Policy Suggestions

An improved rural financial system is needed for efficient rural financial intermediation to serve the rural population effectively. Efficiency is one of the most important criteria for a rural financial model, be it cooperative, commercial, or informal finance. For example, if the government insists on the so-called cooperative system and requires RCCs to make all loans locally, we may end up with NPLs as large as two thirds of loan amount. On the other hand, if the government requires that only 50% of RCC loan amount be allocated locally, RCCs may be able to sustain themselves commercially. If commercial operation is allowed, 50% of the deposits from rural areas can be used locally, the support for rural areas will be much stronger, and local governments can then be freed from "paying" for NPLs made by commercial institutions. Therefore, the guiding principles of rural finance reform are to open the rural financial markets and encourage various forms of financial institutions to compete on a level playing field. This should also be the major difference between this round of reform and the previous ones.

Rural financial markets in Guizhou province have tremendous potential. First, the province has a large number of migrant workers, and their remittances are an inexhaustible source of funds for financial institutions. Second, with appropriate mechanisms, reforms in the near future will retain part or all of postal savings. Third, Guizhou has become an integral part of the national economic system over the past 20 years, and regional division of labor is emerging. If it can take the initiative, the province will be able to catch and create opportunities. Fourth, financial institutions have tremendous potential for innovation. Various types of credit guarantee and risk sharing arrangements such as microfinance, and group guarantees will greatly enhance credit quality. Financial institutions can be profitable if the financial markets open up, if fair competition is allowed, and if exit mechanisms are available for under-performing institutions. Fifth, the withdrawal of SOCBs from rural areas has provided a large platform for the development of grass-roots financial institutions. Sixth, PBC is adjusting on-lending to the central and western regions under the fixed total volume of loans supporting agriculture. Lastly, some RCCs are making innovations with support from local governments in an effort to reduce credit risks. Some RCCs have also made good efforts to meet the credit demands of specialized agriculture as the incomes of the rural households engaged in agricultural industrialization are much higher than those of other households.

New mechanisms must be designed to curb the present outflow of human and financial resources from poverty-stricken areas. Such mechanisms should enable RCCs to make profits on loans to rural households and to achieve economies of scale while satisfying local demand for financial services. However, it is not desirable to have a mechanism that only sustains RCCs but that does not satisfy local needs and creates a vicious cycle of low levels of economic development, low per capita incomes, low savings rates, low investment levels, and a lack of dynamic for development. Financial institutions in poverty-stricken areas need preferential policy and capital support, but more importantly, they need efficient mechanisms. Rural financial reform requires systemic efforts, concerntrating only on RCC reform cannot succeed.

Market-Based Interest Rates will Induce Flows of Funds to Poor Areas

With large numbers of clients spread over extensive areas, small loan sizes, and high transaction costs and risks, rural financial institutions can survive only with an adequate interest spread. Liberalization of interest rates on loans is one prerequisite for the sustainability of rural financial institutions and for the flow of funds to rural areas. Our survey shows that when rural households have to choose between high interest rates and accessibility of loans, they prefer the latter. However, liberalizing interest rates for loans may be used by RCCs to transfer their low efficiency to farmers given their monopoly status in the current rural financial market. In addition, liberalizing interest rates for deposits may also cause fierce competition among financial institutions if those with high risks increase their rates to hide operational losses.

Nevertheless, liberalizing interest rates is the only way to go in the future, and it has to be done in parallel with opening markets. Without adequate interest rates, suppliers will not enter the market. Only when interest rates are sufficient to cover costs and risks, competition among market players may be able to drive the rates down. Bolivia is a good example. When interest rates were first liberalized, the rates climbed rapidly but were then were pushed down to a reasonable level by microfinance market competition. This is called the competitive equilibrium of interest rates, but it cannot be achieved in the PRC where there are many counties with one RCC as the only financial institution.

Introduce New Types of Financial Institutions and Explore New Forms of Financial Organizations

Preconditions for successful RCC reform include opening rural financial markets, introducing various types of financial institutions, and establishing a competitive environment. In addition to formal financial institutions, regulated and commercially oriented microfinance institutions (engaging in lending only and initially prohibited from taking deposits), village-based cooperative associations, privately owned banks, and informal finance providers should all be considered. Options for organizing RCCs should not be restricted to the types stipulated in Document 15 of the State Council. The keys to their success are their fitness in local markets and ability to create financial innovations. In rural areas in Guizhou with difficult transportation conditions, the management costs of the provincial RCCU, the supervisory costs of the Bank Supervision Bureau, and the operational costs of the county RCCU are high. Community-based financial institutions with good governance structures will help serve the local economy including *san nong*. Therefore, each area should be allowed to develop new forms of financial institutions and let the markets decide the winners.

In the near term, several potential directions in promoting competition in rural financial markets include RCC reform, pilot tests of regulated microfinance and cooperative finance in real sense, and legalization of informal finance. In the early stages, provincial pilot programs for regulated microfinance agencies that do not accept deposits can be considered. These institutions can initially use their own funds and those donated by international organizations. At a later stage, funds from wholesale institutions (e.g., postal savings) can be a major revenue source. These institutions can avoid possible moral hazard problems from taking public deposits without prudential financial supervision. This is different from institutions accepting deposits that are backed by implicit state guarantees against loan losses which can lead to moral hazard problems. The development of regulated microfinance institutions can not only introduce competition in the rural financial market, it can also play an important role in legalizing informal finance.

Implement Market-Based Rural Credit Cooperative Pilot Programs

Based on the theory of financial hierarchy, different financial institutions have their advantages and disadvantages, and the market should select the survivors. In the PRC, cooperative finance is not cooperative finance in a real sense as it has to address policy issues. In fact, neither cooperative nor commercial finance can be sustained with government intervention. The government should not preempt any form of financial institution; the market and investors should have the final say. To achieve this, policymakers should answer the following questions. Is it possible to allow some RCCs to stay out of a county RCCU? Is it possible to allow two RCCUs in one county? Is it possible to allow some county RCCUs to stay out of a provincial RCCU?

Establishing cross-regional RCCs should be allowed. Interventions in RCC operations mostly come from local governments, especially county and town governments. Establishing cross-regional RCCs would avoid the current overlapping of administrative and business regions. That is, one RCC could cover several towns, and if needed, an RCCU could cover a number of counties. The number of towns and counties covered by each local RCC or RCCU may not be large, but should not be fewer than three. Using the game theory, it is highly possible for two county and town governments to collaborate in rent-seeking from RCCs, but the possibilities for collaboration are much lower if three or more than three towns and counties are involved. This is in line with the PBC strategy of establishing cross-province regional centers to prevent local government interference.

Profitable RCCs should be allowed to choose to join an RCCU or to stay outside at their own discretion. Under the present pilot program, RCCs have no choice but to join the RCCU system which will prevent any external competition. This has essentially led to monopolies, the natural enemy of innovation. If profitable RCCs are allowed to join RCCUs or to stay outside, a competitive environment will be created. This will also resolve the problem of exit mechanisms and subject RCCs to market discipline.

Create an Enabling Environment for the Sustainable Development of Rural Credit Cooperatives

Most areas in Guizhou are inhabited by minorities and are underdeveloped. Although reforms and policies of the central government that support them have helped to innovate systems, transform mechanisms, and enhance support for agriculture, RCCs in the province still face a set of particular difficulties due to weak agriculture infrastructure, a large poverty-stricken population, and a high incidence of poverty. These difficulties include heavy historical burdens and the lack of an exit mechanism.[13]

By the end of 2003, the cumulated losses of all provincial RCCs reached CNY1.45 billion, in addition to CNY2 billion in NPLs due to policy and system changes[14] and to political interventions. Statistics from supervisors show that total outstanding RCC liabilities were CNY1.438 billion more than their capital by the end of 2002. About 50% of the amount, or CNY719 million, has been covered by funds from the central government, while the rest needs support from RCCs and local governments. As an underdeveloped province with many poverty-stricken areas, RCC development should be on a progressive, long-term course as it is almost impossible to resolve all historical problems in the short-term.

Many RCCs are unable to make ends meet but cannot be closed, and they are unable to get out of their difficulties by themselves. Among the 959 RCCs at the grass-roots level, 748 have deposits of less than CNY2 million per RCC employee, of which 234 have deposits per employee of less than CNY1 million and can hardly survive but cannot be closed. Most of these RCCs are in remote areas where ethnic minorities live. They have to cover extensive service areas with difficult transportation conditions and poor operating environments. Although current policies permit their merger and closure, this will at the same time create a financial service vacuum in serving san nong that is unimaginable for both the farmers and the governments.

To get RCCs out of difficulty, party committees and governments at all levels of Guizhou Province have made great efforts that have boosted RCC development and smoothed implementation of the pilot programs. However, the provincial government cannot solve the fundamental problems faced by RCCs. It is worth noting that RCCs in the western region differ from their eastern counterparts in business size, NPL size, operating environment, and sustainability. Although the policy on the pilot programs is set according to the level of local economic development and to the geographical and social environment, the actual result of implementation shows that those RCCs in the western region in need of support have not benefited much.

In addition, except for those not-so-significant preferential taxation treatments and "policy fund selections", other support policies are uniform. In the long run, the resolution of issues of RCCs in Guizhou depends on the development of the local economy and the deepening of reform efforts, especially transforming operating mechanisms and improving RCC institutional capacity. Nevertheless, in the short term, it is necessary for the central government to introduce further supporting policies and measures. These can include, among others, prolonging the exemption period for corporate income tax in the western region, removing business taxes, and establishing an RCC development fund in the western region to build an electronic network, purchase an armored car, and train employees.

Other elements of an enabling environment include the development of agriculture insurance and futures market for agricultural products, promotion of financial innovation of rural financial institutions, and provision of substitutes for collateral and guarantee for rural households and SMEs.

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[13] PBC only shared half of the costs, and some local governments of poor areas could not afford the remaining half. In addition, the rural financial markets are monopolies, and there is no deposit insurance mechanism.

[14] When RCC management was separated from ABC in 1999, ABC transferred a large amount of NPL to RCCs. In addition, RCCs suffered huge losses when the central government decided to close five types of small enterprises (hydropower, etc.) and when the central bank required indexed loans to guard against inflation.

Role of the Government: Create an Environment to Attract External Funds to Poverty-Stricken Areas

The central government should increase inputs into infrastructure in poverty-stricken areas including transportation, communication, water conservation, education, and health care. A social security system in rural areas should also be created to enable RCCs to conduct commercial operations. Presently, many RCC loans have been used for public aid and as public finance funds. A healthy public finance system in rural areas is the basis for a sound rural financial system and a prerequisite for preventing local government intervention in the operations of rural financial institutions. The provincial government should regulate the behavior of local governments. Regulations are also needed to punish debt evasion and to establish standards for creditworthiness for households, villages, and townships[15] in order to create an enabling credit environment. Only with a good credit environment can more external funds be attracted.

In addition, the government should change the use of poverty alleviation funds for interest-subsidized loans to a risk-sharing fund to mitigate some financial risks of RCCs or to distribute subsidies directly to households. This will leverage fiscal funds and strengthen awareness of finance and risks in rural households. Many rural households regard interest-subsidized poverty loans as aid that does not need to be repaid. This has distorted market order. Financial awareness can only be strengthened when the poverty alleviation loan is renamed, when there are no preferential interest rates, and when risk premiums are decided by creditworthiness. Meanwhile, rural households will acquire risk awareness when families with high credit ratings can borrow at low interest rates while families with poor ratings will have to pay more and will have little bargaining power. This does not mean that subsidies will be completely abolished; instead, direct fiscal subsidies can be provided to destitute rural households. The only difference is that support is provided by the government through fiscal aids rather than by financial institutions through loans.

The establishment of a risk-sharing fund can also help to maintain order in financial markets. With such a fund, loans from financial institutions can carry only market-based interest rates. This will prevent potentially destructive competition among financial institutions that use interest-subsidized funds to invest in commercial projects thus creating an unequal playing field. Some ABC branches in certain areas have used poverty alleviation loans[16] to compete with other commercial banks on small hydropower and express road projects, thus distorting the markets. In the future, interest-subsidized loans should be stopped, and loans should carry only normal interest rates aligned with risk and creditworthiness. The government will provide direct support to destitute households. These measures will effectively keep the financial markets in order. Moreover, preferential tax treatment can also reduce operation cost of financial institutions, and encourage them to set up more outlets in poor areas.

[15] For example, if the repayment rate of the village as a whole is more than 95%, the village can be qualified as a "creditworthy village." This will enable the village to get lower interest rates for PBC-supported microfinance lending. Or an RCC can choose to let the village rate the households of the village which will enable them to get loans more easily. Nevertheless, RCCs in practice set the lending limits of the households within the limit of their own deposits and PBC on-lending.

[16] The poverty alleviation fund is distributed mainly through the Agricultural Bank of China.

Promulgate a Community Re-Investment Law and Establish a Mechanism to Reduce the Outflow of Postal Savings

Rural areas suffer from large outflows of funds. Many state-owned financial institutions take deposits but make few loans in these areas, and postal savings has extracted large amounts of funds from rural areas by re-depositing them in PBC. Such outflows over a long period of time will inevitably hamper the growth of the rural economy. The PRC should learn from international experience to promulgate laws and regulations on community re-investment. The community re-investment law in the United States requires financial institutions to meet credit demands of their communities if operations are based on sound and prudential criteria, though no compulsory ratio is specified.[17] In comparison, Thailand requires all financial institutions to lend 20% of all deposits to the agricultural sector. More research is warranted on which model the PRC community re-investment law should adopt, and more time is needed to formulate regulations or directives.

Nevertheless, pumping postal savings back into rural areas and increasing rural financial inputs through ADBC can be implemented in the near future. In the PRC, one third of postal savings comes from rural areas, one third from counties and towns, and the remainder from cities. In Guizhou, CNY800 million in new deposits have been added since August 2003 which can be used at the discretion of postal savings authorities.[18] Without opening rural financial markets, keeping postal savings where they originate will only strengthen the monopoly status of RCCs and will present a significant moral dilemma. In addition, in the absence of a deposit insurance system, the inflow of postal savings to rural areas through RCCs still presents an asymmetric risk, i.e., the borrower is the provincial RCCU but the actual user is the county RCCU. Therefore, liberalization of rural financial markets has to be integrated into the determination of a potential market-based mechanism to induce additional postal savings back to rural areas. Also, the internal control mechanism of ADBC should be improved, and its operational transparency should be enhanced. With this, the operational scope of ADBC can be expanded according to its capability.

Separate Regulation from Management and Implement Minimum Regulatory Requirements

The current financial supervision system in the PRC is an integral part of the traditional government administration system; administrative intervention or micro-management is the main means of supervision. Financial supervisors lift market entry criteria for financial institutions especially for private financial institutions through administrative approvals. They direct the lending of financial institutions under the name of supervision. They set the goal of supervision as reducing NPLs, not as safeguarding the soundness of the financial system.

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[17] The Community Reinvestment Act (CRA), enacted by Congress in 1977 (12 U.S.C. 2901) and implemented by Regulations 12 CFR parts 25, 228, 345, and 563e, is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods, consistent with safe and sound banking operations. The CRA requires that each insured depository institution's record in helping meet the credit needs of its entire community be evaluated periodically. That record is taken into account in considering an institution's application for deposit facilities, including mergers and acquisitions. (http://www.ffiec.gov/cra/about.htm) Most depository institutions have at least one CRA officer responsible for implementing CRA and meeting the regulatory requirements.

[18] Starting 1 August 2003, PBC reduced the interest rate for new re-deposits from postal savings to the level of interest rate of reserves of financial institutions and allowed postal savings to use the new deposits at their discretion. Prior to the date, the interest rate for re-deposits from postal savings was 4.131%.

They apply uniform supervisory standards for all financial institutions. These practices, combined with limited supervisory capacity, have limited the diversification of financial institutions.

Therefore, the success of RCC pilot programs also depends on the reform of supervision. First, a firewall between supervision and micro-management should be built. Such a firewall can prevent moral hazards in RCC operations as well as excessive supervision. Second, minimum regulatory requirements should be implemented. A rigid supervisory legal framework may suffocate financial innovations; this is particularly true in transitional economies. The main objective of supervisory authorities is to prevent financial risks while avoiding rigidity in supervision. Minimum regulatory requirements can ensure basic financial safety while leaving room for financial innovation.

Enhancing Regulatory Mechanisms and Establishing a Deposit Insurance System

Supervision of RCCs is relatively difficult because RCCs are normally in scattered geographical locations which makes collecting information more expensive. To ensure efficient supervision, it is imperative to strengthen the governance structures of rural financial institutions and to improve their operational transparency. An efficient supervisory mechanism should be a positive incentive mechanism at the heart of which are prompt corrective actions. Under such a system, the supervisor should take actions such as restricting the business scope and dividend distribution of a financial institution whose capital adequacy ratio, leverage ratio, and / or other performance indicators are beyond certain initial thresholds. These actions may prevent managers from taking more operational risks or other actions that endanger the interests of the shareholders. If performance indicators reach the second threshold, the regulator may request acquisition or merger of the financial institution to maximize its value and protect the interest of shareholders. If performance keeps on deteriorating, the regulator should take actions to close the institution when its assets are still at least equivalent to its liabilities.

In the PRC, it is also necessary to establish a timely and effective exit mechanism under which small and medium-sized depositors can be properly protected and compensated in case of failure. Therefore, a deposit insurance system should be established as soon as possible. While opening rural financial markets, the regulator should take corrective measures to strengthen regulation in accordance with the development of rural financial institutions. Meanwhile, a deposit insurance system should be established to ensure the effective operation of the rural financial markets.

Establish an Evaluation System for Rural Credit Cooperative Pilot Programs

The results of any reforms will vary in different regions and external environments; this is particularly true of financial sector reform. An evaluation system can be used to alleviate risks in reform, to summarize experience, and to improve reforms in the future. The evaluation system for RCC reform should cover, among others, the following three aspects: (i) the post-reform sustainability of RCCs; (ii) the compatibility between the post-reform rural financial system and the local economy; and (iii) the post-reform capacity for financial innovation. Only with such an evaluation system will PBC notes with futures options be valuable.