used as public finance, losses are inevitable. On the other hand, much of the local government budget is used to cover employee expenses. Under heavy pressure to develop the local economy, the local government will naturally instruct RCCs to use their funds at the government's discretion because RCCs are the only financial institutions under the local government's influence. When the local supply of funds is insufficient, PBC on-lending has become the sole funding source, and the central government has to bear the subsequent risks.

The Main Constraint of Rural Credit Cooperatives is Not a Shortage of Funds but a Lack of Mechanisms

The only focus of RCC pilot programs is money, and all efforts are centered on the special 2-year PBC notes (see Appendix). This is off target. Outstanding PBC on-lending to RCCs in Guizhou was CNY2.4 billion at the end of July 2004 while funding for the pilot programs was less than CNY800 million. If the vast amount of PBC on-lending can not resolve RCC issues, it is difficult to believe that a PBC contribution of one third that amount can make much difference.

In our field interviews with RCC directors, we asked two questions: (a) if you were the owner of an RCC, would you operate it in the present mode, and (b) if you were the owner of an RCCU, could you make money? The answers to the first question were all negative while the answers to the second one were all positive. The major problem with many RCCs lies in their lack of efficient mechanisms to activate idle capital and attract investors, not in a shortage of funds. The establishment of an efficient mechanism should have been a high priority in this round of pilot programs, that is, using an efficient mechanism to attract capital and using a sustainable mechanism to retain capital.

The Arrangement of Provincial Rural Credit Cooperative Unions Can Barely Meet Diversified Rural Financial Demands

The one-size-fits-all approach in establishing county and provincial RCCUs may be convenient for RCC management, but it concentrates risks on county and provincial RCCUs. If the central government required the provincial government to shoulder the risks inherit in reforms, it would still be a question of whether Guizhou would be able to do so.

The weaknesses in the provincial RCCU system are numerous. First, the system uses management to replace regulation. Regulators bear no risk while the manager has no one to blame. Second, provincial RCCUs may be suited for other provinces but may not be suited for Guizhou. Areas in Guizhou differ in their levels of economic development and financial demands, and the same provincial RCCU policy may not apply to all. Third, the provincial RCCU arrangement is likely to inhibit financial innovation. This is because county RCCU operations have to follow the directives of the provincial RCCU, but some directives may neglect local financial demands. Moreover, all RCCs have to become members of the provincial RCCU which constitutes a de facto monopoly and precludes any outside competition. Monopoly is the natural enemy of financial innovation.

The Selection of New Mechanisms is Not Done by Shareholders

The key to success in RCC pilot programs is who should decide on new mechanisms. The impact of the pilot programs and the local capability for innovation will be restricted if the pilot programs must delegate decision-making power to provincial governments to decide the model for the pilot. In this way, it is difficult to avoid following the same path as previous attempts in the past decade, and concerns of "old medicine in a new bottle" will still need to be addressed.

To resolve the issue of who determines a new mechanism, the role of the government should be transformed. Instead of directing reform models, the provincial government should design a new mechanism that is both adaptive and flexible with self-correcting capability. In other words, the duties of the government are to set the principles that will allow RCCs to operate and innovate on a market basis according to local situations. Specifically, all types of RCCs and investors should be allowed to make decisions about merging and restructuring. RCCs should decide for themselves whether or not to join county RCCUs, to be independent, to form another alliance, or even to form a rural commercial bank. Potential investors should also be allowed to form new financial institutions. Only in this way can there be effective competition among financial institutions and will farmers be able to find reliable institutions for financial services. In short, an efficient mechanism will encourage diversification of financial institutions and competition among them and will protect the interests of borrowers and depositors.