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People's Republic of China: Rural Finance Reforms and Development of Microfinance Institutions for the Inner Mongolia Autonomous Region

Prepared by Mel Brown (Agriculture Banking Specialist), Enjiang Cheng (Micro finance Specialist) and Ingrid Fischer (Rural Finance Specialist)

For the Asian Development Bank

Asian Development Bank

CURRENCY EQUIVALENTS
(as of 31 of March 2005)

Currency Unit	–	Yuan (CNY)
CNY1.00	=	USD 0.1208
USD1.00	=	CNY 8.2144

ABBREVIATIONS

ABC	–	Agricultural Bank of China
ADBC	–	Agricultural Development Bank of China
ACB	–	Agriculture Commercial Bank
ACOB	–	Agriculture Cooperative Bank
ADB	–	Asian Development Bank
ARRCCU	–	Autonomous Region Rural Credit Cooperative Union
ASOL	–	Agriculture Support On Lending from PBOC
CAR	–	Capital adequacy requirement
CBRC	–	China Banking Regulatory Commission
CCC	–	China Cadet Corps
CFSD	–	Cooperative Supervision Department of CBRC
CICETE	–	China International Center for Economic and Technical Exchange
GDP	–	Gross domestic product
IMAR	–	Inner Mongolia Autonomous Region
IMFO	–	Inner Mongolia Financial Office
MCL	–	Micro Loans
MFI	–	Micro Finance Institution
MFP	–	Micro Finance Program
MIS	–	Management information system
NBFI	–	Non bank financial institution
NGO	–	Non government organization
PBOC	–	People’s Bank of China
PMO	–	Project Management Office
PRC	–	People’s Republic of China
PRCCU	–	Provincial Rural Credit Cooperative Union
PSB	–	Postal Savings Bank
RCB	–	Rural Commercial Bank
RCOB	–	Rural Cooperative Bank
RCC	–	Rural Credit Cooperative
RCCU	–	Rural Credit Cooperative Union
RFI	–	Rural financial institution
SMAP	–	Sustainable Micro Finance to Assist the Poor
SPPA	–	Social Program for Poor Areas
UNDP	–	United Nations Development Program
UNICEF	–	United Nations Children’s Fund

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EXECUTIVE SUMMARY

1. Strengthening financial services to the agriculture sector and to rural non farm activities has become a major policy objective of the Government of the Peoples' Republic of China (PRC). Accordingly the Government requested the Asian Development Bank (ADB), during the 2004 Country Programming meeting, to provide advisory support of rural finance reforms and the development of micro finance institutions in the Inner Mongolia Autonomous Region (IMAR) and Guizhou Province. This report examines the proposed rural finance reform in IMAR and makes recommendations for structural and operational reform of the Rural Credit Cooperative (RCC) sector and introduction of micro finance models to improve outreach and effectiveness of rural finance.

2. State Council Document 15 'Pilot Scheme to Deepen Reform Of Rural Credit Cooperatives' issued in July 2003 initiated the third significant reform of rural credit cooperatives in a decade (Supplementary Appendix1). The reform includes changing the legal structure of selected Rural Credit Cooperatives (RCCs) and Rural Credit Cooperative Unions (RCCUs) to incorporate conversions to Rural Commercial Banks (RCBs) or Rural Cooperative Banks (RCOBs)[1] based on predetermined asset and capital adequacy criteria. Existing institutions are being assisted to meet capital adequacy requirements by the provision of redeemable bills to replace a portion of 'historical' losses. The reform also introduces a new administrative level to the system by establishing provincial or autonomous region RCCUs and down loads the responsibility for financial risk in the sector to provincial and regional governments.

3. The reform program is rife with moral hazard; this is evidenced in the pilot provinces and the implementation plans and approach of IMAR and other provinces. The reform program does not clarify ownership structures and with the addition of new levels of administration increases ambiguity as to who is ultimately responsible for RCCs. Actions taken by local governments and RCCs have been focused on obtaining free money, IE redeemable bills, rather than strengthening corporate governance and risk management.

4. Introduction of additional levels of administration and changes to the legal and ownership structure of rural financial institutions (RFIs) raises a number of concerns. Increasing administration will increase costs but will not necessarily improve the performance of RFIs. Under the new legal structures share requirements are substantially increased and generally unaffordable by the current shareholders who are primarily poor rural households (Appendix 5). There is concern that increasing the number of institutional and business investors will result in reduced access to financial services for rural households as investors demand return on their investment in the form of dividends and increased loan access.

5. In order to meet these demands the RFIs will be under pressure to consolidate operations and discontinue expensive services such as access to remote areas. This is a necessary and productive result to improve the viability of RCCs. Some regions of IMAR do not have the economic and human resource capacity to support an RCC. However, other means of delivering financial services in remote rural areas must be found such as micro finance institutions and member driven savings and credit cooperatives (Appendix 10).

6. Inadequate capital is a fundamental characteristic of all RFIs in IMAR (Appendix 2). Reform measures do not go far enough in requiring RFIs to improve their capital position. There

[1] Throughout this document, RCCs, RCCUs, RCOBs and RCBs are collectively referred to as RFIs.

is no mandatory restriction on dividend payments when an RFI fails to meet minimum capital adequacy requirements (CAR) or posts an operating loss.[2] In an effort to attract investors to the new banks, local governments are promising to pay dividends on behalf of the RFIs. This practice reinforces imprudent management practices and continues the perception that RFIs are government institutions that do not need to be managed under sound business principals. Failure to effectively address this prevailing attitude, by requiring RFI directors and management to be proactive and accountable to depositors and shareholders and continued involvement of local governments, increases risk and cost for the IMAR government.

7. An appropriately focused Autonomous Region Rural Credit Cooperative Union (ARRCCU) can add value to the RFI system by providing needed services and representing RFIs as a group to the national government, suppliers, other financial institutions and agencies (Appendix 8). Value to RFIs should be the overriding concern of the ARRCCU. One way to achieve value is to contract services from professional agencies on behalf of the RFIs instead of building up internal structures that can quickly become outdated and cumbersome. RFIs have identified training as an urgent need and should be the first priority of the ARRCCU. Investment in training will be rewarded with better business management, reduced non performing loans, greater transparency and reduced risk to the IMAR government.

8. Risk management is a major concern for the IMAR government (Appendix 6). There are many strategies that can be employed to reduce risk and most of them reduce cost, over the medium to longer term, rather than increase cost. Improved management skills is a principal risk management strategy, other strategies focus mainly on improving controls and building capital. Introducing risk based fees are a good way of instilling a risk control culture in RFIs. Requiring active contributions from RFIs to the Risk Fund in addition to passive contribution from tax reallocations is another tool to encourage risk averse behaviour.

9. Financial analysis conducted on 9 RCCUs scheduled to be converted to rural banks reveal systemic weaknesses particularly with regards to delinquency management, loan loss provisions, inadequate capital and poor profitability despite relatively high interest margins (Appendix 3). As these institutions probably represent the strongest RCCUs in IMAR, the trends are deeply troubling. Analysis on the basis of international standards suggests these 9 institutions represent a capital shortfall of CNY644.4 million or USD 78.5 million after application of redeemable bills and other interventions to recapitalize the system. Given current operational inefficiencies of RCCUs they are incapable of growing out of their NPL problems or attaining sound capital accounts without considerable outside assistance. In other words the restructuring and financial support being delivered under the current reform program is insufficient to solve the problems facing RCCs today and in the near future.

10. Reviews of progress in 8 pilot provinces support the previous assessment (Appendix 9). While it appears at first glance that profitability in the pilot RCCUs that have already received redeemable bills improved substantially over 2003, closer examination reveals that increased profitability is almost entirely due to tax relief and cash payments from PBOC to cover losses from inflation proof savings. Net performance in the pilot provinces has in fact worsened in the past year.

11. The two micro finance programs currently operating in IMAR are popular with their clients but both face constraints in not having sufficient scale for sustainability (Appendix 10). Despite relatively high interest rates credit demand exceeds supply. Households borrow from as

[2] CBRC does have an internal rule in some areas that it will not allow loss making RCCs to pay dividends.

many sources as possible especially to finance education expenses. Households with school aged children often carry unsupportable debt loads and are very vulnerable. Supporting education expenses for children and strong drive for income growth also lead to unsustainable income generation activities such as developing large herds in environmentally fragile regions. Micro finance whether delivered through micro finance institutions or through RCCs will not, on its own, solve poverty issues for rural households. Investment in infrastructure and social systems such as education and health care are required. It may be less expensive in the long run to make direct investments in social systems than to blur the lines between governments' social obligations and support for economic develop by channeling policy loans through RFIs and micro finance organizations. Some RCCs in remote banner with widely scattered populations, primarily dependent on livestock production, will never be financially viable under the current system or under proposed reforms. IMAR should experiment with several financial service delivery options on a pilot basis to determine which would be most appropriate in the circumstances. One option is to continue with RCCs but to subsidize their micro finance activities so they are not a drain on regular operations, the second is to pilot an MFI and the third option is to assist the establishment of a traditional, member owned, member managed savings and credit cooperative.

12. Detailed analysis of the rural finance sector in IMAR can be found in Appendixes 1–12.

SUMMARY RECOMMENDATIONS

A. Rural Credit Cooperative Restructuring

Below is a summary of recommendations to implement effective rural credit reform within the current reform framework. Most of these initiatives do not require additional financial resources but require a change in current operating procedures. The column on the right identifies the organizations most appropriate to be responsible for implementing these recommendations.

1. Moral Hazard

	Recommendation	Responsibility
(i)	Match authority to responsibility; those who have authority must be responsible and must face consequences for poor performance	IMAR Gov, RCCs
(ii)	Set NPL recovery targets as a percentage of current NPL portfolio or absolute value rather than of total loan portfolio	IMAR Gov
(iii)	Prohibit payment of dividends by RFIs that do not meet CAR or post an operating loss	CBRC
(iv)	Within 5 years of establishing Risk Fund, require RFIs to make direct contributions to fund, levies should be risk based	IMAR Gov

2. Financial Data Transparency (details see Appendix 2)

	Recommendation	Responsibility
(i)	Require independent audits from professional and accredited audit firms at least bi annually	CBRC
(ii)	Evaluate performing loan portfolio to isolate restructured and refinanced loans and require separate reporting of those loans	RCC
(iii)	Phase in international standard loan loss requirements over a 3 year period using international risk weighting methodology	CBRC
(iv)	Establish write off schedule and write off uncollectable loans	RCC
(v)	Develop disclosure requirements for Senior Management and Directors to be included in annual reports to shareholders. Disclosure statements to shareholders should include aggregate indebtedness of Staff, Directors and Related Parties as well as the largest single related party loan connection	CBRC

3. NPL Resolution (details see Appendix 4)

	Recommendation	Responsibility
(i)	Carry out objective evaluation of current NPL and classify according to age, recoverability and original credit rationale	RCC
(ii)	Do not accept non income generating assets as collateral substitutes for historical non performing loans	RCC
(iii)	Establish loan loss reserves based on actual risk	RCC
(iv)	Reduce acceptable NPL level to 5% of average portfolio for all loans except for micro loan portfolio	CBRC
(v)	Discontinue practice of allowing loans to remain in arrears as long as interest and penalty payments are maintained.	RCC
(vi)	Demand payment on idle loans	RCC

(vii)	Establish delinquency management policies requiring collection activity to begin within 30 days of arrears	RCC
(viii)	Change underwriting practices to match loan repayment to cash flow, enterprises with regular and frequent cash flows should be required to make installment payments on operating loans	RCC
(ix)	Develop new loan products with longer maturities, ie greater than 2 years for capital asset acquisition including large livestock for small farmers	RCC
(x)	Stop practice of 'stacking' large group loans with micro finance loans. This practice raises household debt to unsustainable levels.	RCC

B. Institutional Strengthening

1. **Corporate Governance** (details see Appendix 5)

	Recommendation	Responsibility
(i)	Develop disclosure requirements for Senior Management and Directors to be included in annual reports to shareholders. Disclosure statements to shareholders should include aggregate indebtedness of Staff, Directors and Related Parties as well as the largest single related party loan connection	CBRC
(ii)	Develop codes of conduct for Staff and Directors	RCC
(iii)	Require removal of Directors when a Director or a related party is more than 90 days in arrears in any obligation to any financial institution	CBRC
(iv)	Prohibit staff participation on Supervisory Committees	IMAR Gov
(v)	Discontinue selection of Directors and Senior Management by government authorities, convert to veto system for government authorities with possibility to directly appoint a minor number of directors (less than 30%)	IMAR Gov
(vi)	Create 3rd class of shares for current small shareholders to grandfather their shares and establish delegate voting system for 3rd class of shares to ensure that rural households have a voice in the management of their RFI.	IMAR Gov

2. **Risk Management** (details see Appendix 6)

	Recommendation	Responsibility
(i)	Identify and quantify risk through increased segregation of non performing assets an aged basis	RCC
(ii)	Develop comparative peer analysis reporting and share with RFIs	ARRCCU
(iii)	Establish industry concentration limits for credit granting	RCC
(iv)	Explore insurance products for creditors, debtors and general micro insurance for households	ARRCCU and IMAR Gov
(v)	Invest in staff training	RCC, IMAR Gov, ARRCCU, CBRC
(vi)	Establish staff performance management programs with	RCC

	performance based pay	
(vii)	Establish model policies in key operational areas such as Investment and Lending, Human Resources, Asset Liability Management, Codes of Conduct for Officers and Employees including disclosure requirements.	ARRCCU, customized by RCCs
(viii)	Develop environmental policy	ARRCCU
(ix)	Supervise RFIs against internal policies as well as national regulations	CBRC
(x)	Develop experts at RCCU level as resource persons for independent RCCs	RCCU
(xi)	Introduce risk based fee levies for RFIs	IMAR Gov
(xii)	Discourage intervention by local governments by requiring them to set up loan guarantee funds if they want to encourage lending to a specific sector	IMAR Gov

C. **RCC Capacity Building** (details see Appendix 5)

	Recommendation	Responsibility
(i)	RFIs must be prohibited from issuing dividends if the RFI does not meet CAR or experiences a net operating loss.	CBRC
(ii)	Borrower concentration limits should be established for unified RCCUs in line with commercial banks at 10% of capital	CBRC
(iii)	Establish a 3rd class of shares for new RFIs to grandfather existing shareholders rather than redeem their shares.	IMAR Gov
(iv)	Upgrade skills of lending staff and decrease borrower to lending staff ratio	RCC

D. **Interagency Relationships** (details see Appendix 5 and 8)

	Recommendation	Responsibility
(i)	Clarify Relationships between CBRC, PBOC, IMFO and ARRCCU to avoid duplication, excessive administration and over regulation	IMAR Gov
(ii)	Develop Memorandums of Understanding between above agencies to define specific roles and share them with RFIs	CBRC, PBOC, ARRCCU and IMAR Gov
(iii)	Based on clarified roles of agencies look for ways to share existing revenues rather than increase the financial burden on RFIs.	CBRC, ARRCCU and IMAR Gov
(iv)	CBRC should stop any involvement in lending and administrative decisions with RFIs.	CBRC
(v)	ARRCCU should not assume any supervisory or regulatory responsibility for RFIs	ARRCCU
(vi)	Avoid duplicating existing structures and setting up offices at lower administrative levels	CBRC, ARRCCU and IMAR Gov
(vii)	Avoid taking over administrative functions of RFIs that are the responsibility of RFI management	ARRCCU and IMAR Gov
(viii)	Maintain an efficient organization structure, contract services such as training and audit whenever possible	ARRCCU and IMAR Gov

E. **Micro Finance Services** (details see Appendix 10)

	Recommendation	Responsibility
(i)	Develop specific group loan product for marginal households that are not currently served by the micro loan program	RCCs, MFIs
(ii)	Develop database of household incomes, family labour, loan performance, loan purposes, sectoral micro enterprise performance and other economic data to analyze and understand micro finance , trends and performance	RCCs, MFIs, central database managed by ARRCCU
(iii)	Develop credit scoring system based on database.	RCCs
(iv)	Replace household rating system with credit scoring system	RCCs
(v)	Target women instead of heads of households	RCCs
(vi)	Apply transparent sustainable interest rates to micro loan programs to improve services and access and remove hidden costs such as loan application time, gifts and other considerations for loan officers	PBOC
(vii)	Develop new loan products with longer maturities to allow micro finance clients to invest in long term capital assets for income generation	RCCs, MFIs
(viii)	Compensate RCCs for administration costs of micro finance loans to encourage participation. Compensate administration costs in two stages, at delivery and at repayment to promote responsible credit granting practices	PBOC
(ix)	Experiment with new micro finance delivery agencies but ensure that legal status is clarified before any funds are mobilized or loaned. Set up pilot programs in 3 marginal herding areas, one for subsidized RCCs, one with an MFI and one with traditional member driven SCU.	IMAR Gov
(x)	Develop training programs to sensitize RCCs to the needs and benefits of micro finance and improve human capacity to service the sector effectively	ARRCCU
(xi)	Establish credit reporting system	ARRCCU
(xii)	Experiment with genuine member driven, bottom up, savings and credit unions in remote areas	IMAR Gov
(xiii)	Increase government support of rural infrastructure such as education, health, market access and land development to reduce vulnerability and expenses of remote rural household for whom these costs are disproportionate in comparison with peri urban households	IMAR Gov

I. RURAL CREDIT COOPERATIVE RESTRUCTURING

A. Moral Hazard

1. Moral hazard is the single greatest impediment to achieving meaningful RCC reform and effective restructuring. Moral hazard is defined as the principle that if actors are allowed to escape the consequences of their risky actions, they are more likely to engage in reckless behavior in future.[3] The presence of moral hazard in the rural credit reform program is readily evident in the approach taken to project implementation in the 8 pilot regions; an approach being largely copied in IMAR.

2. In the context of rural credit reform program moral hazard is most obvious in the focus on achieving eligibility for redeemable bills without changing risk behaviours or improving ownership structures of RCCs. The intent of the central governments RCC Reform program is not to provide free money to RCCs but to effect meaningful change that results in stronger more sustainable institutions delivering cost effective and needed services to rural households. The provision of redeemable bills is intended to strengthen the capital base of RCCs that when coupled with better governance, controls and improved operational management results in better performance over the long term. Instead the focus as noted by Wu Xiaolong, Vice President , PBOC " Provinces are too concerned with getting government monetary support rather than with improving ownership structures, improving operational mechanisms, strengthening internal controls, decreasing operational costs or resolving NPLS." Madame Wu's statements are borne out by careful examination of the performance of RCCUs in the eight pilot regions.

3. It is reported that RCCUs in the 8 pilot regions posted increased profits of CNY0.1billion in 2004 over 2002. However after removing tax benefits and non operating incomes, (CNY1.69 billion of operating taxes, CNY1.63 billion of income taxes and CNY0.89billion replacement of interest losses from inflation proof policies) the net performance is actually a deterioration of CNY3.1 billion. In other words, net income before extraordinary items in 8 pilot regions decreases from CNY6.8billion in 2002 to CNY3.7billion in 2004, or a net change of minus 46% over two years. This occurred despite increased assets and improved interest rate margins.

4. The poor performance of restructured RCCUs in the 8 pilot regions is a graphic but partial illustration of the financial cost of moral hazard. Analyses of the aspects of the rural credit reform program that give rise to moral hazard and recommendations to mitigate moral hazard follow.

1. **Ownership Structure** (details see Appendix 5)

5. One of the two main objectives of the reform is to "clarify ownership structure and strengthen corporate governance". The implementation of the reform program fails to achieve this for a number of reasons. Firstly the reform program does not reconcile ownership with control. RCCUs are being encouraged to find new private investors to increase the viability of the organizations but control effectively remains with local and provincial governments. Local and provincial officials have the capacity to appoint and remove directors and management; the shareholders/owners do not have that right. So while shareholders are being asked to take a financial risk they are not given the basic right to protect their risk by controlling the single biggest risk factor, management.

[3] Halifax Initiative Coalition

6. Secondly corporate governance is weakened rather than strengthened by the introduction of two additional levels of administration, the IMAR Government and the ARRCCU and the lack of role clarity between the various official stakeholders, the CBRC, PBOC, ARRCCUs and government. In Jiangsu it has already been seen that the RCCS take advantage of the role confusion by playing one agency off against the other to avoid taking meaningful action to correct operational deficiencies.

7. Theoretically the CBRC is empowered to close non viable RCCs but it faces strong opposition from government officials who would have to deal with social discontent as a result of closures so few if any RCCs have been closed. Management of these RCCs are not motivated to seek any performance improvements as there are no consequences to continuing as they are.

8. Ultimately the reform program does not answer the question “who is responsible for RCC performance?” Government involvement in RCC administration does not encourage management to take responsibility for performance, at an institutional or personal level. Management always has the excuse that it was just following orders from a higher level authority and there are no meaningful consequences for poor performance.

9. No matter how badly the RCC performs the management enjoys the status and perquisites of their position. Investor/owners are not responsible because they do not have the right to appoint or remove management and therefore have effectively no control or authority. In order to clarify ownership structure and improve corporate governance, authority and responsibility must be in the same hands. Those who are responsible must be held accountable, that is there must be performance expectations and there must be consequences for poor performance.

2. **NPL reduction ratios encourage poor lending practices** (details see Appendix 4)

10. The NPL reduction targets are based on a percentage of the portfolio, rather than an absolute number and this also give rise to moral hazard. The easiest way for RCCs to achieve their reduction targets is to increase lending and increased lending can be achieved more quickly by maintaining lax underwriting practices. In this case RCCs not only avoid consequences of poor past practices they are rewarded for continuing or increasing bad practices by achieving their NPL reduction targets. Continuing these bad lending practices will lead to even greater losses in the medium to long term.

11. The NPL ratio in IMAR RCCs at the end of 2002 was 57.1 % or CNY 8.3 billion. At September 2004 the NPL portfolio was reported to have declined to 28.4%, however loan balances grew by 85% over the same period so the ratio reduction was largely due to loan growth not resolution of NPLs. The balance of NPLs as at September 2004 was 7.7 billion indicating that real NPL reduction was only 7% over a two year period.
There is no indication that lending practices have been improved to provide confidence that loans issued since 2002 are better quality assets than those issued prior to 2002. Without improved lending practices establishing NPL reduction targets as a percentage of portfolio will only increase risk as RCCs increase lending volume to meet the targets and does not require them to address the existing NPL portfolio.

12. To achieve real NPL resolution, targets should be set for reduction in the amount of the NPL portfolio as at year end 2002 and a percentage target for loans issued after 2002. A 15% target is far too high for efficient operations or for institutional sustainability. In order to be efficient and RFI should maintain arrears greater than 30 day below 5% and portfolio at risk, that is, arrears greater than 1 day, below 10%.[4] While it is very common for financial institutions or their representatives to state that things are done differently in their country, there is a fundamental truth, no matter what the culture, no matter what the economy, a financial institution will not survive high non performing loan ratios. The over 30 day non performing loan target of less than 5% is widely accepted through the experience of many countries in many different situations as being a minimum guideline. Government promises to pay dividends encourages continued interference by local governments and discourages managers and investors from taking responsibility for performance. (details see Appendix 7).

13. Promises by local governments to pay dividends to new investors regardless of institutional profitability increases moral hazard on two levels. It sends a clear signal that neither RCC management nor investors are responsible for performance of the institution, and it encourages continued interference by local governments. Managers will feel comfortable that they are earning a good return for their investors without any extra effort and investors will not pressure managers for better performance because they feel their investment is safe and productive. Local governments will at the same time feel they are justified in asking for sponsorship of their pet projects in return for insulating managers from the demands of investors and investors from risk of lost income.

14. Much of the 'historical burden' of RCCs stems from directed lending to unviable projects initiated or sponsored by local governments. Local governments will continue to expect priority consideration for their initiatives in return for their investment in the institutions by way of paying dividends on its behalf. "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"[i]

15. RCCs should not be permitted to pay cash dividends if the institution has not posted profits or met its capital adequacy requirements regardless of the source of those dividend payments. Payment of non cash dividends, ie additional share allocations, may be paid considered for new investors as that may incent new investors to pressure managers to ensure and expedite increased institutional performance so that the eventually a cash reward may be obtained.

3. **Passive Risk fund development encourages poor lending practices** (details see Appendix 6)

16. The IMAR government will establish a risk fund using tax revenue received from RFIs in excess of the threshold established by tax receipts to year end 2004. RCCs paid CNY58.5 million in taxes at year end 2004. Tax revenues collected in excess of CNY58.5 million for the next 10 years beginning at year end 2005 will be allocated to a risk fund. The IMAR government anticipates achieving a fund of CNY330 million by 2015. On a straight line basis, achieving a fund balance of CNY 330 million in 10 years requires additional tax revenues of CNY29 million per year at a yield of 2.25% per annum assuming that no demands are made against the fund.

[4] IFAD (define)

17. The IMAR government is to be commended for establishing a risk fund and doing it in a painless fashion in the short term. However, the creation of a risk fund also gives rise to moral hazard. The seamless manner in which the fund is being created increases the hazard. Establishing a fund on excess tax revenue may be considered a passive risk management tool. It has the potential to build the fund fairly quickly without increasing the burden on struggling RCCUs. These are important considerations in the short term given the present vulnerability of RCCUs in IMAR. At the same time it is important that RFIs and RFI investors take responsibility for risk management so the fund should be built visibly with active involvement of the RFI.

18. To encourage responsible management from RFIs and responsible oversight from RFI investors, RFIs should be required to make direct contributions to the fund in the medium term. Fund contributions should be instituted through a risk based levy. RFIs that exceed prudential norms and engage in risk averse practices are less likely to cause a claim on the fund and therefore should be rewarded with a reduced levy. Institutions that do not meet prudential requirements and engage in risky practices are more likely to cause claims against the fund and should, accordingly face higher levies.

19. Levies should be calculated on average assets to encourage responsible growth and reflect potential claim size. Levies should not be based on capital as that discourages capital accumulation and decreases risk avoidance.
When RFIs begin to contribute the risk fund, the earnings of those funds contributed by RFIs should be reinvested to build the fund and/or used to offset risk mitigation services such as audit and training. Earning from funds contributed by RFIs should not become part of the IMAR governments' general revenue.

B. **Financial Data Transparency** (details see Appendix 2)

20. Lack of clear financial reporting makes it very difficult for any investor to assess the true financial status of an RCC and also provides inaccurate management data leading to inappropriate or ineffective business decisions.

21. While attempting a financial analysis of selected RCCUs the Banking Specialist noted" The scope and completeness of the financial analysis was severely limited by the nature of the financial information provided. None of the RCCU operations in IMAR are audited by established accounting firms and consequently audited financial statements with accompanying schedules are non-existent. Problems in conducting a complete analysis on these institutions arose due to:

- (i) failure to follow international accounting standards in the creation of the financial statements;
- (ii) notable differences in the treatment and accounting for key accounts such as loans and loan loss reserves;
- (iii) inclusion of interest accruals on non-performing loans which should rightly be on non-accrual;
- (iv) inconsistent reporting and treatment of income and expense items;
- (v) misclassification of deposits as shares and inclusion of inter-RCCU and inter-RCC accounts on the balance sheets, and;
- (vi) mistreatment of revenue and loan loss reserves items as additions to the capital account.

22. Financial review and analysis of these RCCUs was compromised by a variety of risk management and reporting relationship issues involving the operational affiliation between RCCUs and their member RCCs. No clear data providing the necessary breakdown of the consolidated loan portfolio by the number of accounts and loan amounts extended to rural households versus urban-based or government controlled enterprises was provided by any of the RCCUs. In several cases the response was that such data did not exist. Omission of this and other data made a complete and detailed analysis of the strengths and weaknesses of the loan portfolio and loan underwriting practices of the RCCUs difficult to complete.

23. Segregated information or a schedule of the loans extended directly by the RCCU itself vs. the loans initiated by the member RCCs for their local market was not available. Financial statements presented included only profit and loss statements and balance sheets.[5] No Cash Flow Statements, notes, or discussion of contingent liabilities or funding mismatches were presented. These are examples of various accounting errors or practices that result in lack of transparency. The following sections identify some of the most critical areas and make recommendations to improve financial transparency. Financial transparency is key to attracting investment.

1. RCCs should be subjected to independent audits (details see Appendix 2)

24. Requiring RCCs to have independent and certified audits from accredited audit firms or agencies could mitigate many of the problems identified above. An important aspect of certified audits are the notes to financial statements which provide greater understanding of the figures presented and address some of the off balance sheet items that are not shown on financial statements.

25. One of the responsibilities assigned to the ARRCCU is audit. This can be achieved more effectively through hiring professional audit firms than through setting up league, county or banner level offices with audit staff as has been done in all of the pilot regions. The advantages of hiring professional audit staff are many. Firstly skills of professional auditors tend to be higher and are upgraded on a continuous basis. Audits are performed quickly as a private firm is naturally incented to be efficient. Secondly, when the auditors are based in the same locality as the client they become ‘part of the family’ and there is a tendency to develop empathy which often leads to less critical audit practices. Thirdly, professional auditors are exposed to practices in many different settings and can as a result share best practices and introduce new ideas to clients during the course of the audit.

26. RFIs may be held directly responsible for costs of employing professional auditors and that tends to promote improved practices as RFIs quickly find they can reduce costs by maintaining better records and practices. ARRCCU may subsidize audit costs for smaller RFIs if necessary but this is still more cost effective than maintaining an in house audit structure.

27. The ARRCCU should develop a roster of authorized audit firms which the RFIs can engage and require professional independent audits instead of setting up internal structures to perform this function. If there are not enough audit firms in IMAR to meet the need, the

[5] Financial statements are prepared in accordance with tax requirements. It is important to note there is not a country in the world where reporting requirement for tax purposes conform to good accounting practices. The purpose of tax statements is to maximize tax revenue not to provide guidance for good business decisions or to present a true picture of the financial status of the enterprise. All sound businesses prepare corporate financial statements on a monthly basis in addition to required tax statements.

ARRCCU can encourage firms to expand their practices into IMAR knowing they have customer base. To encourage efficiency and cost effectiveness, the Supervisory Committees of the RFIs should tender audit work to 2 o 3 suppliers and audit firms should be changed periodically.

2. Identify and Report Refinanced Loans (details see Appendix 4)

28. Refinanced and restructured loans[6] are not separately identified in the financial statements. As refinancing and restructuring have a tendency to delay recognition of potential losses it is important that these loans be separately identified. A portfolio with a large percentage of refinanced or restructured loans is a strong indicator of pending NPLs.

29. There is evidence that refinancing and restructuring loans is a prevalent practice among RCCs in IMAR and as a result outreach numbers are likely substantially overstated as loan are circulating in a small sector of the community rather than through the community.

3. Adequate Loan Loss Provisioning (details see Appendix 6)

30. The current requirement for loan loss provisioning is a flat 1% of the average loan portfolio. This provision clearly does not reflect the risk in the portfolio. The accumulated loan loss provisions of the nine RCCUs analyzed represent less than 27% of the actual losses recognized to the end of 2002 without considering the unrecognized losses hidden in the idle loans portfolios. Inadequate loan loss provisions presents a misleading picture to potential investors and depositors as it greatly overstates the balance sheet and which in turn greatly understates ROA.

31. From an operational perspective, inadequate loan loss provisioning leads to improper budgeting. Revenue streams should be based on assets and as assets are substantially overstated, potential revenues are similarly distorted. Expense planning based on overstated revenue streams will then inevitably result in operational losses and therefore inadequate earnings retentions to build institutional capital to support growth and asset protection.

32. Loan loss provisioning should at least be based on aged delinquency with increasing provisioning requirements for increased aging. While there is no single international standard for loan loss provisioning most jurisdictions use much more detailed aging of portfolio at risk and have significantly higher loan loss requirements than established by MOF. CBRC in its ‘Guidelines on Unified Legal Person Reform of County Level RCCUs’ (Appendix ?) recommends loan loss provisions of 1% for performing loans, 20% for past due loans, 50% for idle loans and 100% for bad loans. This recommendation is very similar to that of Basel II[7].

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[6] Refinancing loans is the practice of paying out an existing loan in addition to disbursing additional funds through a new loan. Restructuring loans is the practice of changing the terms and conditions of a loan to improve repayment probability, such as reducing payments or changing payment frequency, extending amortization, substituting or obtaining more collateral, changing interest rates etc. Refinancing a loan increases the amount of the debt, restructuring a loan does not.

[7] Basel II does not identify a single standard for loss provisioning of non performing loans but balances loan loss provisioning against capital requirements. The interpretation used by the Banking specialist allows the institution to main a risk weighting of 100%, if lower LLP are made the risk weighting should be increased to 150%, therefore requiring more capital to achieve capital adequacy requirements.

33. Adopting the guidelines recommended by the CBRC for Unified RCCUs by all RFIs will result in much stronger institutions.

Table 1: International Standards for Loan Loss Provisions as Percentage ofNon performing loans

	PBOC	CGAP	WOCCU	**Basel II (BIS)**	**CBRC [8]**
0 days					**1**
1- 30 days	10	10	35	**20**	**20**
31-60 days	10	25	35	**20**	**20**
61 – 90 days	10	50	35	**20**	**20**
91-180 days	40	100	35	**50**	**50**
181 – 270 days	40	100	35	**50**	**50**
271 – 365 days	40	100	35	**50**	**50**
>366 days	40 or 100[9]	100	100	**100**	**100**

Source:

4. Establish a Loan Write off Schedule

34. A realistic assessment of the idle loan portfolio will reveal that many of them are in fact bad loans, the underlying collateral is insufficient to pay the debt, the loan has not received a payment in many years, and there are no legitimate means by which the borrower can be made to pay. Under international standards, any loan that has not received a payment in over 1 year would be classified as a bad debt and written off.

35. Writing off a loan does not mean that the debt has been forgiven. Writing off a loan is merely an accounting transaction that provides a clearer picture of an institutions' financial status and capacity. Every effort to collect the debt should continue after the loan is written off. When a written off loan is collected in whole or in part the recovery is taken back into income as bad debt recoveries.

Stricter recognition of bad debt and increasing provisions as recommended will result in a very high level of bad debt in RCCs and to write them off in one fiscal year would have serious negative impacts on net profits and shake investor confidence. RCCs should take a proactive measure and establish a loan write-off schedule to write off loans over a period of time not longer than 5 years. The need to write off bad loans is inevitable and it is better that an RCC take a measured approach under its own initiative than to wait for the next round of reform where they may be required to recognize the losses in one year and face closure due to insolvency.

5. Financial Disclosure

36. The final step in financial transparency is publishing independently audited and certified financial statements to shareholders. Shareholders have the right to full financial information so that they can make informed decisions about their investments. Publishing financial statements to shareholders is an important part of strengthening corporate governance. Ideally each shareholder should receive a copy of the financial statements including Profit and Loss Statement, Balance Sheet, Statement of Changes in Equity, Cash Flow Statement and significant notes. Alternately, these statements should be posted in branch offices.

[8] CBRCs Recommendation for Unified RCCUs Appendix?

[9] There is no time limit for idle loans so if a bad loan is not approved for write off by MOF the LLP is only 40%, if approved by MOF a 100% LLP can be made.

C. **Non Performing Loan Resolution** (details see Appendix 4)

37. The NPL ratio in IMAR RCCs at the end of 2002 was 57.1 % or CNY 8.3 billion. At September 2004 the NPL portfolio was reported to have declined to 28.4%, however loan balances grew by 85% over the same period so the ratio reduction was largely due to loan growth not resolution of NPLs. The balance of NPLs as at September 2004 was 7.7 billion so the real NPL reduction was only over a two year period was only 7%. Most RCCU officials suggested that the easy NPLs have been collected, the remaining portfolio is 'hard core'; that is not only nonperforming, but uncollectable.

38. Effective NPL resolution requires that the structure of the NPL portfolio is clearly understood. RCCU officials and literature about the RCC system attribute the majority of NPLs to an 'historical burden' inherited from the ABC when the RCCs were under ABC management. This statement needs to be carefully examined and challenged; its perpetuation is a convenient explanation that discourages actively addressing underlying problems that continue to plague the RCC system.
For purposes of determining government support for RCCUs the historical burden is defined as the accumulated losses to year end 2002. The actual historical burden, however, applies to loans and losses incurred prior to 1996 when RCCs were under administration of the ABC[10].

39. Bairin Right Banner RCCU of Chifeng, for example, stated that its NPLs have increased by 105% since 2002. This increase was attributed to draught in the banner, but staff of the UNDP micro finance project working in the same villages said the draught has had little effect on loan repayment with their clients. The micro finance project reports an NPL ratio of 0.7% as of March 2005. An RCC in Wuchuan County reports that its entire 25% NPL portfolio is due to micro loans. As the micro loan program was not introduced until 1999, these are clearly not part of the real historical burden.

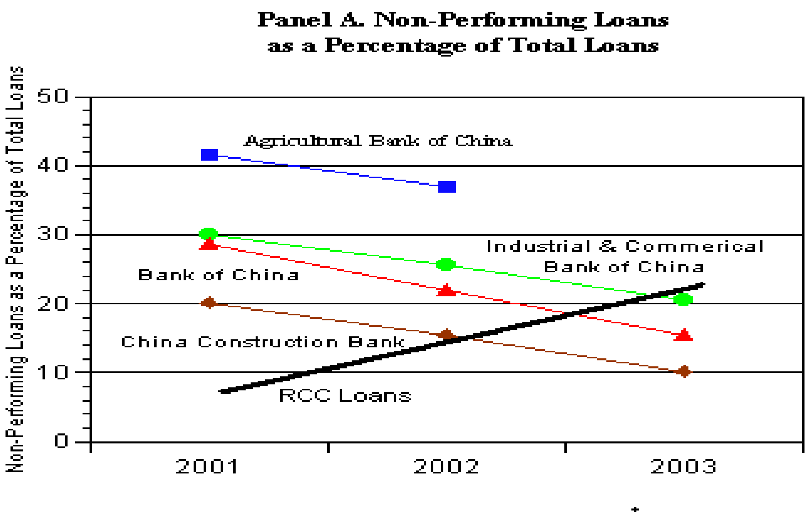
40. An official of the IMAR working group on RCC reform and several RCCU leaders confidently assert that the risk in their NPL portfolios is actually much less than the numbers suggest. These statements are based on the belief that they are collecting interest on 98% of the NPLs, that NPLS are largely due to mismatches between the cash flow cycle and loan terms and that farmers and herder are very honest. Again this indicates that many of the NPLs are more recent. Based on interviews with various RCCU officials the writer intuitively suggests that the historical burden in IMAR is probably less than 20% of NPLs. While this is significant, it is not the major cause of NPLs.

41. The graph below[11], confirms that non performing loans as a percentage of the total portfolio has been growing at a constant rate since 2001 in RCCs while the non performing loans of commercial banks declined steadily over the same period. This would indicate that the majority of NPLs in the RCC system are in fact not a historical burden, but are newer loans, of which directed or policy loans are a big part. Therefore replacing half of accumulated losses to 2002 without addressing current lending practices and pressures to meet the social and

[10] The prevailing attitude toward the 'historical burden' is a classic example of moral hazard. Previous reforms have not adequately addressed the issue of poor lending practices and interference by local governments and as a result there has been no change in risk prone practices.
[11] Wall Street Journal, March 2004

economic goals of local governments, regardless of their viability, will only result in further losses.

CHINA: NON-PERFORMING LOANS, 2001-2003



Source: *The Wall Street Journal*, March 12, 2004, p. A13, based on data from the Chinese banks

1. Realistically Assess Asset Quality

42. An effective NPL resolution strategy, first and foremost, requires a realistic assessment of the problem, (Appendix 2, 3 and 4). The structure of the NPL portfolio needs to be understood to resolve the current situation and to learn from it to enhance future risk management. An objective review of individual NPL portfolios should be undertaken to properly age the credits, classify NPLs as to cause of default, and assess recoverability within a reasonable time frame.

43. Realistic assessment of the recoverability of many idle loans will result in their reclassification as bad loans. It has been reported in some cases that local governments have substituted non earning assets as collateral for directed loans where the original enterprise has gone bankrupt and the assets have little value. Unless the new collateral offered is saleable or is able to earn income to recommence loan payments such collateral substitution is value less and these should be considered bad loans. Upon identifying bad loans, legal steps should be pursued immediately and these loans should be included in the write off schedule.

44. Those loans that have become past due or idle simply because of a mismatch between the loan cycle and cash flow cycle, but are otherwise fundamentally sound, that is the project funded by the loan is profitable and the borrower has integrity, should be restructured to match the cash flow cycle of the enterprise and brought current.
The vast majority of NPLs will likely remain in the idle loan category. These loans need to be worked. Many RCCU officials and a member of the IMAR working group on RCC reform believe

that the majority of loans can be repaid. That statement begs the questions “if RCCU officials are confident that borrowers can repay their loans, why don’t they ask for repayment?”

45. There are many international examples of large NPL portfolios being resolved simply by asking for repayment and setting a clear example that repayment is expected. So RCCs have to contact borrowers and request payment. The key to NPL management is quick action when a loan goes into arrears. Repayment probability declines in direct proportion to the length of time the loan goes into arrears.

2. Ask for Loan Repayment

46. There appears to be a fairly prevalent practice of not demanding loan repayment as long as borrowers are willing to continue to make interest and penalty payments. In fact some RCCUs see this as a means of increasing effective interest rates. This practice in the interest of RCC staff as it reduces their workload in having to write new loans, and gives the appearance of increasing profitability. It is in the interest of the borrower, as they do not have to rejoin the queue to apply for loans when they know the institution has limited liquidity. Not requiring borrowers to repay loans even if they are keeping interest and penalty payments up to date is bad practice for the following reasons:

- (i) The RCC doesn’t really know if the borrower really has repayment capacity because it isn’t tested;
- (ii) Likelihood of repayment declines the longer a loan remains in arrears;
- (iii) A borrowers’ repayment ability can be affected by external events, particularly in the agriculture sector where environmental and market hazards are prevalent; and
- (iv) Non payment of loan principle limits the circulation of funds within the customer base and denies credit access to other worthy borrowers, which in turn, limits economic community development over the long term and ultimately RFI potential.

47. While there is no definitive research as yet to support this statement, it is generally felt by outside observers that the market penetration of the RCC system is greatly overstated, largely due to the practice of not demanding principle loan repayments and circulating loans within the same group of borrowers rather than throughout the community.

48. Finally, it must be recognized that many NPLs are simply unrecoverable and should be written off. Understanding the origination of NPLs is critical to prevention of recurrence and risk management in future. While the historical burden is likely overstated, the practice of directed credits and policy loans still continues and will lead to continued high levels of NPLs in future if not addressed.

3. Focus on repayment capacity to reduce future risk.

49. Credit risk management entails having and <u>implementing</u> sound policies to encourage portfolio diversification in terms of borrowers and projects supported, as well as maintaining a good balance of repayment terms and loan maturities.

50. Loan repayments must be matched to cash flow rather than to arbitrary deadlines. The current practice is to mature all PBOC on lending at December 31, as that is when PBOC requires repayment. Agriculture loans should be maturing earlier as matched to crop cycles or should be given longer terms for asset acquisition. In the case of dairy cattle for example, the initial investment is too large for most households to repay within a year, on the other hand a dairy cow produces daily income and therefore longer term loans of 2 or 3 years with monthly repayment, (with holidays for dry seasons) are more effective than annual or lump sum payments. Matching agriculture loan repayments to PBOC requirements also results in short term high liquidity in late winter that is difficult to invest productively and reduces profitability. More balanced payment cycles will reduce liquidity swings and improve profitability.

51. RCCUs write loans with maturities that they know will result in NPLs, as the payment cycle doesn't match the cash flow cycle. While they are confident that they have little risk in these transactions, it muddies the NPL status and leads to a laissez faire approach to delinquency management. Given the rising levels of NPLs in many RCCUs it appears this confidence is misplaced and the misplaced confidence is hidden in ambiguous NPL portfolios.

II. INSTITUTIONAL STRENGTHENING

A. **Corporate Governance** (details see Appendix 5)

52. Improved corporate governance is one of the corner stones of the RCC reform program yet there is little in the reform policy that gives teeth to such an initiative. When the policy is interpreted by the CBRC in the form of provisional regulations or guidelines some fundamental aspects of corporate governance are omitted and other provisions are introduced that actively work against improved corporate governance. A critical shortcoming in the reform program and attendant provisional regulations is the failure to address potential and real conflicts of interest which are key factors in increasing moral hazard.

1. Disclosure requirements for related parties to include shareholdings and indebtedness

53. RCCs are public institutions that are seeking private investment and mobilize private savings. That is, the general public will be depositing their savings in these institutions and presumably those deposits over the long term will benefit the investors now being sought. Much of the private investment is being encouraged from people who already have an affiliation with the institution, that is, current directors, management and staff. In some cases coercion is being used to obtain investment, in other cases these related parties are investing because they see an opportunity to capitalize on government support, particularly the provision of redeemable bills and promises of dividends.

54. The tendency for financial institutions to give preferential treatment to related parties and major investors is a troubling international phenomena and a major cause of financial institution failure or weakness. Most countries have developed disclosure requirements to mitigate the problem. Disclosure requirements range from filing statements with regulatory bodies and notes to financial statements to requirements to publish disclosure statements along with financial statements in widely circulated newspapers.

55. The content of disclosure statements also varies widely from country to country but at a minimum requires directors and senior managers to disclose the extent of their investment and indebtedness to the institution and that of their close family members. In other cases, directors

and senior management must also disclose their salaries and any financial and non financial considerations they receive from the financial institution such as housing, use of cars or education for children, as well as their investment in, and/or relationship to, other enterprises outside the financial institution. To improve corporate governance and financial transparency all related parties, directors, management, staff and their spouses and immediate family members, and enterprises controlled by those individuals, should be required to disclose the extent of their shareholdings in the RCC and their indebtedness to the RCC.

2. Mandatory removal of directors in the event of payment arrears by a director or related party.

56. Directors and management have a moral obligation to set the tone for the organizations they represent. Within the current provisional regulations for RCCs there are no mandatory qualifications for directors nor any provision for their removal if they fail to perform adequately. It can be very difficult to judge performance of directors but it is very clear that if they are in arrears in any obligation to the RCC they are at least not setting a good example and at worst abusing their authority. To ensure that directors, management set an example for RCC clients, particularly with regard to responsibility for debt obligations, the provisional regulations should include a requirement that directors and senior management be required to resign if they or any of their related parties are more than 90 days in arrears on debt payments to the RCC or any other financial institution.

3. Staff conflict of interest with Supervisory Committees

57. Conflict of interest is another serious management risk were officers and employees use their position within the institution in their own best interests rather than that of the institution. Conflict of interest can take many forms including approving poor quality loans for RCC directors, staff or related parties, making loans on more favorable terms, easier access to loans when the institution has poor liquidity, using RCC assets for personal business etc.

58. The provisional regulations for RFIs create a clear conflict of interest by allowing employees to hold at up to 33% of the Supervisory Committee seats. This means that employees are supervising their own work and that of their superiors and that will not lead to objective supervision. In this situation there is a very strong risk that employee members of the supervisory committee will ignore or even cover up inappropriate practices for their coworkers, including directors, and themselves.

59. The risk is increased because not only may employees participate on the supervisory committee, they may also hold up to 33% of the board seats and own up to 25% of shares. Given their operational knowledge and access to the institution, this gives employees far greater power within the institution that those percentages suggest. Including staff on the Supervisory Board means they are supervising themselves and their superior officers, which influences objectivity and accountability and discourages transparency. As major shareholders it is appropriate that staff have Board representation but they should be prohibited from serving on the Supervisory Board.

60. In the interest of transparency and improved governance, the provisional regulations should be changed to specifically exclude employees from positions on the Supervisory Committee and in the meantime, RCCs should pass internal rules to forbid employees from

serving on Supervisory Committees. It is a common international practice that former employees may not serve on the board or any committees in an official capacity until at least 1 year following the termination of employment.

4. Director election and selection to be done by shareholders

61. A fundamental variation between the stated desire to clarify ownership structure and strengthen corporate governance is the method of selecting directors. Under the guidelines for RFIs, the general assembly elects directors but does not select them; shareholders in effect ratify the selection of directors, made by the IMAR or local governments. This causes tensions in the accountability of directors who should be accountable to the shareholders of the financial institution; instead they are accountable to local officials who may be more concerned with achieving policy goals than financial sustainability.

62. Under the new guidelines the Chairman of the Board and the Manager of the institution may not be the same person. This is a positive step. However the practice is that directors and especially the chairman are actively involved in the day to day operations of the institution. In order to achieve accountability there must be effective separation between governance and management with emphasis on professional skills for management staff and the freedom to take management decisions as required based on sound business imperatives.

B. **Risk Management** (details see Appendix 6)

63. Risk is a part of doing business. Financial institutions risks include governance, credit, liquidity and investments, asset/liability management, capital, new business decisions (such as branching) and internal controls. Risk management should be a cross cutting theme in all activities of any financial institution and must be built into the corporate culture. Underlying successful risk management is a commitment to transparency, accountability, awareness, and skills development. The following section addresses the most common risks experienced by RCCUs.

1. Identify and quantify risk

64. Risk recognition is the first stage of risk management. RCCs must make a realistic assessment of all risk areas and identify and quantify their risk. What is the real risk in the loan portfolio, where is the risk, and how big is it? What is the real cost of having improperly trained and unmotivated staff? What is the real cost of poor quality financial statements and inadequate management information systems? What is the real cost of poor governance and where does it impact the most, in non performing loans, poor staff, poor community relations or image, inability to attract investment? These are some of the question RCC management should be asking themselves to identify and quantify risk.

2. Credit Risk

65. The high level of NPLs, coupled with low loan loss provisions, indicates that credit risk recognition is lacking. Perhaps more importantly there does not appear to be much sense of responsibility for risk management in credit practices of RFIs at present. Recognition of credit risk requires good credit analysis (which includes monitoring the economy and industry trends) and underwriting skills, monitoring and follow up. Aged listing of NPLs should be updated daily and the aging categories should be increased to provide better analysis of portfolio risk. As soon

as a loan is more than 90 days in arrears it should be carefully assessed, interest accruals should cease and a realistic provision based on asset quality should be made.

3. Governance Risk

66. Despite changes to ownership and governance requirements, RCCUs still express concern that they will be pressured by local authorities to engage in policy loans. This sort of interference in the operations in RCCUs is a major cause of the existing NPLs and there do not appear to be many deterrents to recurrence. The reform process is not changing the method of selecting directors, which are effectively appointments by local government officials which are then rubber stamped by the general assembly. In addition, several local governments are promising to subsidize dividends for the newly restructured RCCUs in order to attract investment. This sets the stage for further influence, as local governments will expect consideration for their investment.

67. Selecting directors without appropriate qualifications or background also lead to governance risk. This may lead to poor strategies and business decisions that jeopardize the strength of the institution and impair its public image leading to reduced patronage by clients, unattractiveness to investors and poor performance.
Governance risk increases when there is no accountability or the lines of accountability are unclear as is the case with the current RCC reform. Directors should be accountable to investors but in this case they are accountable to local and provincial governments. Directors should have clear terms of reference that clearly state to whom they are accountable and what the consequences of failure to be accountable are.

4. Management Risk

68. Management risk is the risk that officers and employees of the financial institution will not perform as expected or not have the necessary competencies for effective management. Demonstrable minimum education and experience requirements for new hires or promotions, clear job descriptions and effective performance standards and management systems are effective tools to ensure that officers and employees are competent and committed.

69. Management risk includes the risk of losing key employees without an appropriate succession plan in place. The best strategy to mitigate this risk is to cross train employees for various positions and to continually upgrade employee skills.

5. Upgrade staff and director skills.

70. Training is a key need to sustain development of the RFI movement. The World Bank identifies new management as a critical success factor of restructured financial institutions. The reason for this is that organizational culture usually needs to be changed to achieve sustainable results. In the absence of changing management personnel, upgraded skills, methodologies and technology are essential. Organizational culture can rarely be changed through training, but skills and methodologies can.

71. The financial sector and the needs of customers are changing rapidly but there has been little or no investment in training RFI staff to keep up with the changing environment. Based on interviews with RCCUs and reviewing their financial statements, it is clear that there is urgent

need for improved accounting skills, underwriting practices, delinquency management, risk management, asset/ liability management as well as marketing and product development and human resource management.

72. The RCC system in IMAR has more than 18,500 employees. The financial and time cost of retraining such a workforce is enormous. Targeting at least 5 people in each RFI to receive training in the first year in key areas is a manageable goal. Each RCCU should have at least one accounting expert, 1 commercial lending and 1 micro lending expert, a marketing expert and a human resource expert. RCCUs that remain under the two person structure should have experts on staff to act as a resource person for member RCCs.

73. In most cases it is not effective for an organization like an ARRCCU to develop in house trainers as their skills quickly become outdated if they are not active in the industry. Instead the ARRCCU should contract specialists from professional organizations to deliver training as required, such as accounting and banking institutes or firms.

74. Accounting and underwriting skills are the most immediate training needs. Accurate, timely and meaningful financial records are essential management and marketing tools. To attract and retain investors, RFIs must produce financial statements that are transparent, understandable and present a fair picture of the institutions financial condition. Management similarly requires detailed and truthful financial information to effectively manage their institutions.

6. Introduce performance based pay scales

75. All RCCUs have indicated that in general their staff do not have the skills required to meet the needs of today's financial environment. The system must invest in training, but must also set performance standards to ensure that training is effective. Employees who do not demonstrate positive change in behaviour and performance after receiving training should be denied further training opportunities so that those resources can be directed toward more committed employees.

76. To ensure that the training investment is maintained, RCCs should introduce performance based pay scales. Performance based pay scales offer a minimum salary with the opportunity to improve earning potential through performance. At present RCC staff are quite well paid compared to people with similar levels of responsibility in other organizations such as higher education facilities and government. As there are no negative or positive consequences to performance there is no incentive for employees to change their behaviour.

77. Tuzuo Banner has introduced a responsibility system for loan officials for the collection of micro-loans. The responsibility system means that loan officers are partly responsible for loan defaults. If loan collection ratio falls below 80 percent the loan the loan officer faces financial penalties. With the responsibility system in place loan officers make more effort to collect accurate information about rural households, proper evaluation and monitoring and enforcement of loan repayment. As a result Tuzuo Banner has a lower ratio of non performing micro loans than most banners.

78. Tuzuo Banner is a good example of a simple performance based pay system, but this system can and should be expanded to cover all aspects of RCC operations, not just micro lenders. In developing performance based pay systems it is important to consider the overall strategy and long term plan of the RCC to ensure that incentives are appropriate to the overall

goals of the institution. It is also important that the performance criteria are stretch targets; that is the performance criteria must be set high enough that it results in improved institutional performance. If every employee achieves the maximum performance bonus, either the system targets are not high enough to achieve real improvement or it is not being properly implemented. A performance based pay system where every employee achieves the targets is ineffective.

7. Risk based fees levies

79. The IMAR government will establish a risk fund using tax revenue received from RFIs in excess of the threshold established by tax receipts to year end 2004. RCCs paid CNY58.5 million in taxes at year end 2004. Tax revenues collected in excess of CNY58.5 million for the next 10 years beginning at year end 2005 will be allocated to a risk fund. The IMAR government anticipates achieving a fund of CNY330 million by 2015. On a straight line basis, achieving a fund balance of CNY 330 million in 10 years requires additional tax revenues of CNY29 million per year at a yield of 2.25% per annum assuming that no demands are made against the fund.

80. The IMAR government is to be commended for establishing a risk fund and doing it in a painless fashion in the short term. However, the creation of a risk fund also gives rise to moral hazard. The seamless manner in which the fund is being created increases the hazard. Establishing a fund on excess tax revenue may be considered a passive risk management tool. It has the potential to build the fund fairly quickly without increasing the burden on struggling RCCUs. These are important considerations in the short term given the present vulnerability of RCCUs in IMAR. At the same time it is important that RFIs and RFI investors take responsibility for risk management so the fund should be built visibly with active involvement of the RFI.

81. To encourage responsible management from RFIs and responsible oversight from RFI investors, RFIs should be required to make direct contributions to the fund in the medium term. Fund contributions should be instituted through a risk based levy. RFIs that exceed prudential norms and engage in risk averse practices are less likely to cause a claim on the fund and therefore should be rewarded with a reduced levy. Institutions that do not meet prudential requirements or engage in risky practices are more likely to cause claims against the fund and should, accordingly face higher levies.

82. Levies should be calculated on average assets to encourage responsible growth and reflect potential claim size. Levies should not be assessed against capital because doing so discourages capital accumulation and capital accumulation by individual RCCs is a critical component of reducing systemic risk. When RFIs begin to contribute the risk fund, the earnings of those funds contributed to RFIs should be reinvested in the fund and used to offset risk mitigation services such as audit and training. Earning from funds contributed by RFIs should not become part of the IMAR governments' general revenue.

8. Introduce insurance services

83. Affordable insurance products are needed for both households and rural financial institutions. Use of insurance products is limited in IMAR. Local officials are sceptical about the viability of insurance schemes. Farmers are very vulnerable to both natural disasters and commodity price fluctuations. Effective insurance schemes would stabilize household incomes and decrease risk for RFIs. There has been limited experimentation with agricultural insurance

for households and there are some examples of creditor default insurance for specific loan products such as loans to laid off workers that are funded by local governments.

84. A tripartite risk fund has been developed in Chifeng between farmers, dairy processors and the local government. The local government contributes 12.5% of the value of the loan portfolio for dairy production, dairy processors contribute CNY.02 per kilo of milk and farmers contribute 1% of the value of their herd to the fund. The fund is retained at the RCCU. Participation is compulsory for farmers who borrow from the RCCU to finance their dairy enterprise; farmers without loans may participate. The fund is designed to protect against both loss of livestock and milk price declines. No loans issued under the new program were due at the time of investigation so performance is unknown.

85. Manzhouli RCCU takes advantage of a loan guarantee program for laid off workers. A state insurance company provides the loan guarantee. Loans are guaranteed to 85% of principal and interest. In the event of default the RCCU is paid out and the insurance company assumes collection responsibility for the loans. Borrowers pay the guarantee fee.

86. Many countries are introducing micro insurance programs for their borrowers, such as the MBA Card program in the Philippines, Cambodia, and India, where borrowers are at least as poor as Chinese peasants. Many of these programs allow borrowers to obtain additional loan funds or longer term loan funds to purchase insurance. Micro insurance is not only creditor insurance but general household and health insurance that protects households from financial shocks and enables them to better meet their loan obligations.

9. Remove outside influence from credit decisions

87. Directed loans are a major cause of financial institution instability in almost every country and China is no exception. Directed loans or policy loans arise for a variety of political and social reasons but their very existence is a strong indicator that the projects they support are not viable or financial institutions would not require pressure to issue them.

88. "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"[i] The current reform process has not and will not change local government influence over RFIs as the shareholders do not have real decision making power in the institutions and this influence is the biggest obstacle to NPL resolution and future risk management.
Intervention in RCC lending decisions should be discouraged by requiring local governments to establish pre-funded loan guarantee funds if they want to encourage lending to a specific sector.

III. RURAL CREDIT COOPERATIVE CAPACITY BUILDING

A. Focus on capital accumulation (details see Appendix 2 and 6)

89. A solid capital base is key to institutional sustainability. Capital is required to finance growth, ensure institutional flexibility, maintain profitability, attract investment and provide a cushion against external shocks.

90. The table below shows the gap between the capital currently held in the 9 RCCUs being considered for conversion to RCBs or RCOBS using a median BIS standard for capital

adequacy. These 9 RCCUs (Batou Consolidated represents 2 RCCUs) may be considered the strongest RCCUs in IMAR, and collectively they have slightly more than 1/3 of the capital required for sound institutions. A careful evaluation of their non performing loan portfolios would probably result in an even larger gap. It is clear from this table, regardless of what capital adequacy or credit aging standard is applied, that RCCUs in IMAR are grossly, some of them fatally, under capitalized.

Table 2: Capital Gap of Selected RCCUs in IMAR (CNY 000's)

RCCU	Reported Capital	Balance of NPLs	Balance of LLR	Required LLR Per BIS	Balance Adjusted Capital**	Additional Capital for Risk-weighted CAR of 8%***
Horqin	77,188	220,092	14,444	98,964	(7,322)	101,633
Dongsheng	30,834	65,993	8,975	26,171	13,638	57,028
Hailar	23,747	114,309	5,034	60,766	(31,985)	77,668
Hohhot Suburban	75,483	184,146	17,376	93,456	(597)	133,495
Manzhouli	20,184	23,472	2,284	19,335	3,133	18,697
Naiman	37,436	66,715	4,767	43,505	(1,302)	28,800
Yuanbaoshan	39,475	69,864	5,512	37,485	7,502	30,116
Batou Consolidated	107,993	340,618	13,429	156,655	(35,233)	197,121
Totals	412,340	1,085,209	71,821	536,337	(52,176)	644,389

91. The first step in building and protecting the capital base of RFIs is to disallow the payment of dividends when the institution does not meet capital requirements or experiences an operating loss.

92. The second step in protecting the capital base is to ensure that adequate allowances are made for risks such as non performing loans and investments. The loan loss reserve limits imposed by the Ministry of Finance for tax purposes and the onerous requirements for writing off bad loans discourage adequate loan loss reserves and endanger institutional capital. The CAR requirements established by the CBRC and the risk weighting methodology are very liberal and do not ensure adequate capital accumulation.

93. The legal environment with respect to capital requirements is very weak and must be strengthened. Higher standards for loan loss provisions and capital adequacy must be set. The current environment allows an institution to pay dividends even if it has inadequate capital, and in the case of promises of dividends being paid by local governments, or unprofitable. This creates a situation where shareholders can be in a situation of having non performing loans while still earning dividends on their investment while the IMAR government maintains the risk of institutional failure. This is a win/win for shareholders and a lose/lose for the IMAR government.
The legal environment should be strengthened to absolutely forbid dividend payments if the institution does not meet minimum CAR requirements or posts an operating loss.

B. Upgrade staff and management skills and capability

94. Staff, management, and directors are the single most important asset of any business, including a financial institution. Training is one aspect of improving management skills and capability but it is not enough. In order to operate effectively, staff must have access to good

information, that is accurate financial statements and other operational reports, they must have the authority to carry out their duties, they must be motivated and they must have the tools to do their jobs.

95. Tools include knowledge as much as they include technology. One RCC in Manzhouli says it is actively engaged in lending to laid off workers and yet did not know Manzhouli's unemployment rate. How can a financial institution operate effectively, much less compete in a community, when senior management is unaware of the basic local economic environment?

96. Relatively high employee to operational cost ratios suggest (Appendix 3, 4) that there is room for efficiency improvements in RCCs. As RCCUs are restructured and consolidated, opportunities to improve human resource capacity and efficiency should be sought. An assessment of employee skills and aptitudes should be conducted. There will inevitably be redundant positions as a result of consolidations. The strongest incumbent for a given position should be retained and others should be assessed and redeployed in other areas. Retraining may be required and is a worthwhile investment. To upgrade human resource capacity, RCCs should invest in training, introduce performance based pay systems, use appropriate technology and very importantly share information within the institution. It is important that all personnel understand how their job connects to the overall strategy and the strategy must be connected to the local market and environment.

C. Reduce staff to borrowers ratio

97. A factor in staff capacity is having the time to do their jobs. The staff to borrowers ratio in IMAR is very high, from 3- 500 clients per credit officer in rural areas and 3 – 800 clients per credit officer in urban areas. This compares to less than 200 clients per loan officer in most micro finance institutions around the world. The situation is particularly difficult in IMAR because of the vast distance in rural areas between villages and county seats.

98. It takes just as much effort to properly structure and follow up on a CNY 1000 loan as it does to write a loan for CNY100,000, yet there is a tendency to thing that smaller loans need less attention therefore one loans officers should be able to deal with many more clients. In fact often the opposite is true as micro loan clients are often much less educated and sophisticated and therefore it is more difficult to get proper information.

99. With such high loan to staff ratios it is very difficult for staff to properly investigate a borrower, visit them for follow up and monitoring or loan collection. The result is that improper investigation occurs at the beginning when the loan is first being applied for and that sets the stage for future difficulties.

100. Reducing the staff to borrowers ratio should reduce the level of non performing loans provided that a proper performance management system is in place.

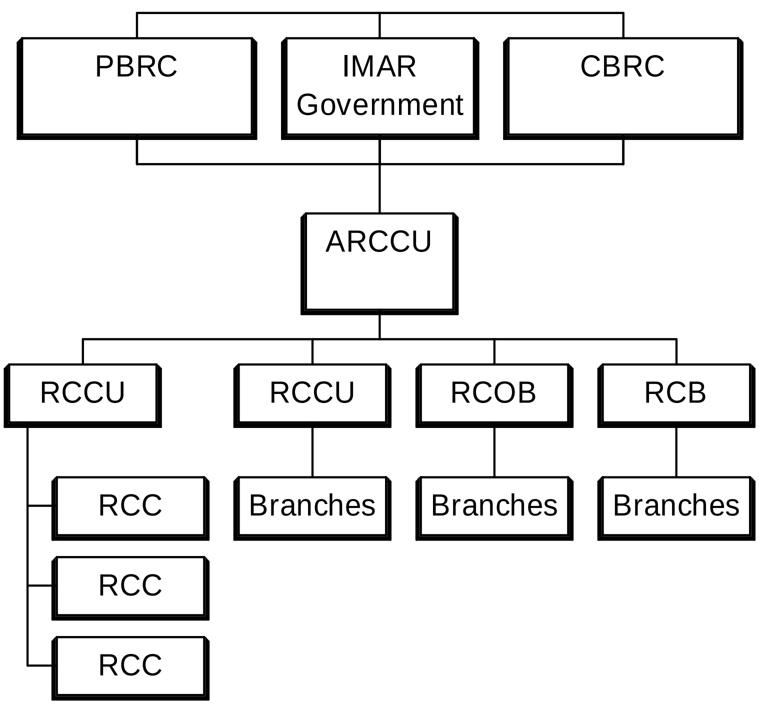
IV. **INTER AGENCY RELATIONSHIPS** (Details See Appendix 5 And 8)

101. Relationships between the various agencies, the CBRC, IMFO, PBOC and ARRCCU and their roles are not clearly defined. Lack of role definition between the four 'supervisory' agencies has efficiency implications in terms of financial and human resource allocations. There may be competition between organizations to attract skilled staff, or organizations may not be able to effectively carry out their responsibilities due to lack of competent staff. The cost of supporting additional layers will impact negatively on the performance of the primary agencies.

There is a very high risk that liberal interpretation of guidelines will lead to over regulation and excessive interference in the operations of the RFIs that will greatly increase their administrative burden without positive effect on their operations. Overlap and competition between higher level agencies has been reported in the Jiangsu pilot causing confusion in the RFIs and allowing them to play one agency off against another.

102. It is important that inter agency relationships are clearly defined at the institutional level and not left open to interpretation by individual officers within the agencies. To institutionalize appropriate roles and functions it is recommended that the agencies develop Memorandums of Understanding to avoid duplication of resources and increase effectiveness of the individual agencies and subsequently the RFIs. Specialization by agencies should give rise to consideration of revenue sharing based on existing fees from the RFIs rather than levying new fees to support redundant structures.

RCC System After Reform



A. Role of CBRC, Government and RCCUS

1. CBRC Supervises

103. The supervisory and regulatory environment for RFIs has become less clear with the latest reform initiative. Prior to this reform, RFIs were mainly under the supervision of the CBRC but were also supervised by the PBOC for specific purposes such as liquidity reserves and PBOC onlending. The current reform potentially subjects RFIs to four different authorities, the PBOC, the CBRC, the IMFO and the ARRCCU without delineating specific responsibilities for

those agencies. Without clarification of roles, supervision will be weakened rather than strengthened; “when everyone is responsible, no one is responsible”.

104. The law on Banking Regulation and Supervision places the responsibility and authority for supervision and regulation of the RCC system with the CBRC. The CBRC has established a Cooperative Finance Supervision Department (CFSD) that is responsible for the supervision of urban and rural credit cooperatives. The CFSD not only supervises and regulates RCCs it continues to implement some of the administrative functions from its predecessor, the PBOC, including approval of large value loans[12], selection of staff and establishing internal policies such as lending policies.

105. Loan approval authority compromises the integrity of the supervisory authority in a number of ways. First, with current round of reform, responsibility for loan losses has been shifted to provincial governments, but a national organization still has authority to make decisions that could increase risk to the provincial governments. Effective management requires authority to be balanced with responsibility; in this case the CBRC has authority without responsibility or risk. Secondly, if the CBRC authorizes loans through RCCs and those loans become non performing, the CBRC loses moral authority.

106. CBRC should cease any administrative roles and confine itself strictly to supervision and regulation.

2. Government facilitates and supports by setting policy

107. Governments’ role, through the FO, is one of facilitation and support through establishing policy and creating an enabling environment. There are many ways that government can create an enabling environment.

108. One is to recognize that IMAR is not a homogeneous environment, in some parts of IMAR, neither economically nor demographically and different policies may be required for different regions. In some areas RCCs are simply not viable and will never be viable under the current demographics. The operational structure of RCCs is to cumbersome and to costly to be supported in remote rural areas with low population density and long distances between households or villages. In these situations the government should work with the CBRC to close unviable RCCS and to experiment with other types of financial models such as genuine, member driven savings and credit cooperatives, which are much more cost effective than RCCs or a variety of other micro – finance models.

109. Government can also encourage and support the establishment of auxiliary services to support financial institutions such as a province wide credit reporting system and micro insurance agencies. A strong role for government is to support infrastructure development such as marketing channels and information networks and health service to enable rural households to be productive and profitable.

[12] CBRC officials at the national level state unequivocally that the CBRC does not approve any loans but some RCCs believe that they do, which indicates at best that CBRC role is not well understood or at worst that some local CBRCs are taking liberties with their mandate.

3. ARRCCUs provide value added services and represent RCCs from the association point of view

110. RCCU officials expressed a need for a regional level institution to represent them on a national level and with large private sector or para-statal organizations. RCCU officials do not feel that they have sufficient status to effectively influence organizations such as the large milk processors. It would be of benefit to RFIs and to rural households for the ARRCCU to lobby on their behalf for such things as direct payments or assignment of proceeds to support loans, for example.

111. Another example of where the ARRCCU would be more effective than individual RFIs is to lobby for changes to the tax policy or interest rate liberalization for micro finance programs. The ARRCCU can also negotiate on behalf of the system with suppliers of such things as technology, stationery, audit services etc. In this respect the ARRCCU would truly be acting as a member driven organization rather than a government organization.

112. The ARRCCU can add value to RCCs by coordinating and facilitating training, developing model policies and procedures, disseminating best practices and acting as a resource centre for RCCs.

V. THE DEVELOPMENT OF MICRO FINANCE MOVEMENT IN CHINA AND IMAR

(Details See Appendix 10)

113. After a decade of experimentation, micro finance programs/institutions (MFPs/MFIs) in China have achieved a great deal in terms of finance for poverty alleviation and through implementing new lending methodologies, market rates of interest and management of small scale financial institutions in China. Many lessons have been learned that are applicable to IMAR. The following section analyses the success factors of micro finance in China and the relationship between outreach and MFI sustainability. A detailed analysis of MFPs/MFIs in IMAR can be found in Appendix 10.

A. Success and Failure Factors for Micro Finance in China

114. MFPs/MFIs in China conducted experiments in new lending methodologies ahead of the formal financial institutions in China. The loans provided by traditional RFIs in China prior to the late 1990s were mainly term loans with low rates of interest of relatively large size. Other mechanisms for loan repayment, such as frequent loan repayment, dynamic incentives,[13] targeting women, and group guarantees were not in place. Loans provided by MFPs/MFIs in China (modified Grameen replicates) have been characterized by small loan size (from RMB 500-about 4,000 (maximum 5,000 RMB) per loan for rural loans, relatively high rates of interest, frequent loan repayments, dynamic incentives and targeting women. Some programs have adopted group guarantees with 5 per cent of loan principal as group fund deducted at the time of loan disbursement and compulsory savings programs. Compulsory savings and group funds could be regarded as collateral substitutes. Some new lending methodologies, such as dynamic incentives, targeting women and frequent loan repayment, have proven useful in raising loan repayment rates for small size loans to rural households. In general, the loan quality of the MFIs

[13] Dynamic incentives also be referred to as positive incentives, which means that if a borrower successfully repays her loan, she will be granted another loan, usually a loan in a larger amount.

is better than that of the poverty loans disbursed by ABC, and the loan quality of well managed MFIs is better than those micro-loans disbursed by RCCs.

115. MFIs/MFPs in China have also tested higher lending rates for loans for poverty alleviation. Most donor-funded programs in China charge an effective rate of interest from 12 to 18 per cent per annum, which is much higher than the rate charged by RFIs in China (3-8.5 per cent per annum). The experiments with micro finance show that the current lending rates of interest for micro-loans on credit charged by RCCs are not able to cover the full costs for small scale RFIs that provide small size loans to the poor. The micro finance experiments indicate that MFIs in central China need to charge an effective nominal lending rate of about 15 per cent to achieve operational viability.[14] Moreover, MFIs in China have no historical burden, no tax obligations and loan repayment rates of well functioning NGO MFIs programs are higher than the average RCCs in China. This is an indicator that to meet their higher operating costs, RCCs should be charging interest rates even higher than those charged by MFIs in order to break even.

116. MFIs/MFPs in China are primarily operated in China's poor counties and therefore have provided a significant proportion of their loans to poor households for poverty alleviation. Despite charging higher rates of interest than traditional RFIs and poverty alleviation programs, there is clearly a demand for MFP/MFI loans. The borrowers are able to use high interest rate loans profitably and in some cases the MFP is also able to extract a profit from the provision of micro-loans to the poor households.
A significant but less noticed contribution of the micro finance movement is the creation of new forms of institutions and new approaches for poverty alleviation, social welfare, and financial development in China. The conventional approach in China is that the provision of financial services, poverty reduction, and social welfare are the responsibilities of governments and their institutions. The development of micro finance movement in China demonstrates that semi official institutions and NGOs could be equally effective, and in some cases more effective and innovative, in delivering public goods.

117. A number of factors have been responsible for the success of NGO micro finance programs in China. First, unlike formal financial institutions such as RCCs that are subject to interest rate regulations, NGO micro finance programs in China have been able to charge higher rates of interest and test new lending methodologies. Second, as new institutions, the employment and remuneration packages of the MFIs are more flexible, as compared with formal financial institutions. MFIs are able to design their own incentive mechanism for their employees. Finally, many MFPs/MFIs have special funds for technical support and training, which is important for capacity building of the poor, and improves repayment rates.

118. The experiments in China's micro finance also show a number of constraints for financial development and poverty alleviation in rural China. Similar to what happened with the formal financial institutions, lack of a proper institutional form with good corporate governance and effective external monitoring/supervision are the two major obstacles for sustainable development of micro finance movement in China. China's micro finance movement has so far failed to test new form of institutions with clearly identified ownership structures and good corporate governance, committed to provide long-term sustainable financial services to the poor in rural China. Many MFIs are subject to influence from local governments. In some cases, local government employees manage the MFPs/MFIs. In other cases, MFPs/MFIs are subsidized to a

[14] See CGAP evaluation report, 2000. Operational sustainability here refers to the incomes of MFIs cover the operational costs, loan loss provisions and real fund costs (usually subsidized, not opportunity cost of capital).

large extent by the local governments and their agencies. There has not been effective external monitoring, supervision and auditing for most MFIs/MFPs in China.

119. Most MFPs in China are Grameen replicates although Chinese MFPs are located mainly in rural areas and a considerable proportion of loans are used for agricultural production. With the increases in household incomes and widening income gaps, there has been a decline in the demand for Grameen model of micro-loans. It should be noted that the Grameen model has not been particularly effective in sparsely populated areas because the meeting requirement to conduct self monitoring is impractical and can be financially burdensome.

120. Finally, it is difficult for any micro-credit programs/institutions to be operationally and financially viable in the very poor and remote mountainous areas of China's southwest and northwest, with high transaction costs and lack of income generation opportunities in these areas. In addition to limited economic opportunity these areas face higher education costs and higher incidence of illness due to poor and expensive health care access. Remote areas of IMAR, especially in the sparsely populated western regions, can be expected to face similar obstacles.

121. A number of factors are responsible for the constraints discussed above. First and foremost, on an experimental basis, it is unlikely for any MFIs to attract funds from private investors and micro finance experiments in China therefore have to be dependent exclusively on the funds from donors. This has contributed to the unclear ownership structure and local government intervention in the operations of MFPs in China. Lack of clarity over ownership of MFPs/MFIs has resulted in the failure of donor supported MFPs/MFIs in many countries and donors are becoming reluctant to support MFPs/MFIs in such an environment. Moreover, with limited funds from donors, the scale of each MFP/MFI is generally small (CNY 2-5 million in each county), which makes it difficult for these programs to be financially viable in the long run. Next, for very poor areas, it is important for the government to invest more in public goods such as rural infrastructure, public health, and school education. The poverty in these areas can hardly be alleviated by micro finance alone. Finally, lack of a legal framework for the operation, monitoring and supervision of MFIs have also contributed to the ineffective external monitoring and auditing of MFIs in China.

122. Trade offs between outreach and financial sustainability of MFIs are shown in Chart 1. As greater poverty outreach is achieved (reaching more poorer clients in the more remote areas), the profit of MFIs declines . A shift from Line B to A represents an increase in efficiency of a MFI. Here efficiency is defined as the profits achieved by a MFI given the poverty level of its clients and the impact of the micro finance services on the clients. For any given level of poverty reached, the profit of the MFI at line A is higher than line B.

123. In Chart 1, Line B represents the current level of trade off between outreach and financial sustainability achieved by well RCCs and NGO MFIs in IMAR (sustainable frontier institutions). At the poverty level of α, a well-performing RCC/MFI is able to provide micro-loans to its clients up to Q without subsidies. With an improvement in efficiency, a well-performing institution will shift from B to A, achieving a deeper poverty outreach (up to point β) while maintaining its financial performance. To promote micro finance for RCCs and NGO MFIs in IMAR, it is important to identify and quantify:

(i) The current levels of subsidies provided and depth of poverty (the level of income and welfare of rural households) reached for the provision of micro-loans by RCCs and MFIs in the following three categories of institutions in different regions of IMAR: the best performing institutions, the average institutions, and worst performing institutions;

(ii) The efficiency gains in moving the performance of all the other institutions to that of the best-performing institutions in different regions of IMAR.

(iii) The potential for efficiency gains for the best-performing institutions in different regions of IMAR by assuming that (a). There are no historical burdens for RCCs; (b). An increase in lending rates of interest for micro-loans without or with little impact on loan repayment; (c), A reduction in the operational costs and risks by innovations in financial products and institutions.

(iv) Point β in Chart 1, beyond that point, subsidies will be required for the MFIs to operate, even all the potential gains in efficiency has been achieved.

Outreach and Financial Sustainability of MFPs/MFIs in IMAR of China

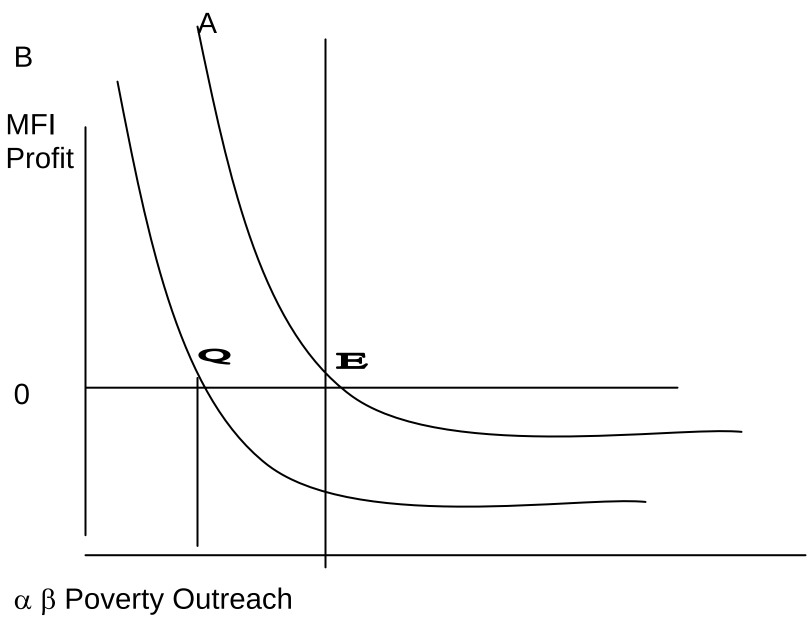


Chart 1. Trade-off between Outreach and Financial Sustainability

124. The analysis above has important policy implications. Actions (information assimilation, training, and technical support and institutional reforms) should be taken to improve the performance of all the other institutions (including RCCs and NGO MFIs) to the level of the best performing institutions to achieve the potential efficiency gains (to point α and Q). Next, further reforms should be undertaken to raise the lending rates of interest for micro-loans, to reduce operational costs and mitigate credit risks by conducting financial innovations (to point β and E).

125. For those regions and clients where a subsidy is required (beyond point β), policy makers need to decide whether micro finance should be supported through subsidies, if so, how to subsidize these institutions and who is going to pay for it? Even if subsidies are available, there is no guarantee that the subsidies will lead to greater outreach to the poor. Subsidies in

themselves do not guarantee greater outreach to the poor. Subsidies must be accompanied by performance standards and monitoring. It is perhaps more important for the governments to provide more fiscal input to improve rural infrastructure, educational and health services in these poor and remote areas so as to reduce the subsidies for the provision of financial services.

126. Different institutional forms, such as real, member driven, credit cooperatives at the village level could be tested first in the remote sparsely populated areas of IMAR to provide sustainable micro finance in these regions where the competition for the services is very limited.

VI. MICRO FINANCE OPTIONS FOR IMAR

127. Micro finance loans are currently being offered through both RCCs and MFPs in IMAR. A number of improvements can be made the current loan practices and procedures of RCCs to improve the outreach and effectiveness of their micro loans.

1. Improve RCC Micro-loans on Credit

128. Micro-loans on credit can be improved in terms of loan quality and outreach through:

(i) Setting an overall standard in IMAR to link household credit rating to credit risk on two levels. RCCs with a higher proportion of non-performing loans may have a low credit limit for households in the area until loan performance improves. Household limits will be determined on the basis of repayment capacity rather than collateral or other considerations.

(ii) When possible replace credit rating with credit scoring. Under credit scoring, information on credit rating helps RCCs to assess loan applications, instead of replacing the process of loan application assessment, monitoring, and enforcement. Information on credit rating can help RCCs to determine the time and effort to be spent on threshold applicants, those with higher risks, and rewards and loan limits for rated households.

(iii) Enter data on rated households collected into a computer database, including the household incomes, family labour available, assets and past loan repayment records. This information is valuable for RCC credit scoring, loan assessment, and information sharing with other institutions.

(iv) Introduce a responsibility system for disbursement and collection of micro-loans with the RCC directors and RCC loan officials, following the experience from Tuzuo Banner. RCC directors and loan officials shall be made responsible, or at least partly responsible, when the loan collection rate falls below a certain percentage. The lessons from NGO micro finance pilots in China indicate that to link the remuneration package for loan officials to loan repayment rate is an important means for MFIs to improving loan quality. To avoid abuse of the responsibility system, RCCs need to segregate refinanced and rescheduled loans in their reporting.

(v) Credit rating is only one mechanism for encouraging loan repayment. Other mechanisms, such as frequent repayment of loans,targeting women, progressive loans and other tools based on local conditions shall be introduced by RCCs.

(vi) Set more sustainable lending rates for RCC micro-loans, based on cost of funds, operation expenses, projected loan losses and profit for growth. At the same time to reduce other borrowing costs for borrowers, such as time spent on loan

applications, small gifts and other considerations for loan officials, etc. With a relatively high lending rate, RCCs can rebate those who repay loans on time.

(vii) With improvement in loan quality, RCCs shall pay transportation costs and a small living allowance for loan officials going to villages for loan monitoring and collection.

(viii) Instead of targeting extensively household heads who are mainly men, RCC micro-loans shall target more women. In many NGO MFPs women have proven more reliable with a higher loan repayment rate. Moreover, when a loan is granted to a woman, it tends to have a larger impact on the improvements of the welfare of the women and children in a family.

2. Improve RCC Group Loans

(i) Group guarantee loans should target poor rural households who have no physical collateral and other guarantee. The size of group loans shall be smaller than individual loans. Instead of pooling an individual loan with a group for a better off households, RCCs shall target poorer households with group loans and then graduate them into individual loans, as they demonstrate successful loan repayment over time.

(ii) Group sizes shall be restricted to less than 6-7 households, and limit to around five households if possible. No close relatives shall be allowed in a group.

(iii) Group funds and/or compulsory savings (as risk funds) could be introduced by RCCs to improve the loan repayment rate.[15]

3. Develop New Loan Products

129. A new loan product for agricultural enterprise shall be introduced by RCCs to finance farm production and investment with longer production and income generation cycles, such as cattle raising and production of some cash crops. Lack of appropriate agricultural loan products have increased loan defaults, as most of the micro-loans are short term, generally within 12 months and most from 7-9 months. Larger and longer term agricultural loans shall be based on repayment capacity and require more physical collateral, such as large farm machines and land use rights. There could be regulations as to the maximum proportion of large agricultural loans to ensure that the small farmers will be served as well.

4. Medium and Long Term Actions[16]

130. It is important to clarify whether RCC micro loans are policy or commercial loans. RCCs shall be compensated for disbursement and management of policy driven micro finance loans. Compensation can be made in two installments to encourage prudent credit management, a portion up front to cover disbursement cost and the remainder upon successful repayment of loans. Otherwise, market principles shall be applied. Local government intervention on lending decisions, especially intervention from county level governments shall be removed. In the short term, direct local government intervention could be replaced by indirect interventions such as setting up guarantee funds to encourage RCCs to lend to specific sectors that are important to the local economy.

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[15] RCCs have compulsory savings for their group loan programs.

[16] Medium and long terms actions are actions upon the changes in central government policies and the ways in which the local governments are operating, which is often beyond the control of RCCs.

A. Experiment and Support NGO Micro Finance Institutions

131. As one of the more successful MFPs in China, the lessons from Chifeng MFP shall be summarized and learnt by RCCs and other NGO programs in Inner Mongolia. The pilot in Chifeng shows that; a) MFIs in most areas of Inner Mongolia can serve the rural households in a sustainable manner, with a certain scale of fund input and sustainable lending rate of interest; b) Rural Mongolian women and other women in IMAR are bankable; and c) Non-financial institutions can play an important role in financing the poor.

132. The Chifeng Project can be strengthened by clarifying its relationship with the prefecture Women's Federation to an extent that changes in personnel and policies of the prefecture Women's Federation will not affect operations of the MFI. Productivity of the MFI needs to be improved. In the longer term, ownership of the MFI needs to be clarified with real owners. Corporate governance of the program needs to be improved as well.

133. The SPPA in Wushen is a government program, not a NGO MFI. The Program in Wushen cannot stand on its own and continuous subsidies are required if the program is to continue. In remote herding areas of Wushen and other areas of IMAR, pilot programs shall be undertaken to test real self funded rural savings and credit cooperatives organized by farmers based on compulsory savings program in Wushen SPPA.
In general, MFIs in IMAR shall have a clear ownership and management structure, with real owners. Insider control (control by management) is a common problem for RCCs in China. With capital funds from donors and the government sector, NGO MFIs also have no real owners. Given the difficulties with ownership and institutional transformation of RCCs, in the short term we shall concentrate more on development of alternative institutional forms of micro-credit providers to promote competition in the provision of micro-finance services in the region in order to provide better micro finance services for the poor and micro-entrepreneurs.

134. Experiments can be undertaken in IMAR to test a new form of institutions with a clarified ownership structure and private investment for providing micro-finance services to micro entrepreneurs on a sustainable manner, provided the necessary policy and other support from the provincial government and CBRC.

B. Build up the Infrastructure and Environment for Micro Finance Development

135. The infrastructure and environment for micro finance development must be built up through:

- (i) Experiment on possible collateral for loans, such as long-term land use right, especially for large size agricultural loans.
- (ii) To increase government input in rural infrastructure, education and health and prevent rural households from over borrowing from RCCs and NGO MFIs for education, health and land development. The medical insurance program could be studied and experimented as well.
- (iii) To take the environment and sustainable development into consideration when assessing household applications for credit. Large increases in the number of animals, supported by loans from formal and informal sources will contribute negatively to the sustainable development in IMAR.

(iv) Set up a credit bureau system to collect and exchange information on household borrowing. RCCs and NGO MFIs shall share and exchange client information. Some households have explored the system and borrowed from both sources and the borrowing has not been necessarily backed by the loan repayment capacities. This not only increases risk to lending institutions it increases the vulnerability of households.

(v) Conduct training program for RCCs as soon as possible on RCC credit scoring, micro finance, etc to build the capacities for RCCs to conduct micro finance programs.

136. Experiments can be undertaken in IMAR to test a new form of institutions with a clarified ownership structure and private investment for providing micro-finance services to micro entrepreneurs on a sustainable manner, provided the necessary policy and other support from the provincial government and CBRC.

[i] Establishing a Framework for Sustainable Rural Finance, ADB, February 2005

APPENDIX 1: CONTEXT FOR RURAL FINANCE IN IMAR

1. Strengthening financial services to the agriculture sector and to rural non farm activities has become a major policy objective of the Government of the Peoples' Republic of China (PRC). Accordingly the Government requested the Asian Development Bank (ADB), during the 2004 Country Programming meeting, to provide advisory support of rural finance reforms and the development of micro finance institutions in the Inner Mongolia Autonomous Region (IMAR) and Guizhou Province. This report examines the proposed rural finance reform in IMAR and makes recommendations for structural and operational reform of the Rural Credit Cooperative (RCC) sector and introduction of micro finance models to improve outreach and effectiveness of rural finance.

2. This consultants report is based on the results of examining the current status of rural finance mechanisms in IMAR, the proposed changes to RCCs as outlined by State Council Document 15 (2003) "The Implementation Plan of Enhancing Reform of Pilot RCC's" and adopted by the IMAR government, discussion with the China Banking Regulatory Commission (CBRC), Inner Mongolia Financial Office (IMFO), RCCUs, RCCs, farmers and other stakeholders and the international experience and expertise of the consultants.

3. For the purposes of this report, use of the term bank refers to both the Rural Commercial Banks (RCB) and Rural Cooperative Banks (RCOB) and the term rural financial institution (RFI) refers to Rural Credit Cooperative Unions (RCCU), RCB's, RCOBs and RCCs collectively.

A. Background

1. Sector Description

a. The Economy

4. IMAR is PRC's third largest province with a total area of 1.18 million square km and a population of 23.8 million. Agriculture is a key sector. Rural households comprise 64% of the total population. While close to 10% of the total population is poor, and about half of the rural counties are classified as either national or regional poverty counties, per capita GDP in IMAR exceeded the national average for 2004 by CNY800. The higher per capital income is not necessarily reflected in household welfare however as rural IMAR households face higher expenses as well especially with respect to education and transportation as well as reduced access to services such as quality health care.

5. The IMAR economy has expanded recently in recent years with reported GDP growth of 16.3% in 2003 and 19.4% in 2004, which was more than double the national average. The IMAR government predicts continued growth through 2007 with estimated growth rates between 15 and 20 percent. This growth rate is predicated on IMARs' rich natural resources, particularly coal and natural gas, both of which are in strong demand to fuel national industrial development. Low labour and land costs also attract manufacturing enterprises such as electronics, medical supplies and chemicals. There is concern that these manufacturing enterprises will widen the gap between rich and poor as they are technology driven and have low employment requirements. Therefore, in the near future, a low employment rate will co-exist with a high economic growth rate.[ii]

b. The Rural Economy

6. Farming and animal husbandry accounted for 28% of IMAR's GDP in 2003. However the per capital annual income for farmers and herders in 2004 was only 88% of the national average at CNY2606. Milk production is an increasingly important agricultural industry for peasants in IMAR and many of the RCCs visited cited loans to milk producers as a major purpose of micro credits. However increasing input and intermediation costs coupled with declining product prices are putting pressure on producer income.

7. There is continuing migration to urban areas especially among the young and middle aged to seek employment. Immigrant workers are flowing to cities within IMAR as well as the rest of China. These migrant workers are a source of remittances to rural areas and RFI's.

2. Rural Financial Services

8. The RCC system is the largest financial institution network in IMAR, with the most branch networks and number of employees.[17] As of year end 2004 there were 1313 individual RCCs. RCCs are almost the sole provider of credits to small farmers and agriculture producers and are the main conduit for agricultural onlending from the Peoples Bank of China (PBOC). Additionally RCCs are the only institution serving non agricultural sector in many rural areas. There are two micro finance programs working in IMAR, one in Chifeng city and the other in Wushen Banner. Informal credit sources, particularly family, continue to play a large role in rural financial services.

9. There are few affordable financial services other than savings and credit available to rural households. Savings product are limited and do not vary between commercial banks and RFIs. Savers can access demand savings accounts or fixed deposit accounts with terms of 3, 6, 12, 24, 36 or 60 months. There is no interest rate differentiation on savings products between RFIs and commercial banks. Affordable insurance products are needed for both households and rural financial institutions. Use of insurance products is limited in IMAR. Local officials are skeptical about the viability of insurance schemes. Farmers are very vulnerable to both natural disasters and commodity price fluctuations. Effective insurance schemes would stabilize household incomes and decrease risk for RFIs. There has been limited experimentation with agricultural insurance for households and there are some examples of creditor default insurance for specific loan products such as loans to laid off workers that are funded by local governments.

10. A tripartite risk fund has been developed in Chifeng between farmers, dairy processors and the local government. The local government contributes 12.5% of the value of the loan portfolio for dairy production, dairy processors contribute CNY.02 per kilo of milk, and farmers contribute 1% of the value of their herd to the fund. The fund is retained at the RCCU. Participation is compulsory for farmers who borrow from the RCCU to finance their dairy

[17] 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.

enterprise; farmers without loans may participate. The fund is designed to protect against both loss of livestock and milk price declines. No loans issued under the new program were due at the time of investigation so performance is unknown.

11. Manzhouli RCCU takes advantage of a loan guarantee program for laid off workers. A state insurance company provides the loan guarantee. Loans are guaranteed to 85% of principal and interest. In the event of default the RCCU is paid out and the insurance company assumes collection responsibility for the loans. Borrowers pay the guarantee fee.

a. Commercial Banks

12. 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 marketing and 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.[18]

13. Technically ‘rural’ is defined as anything at county/banner level or below. The Industrial and Commercial Bank of China (ICBC) has branches in many county seats, however they do little lending and that which is done is not done outside the county seat.

b. Non Bank Financial Institutions and the Informal Sector

14. Two micro finance programs have been identified in IMAR. A UNDP supported initiative in Chifeng banner and a UNICEF supported project in Wushen banner. Both micro finance programs target women and employ group lending technologies. Informal lenders continue to play a significant role in household finances as evidenced by the household survey of Wushen Banner. Households perceive value from informal sector loans despite interest rates of up to 24% per annum. However, family is a major source of informal credit and often has no terms or conditions attached making it a very attractive alternative to the formal sector although the volume is limited.

3. Interest Rates

15. Interest rates in China are controlled by the PBOC. There has been some interest rate liberalization for RFIs within the current round of reform. RFIs are permitted to float loan rates up to 100% from the base rate and deposit rates can be floated up to 30%. Most RFIs offer slightly lower interest rates for agriculture and household loans than for commercial loans. The two pilot micro finance programs have been given greater latitude on interest rates.

4. Demand for Financial Services in Rural Areas

16. The mission did not undertake a formal study of financial services demand in rural areas of IMAR. However it is clear that demand exceeds supply at present. A household survey in Wushen Banner indicated that households were borrowing from the UNICEF micro finance

[18] 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.

project, RCCs and from informal sources when they could. Households were willing to pay up to 24% for credit from informal sources.

17. RCCUs indicated that their credit demand for micro loans was well in excess of their own resources and onlending funds available from PBOC. However, this statement should be tempered with the recognition that RCCs only consider raw demand and not effective demand, as repayment capacity appears to be a secondary consideration, at best, when issuing micro finance loans for agriculture support.

18. The perceived excess demand for financial services is enhanced by the operating practices of RCCs. While a definitive statement would require deeper research than was conducted by this mission, it appears that the outreach claims of RCCs is overstated. There is evidence that, given the prevailing practice of refinancing and rescheduling loans, as well as the practice of not taking action against delinquent loans as long as the borrower is willing to pay interest and penalties, that loans remain within a fairly static group of borrowers rather than revolving through the membership.

APPENDIX 2: ANALYSIS OF SELECTED RCCUS

A. A General Survey of the RCCs In IMAR

1. The following general background and survey information was received from the IMFO. As of the end of 2002, there were a total of 1,313 RCCs in IMAR, which were registered as 'independent legal persons'. Among these were 88 Banner or County RCCUs and 1,225 township, village and suburban RCCs. Total assets of these credit cooperatives were reported to be CNY 32.5 billion, including CNY14.6 billion in loans outstanding.

2. Total liabilities of the system were reported at CNY 31.7 billion, including CNY 20 billion in individual customer and enterprise deposits. (Individual customer deposits are referred to as savings deposits and enterprise deposits are referred to simply as deposits on the balance sheet.) The non performing loan ratio was reported as 57.1% of total loans. Consolidated capital of the RCCs was reported to be 751 million, including CNY 97 million of equity capital, and CNY 4 million in profits for the year.

3. According to the formula for insolvency calculations established by the state council there were 226 RCCs in IMAR with positive capitalization of CNY 17 million and 1,087 RCCs in IMAR suffering from insolvency with negative capitalization of CNY 2.7 billion.[19]
As of September 2004, the total debt of RCCs in IMAR amounted to 46.84 billion, of which 29.3 billion was customer deposits; total assets amounted to CNY 47.8 billion, of which 26.96 billion was customer loans. The non performing loan ratio dropped to 28.4%; or a total of CNY 428 million.[20] Total capital was reported as CNY 1.53 billion including shareholder equity capital of CNY 1.04 billion.

4. It should be noted that basic financial information was provided through year-end 2004 for only the nine (9) RCCUs which have been selected for conversion into RCBs or RCOBs. The financial analysis conducted on these institutions utilized figures which had to be significantly adjusted to create useable financial statements.

B. Financial Analysis of Selected RCCUs

5. The following section presents a summary of the financial analysis, findings and policy recommendations regarding the conversion of 9 selected RCCUs into 2 RCBs and 6 RCOBs.

6. Basic financial analysis was conducted on the following RCCUs: (i) Horqin RCCU of Tongliao, and Dongsheng RCCU which are to be converted into RCB operations; (ii) Hailar RCCU, Suburban RCCU of Hohhot, Manzhouli RCCU, Naiman RCCU, and Yuanbaoshan RCCU, which are to become RCOB operations, and; (iii) a joint analysis of the Baotau Southern Suburb and Baotou Suburb RCCUs which are scheduled to merge and form one RCOB.

7. The scope and completeness of the financial analysis was severely limited by the nature of the financial information provided. None of the RCCU operations in IMAR are audited by established accounting firms and consequently audited financial statements with accompanying

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[19] Insolvency = actual loss- owners equity – bed debt reserves.
[20] There are strong indications that the NPL ratio decreased more through a liberal re-classification of past due loans than through effective collection efforts or significant loan repayments.

schedules are non-exisistent. Problems in conducting a complete analysis on these institutions arose due to:

(i) failure to follow international accounting standards in the creation of the financial statements;
(ii) notable differences in the treatment and accounting for key accounts such as loans and loan loss reserves;
(iii) inclusion of interest accruals on non-performing loans which should rightly be on non-accrual;
(iv) inconsistent reporting and treatment of income and expense items;
(v) misclassification of deposits as shares and inclusion of inter-RCCU and inter-RCC accounts on the balance sheets, and;
(vi) mistreatment of revenue and loan loss reserves items as additions to the capital account, and;
(vii) poor translations of account titles from the Chinese and the consequent misplacement of figures into the proper balance sheet and income statement classifications.

8. It is important to note that the financial review and analysis of these RCCUs was compromised by a variety of risk management and reporting relationship issues involving the operational affiliation between RCCUs and their member RCCs. No clear data providing the necessary breakdown of the consolidated loan portfolio by the number of accounts and loan amounts extended to rural households versus urban-based or government controlled enterprises was provided by any of the RCCUs. In several cases the response was that such data did not exist. Omission of this and other data made a complete and detailed analysis of the strengths and weaknesses of the loan portfolio and loan underwriting practices of the RCCUs difficult to complete.

9. Segregated information or a schedule of the loans extended directly by the RCCU itself vs. the loans initiated by the member RCCs for their local market was not available. The role of the RCCU as a separate business unit, which lends funds collected from its member RCCs (effectively competing with its members), into the non-rural or agricultural-based businesses sector is a systemic problem discussed in detail in another section of this report.

10. Two RCCUs are scheduled to convert to Rural Commercial Banks (RCB) and seven additional RCCUs, with two merging their operations, are scheduled to convert into six Rural Cooperative Banks (RCOB). These institutions are required to meet the following capitalization levels and asset structure, including potential redeemable bills, before they are eligible for transformation:

11. For Rural Commercial Banks[21]

(i) Minimum paid–in capital of CNY 50 million. The share capital held by the member RCCs can not be counted towards this total.
(ii) No less than 500 subscribers or shareholders (investors) either individuals or institutions
(iii) Minimum capital adequacy ratio of 8%
(iv) Total assets of the RCCU before conversion of at least CNY 1 billion[22]

[21] Horqin RCCU of Tongliao and Dongsheng RCCU of Erdos

(v) Non-performing loan ratio before conversion, must be 15% or less

12. For Rural Cooperative Banks[23]

(i) Minimum paid–in capital of CNY 20 million. The share capital held by the member RCCs can not be counted towards this capital requirement.
(ii) No less than 1,000 subscribers or shareholders (investors) either individuals or institutions
(iii) Minimum capital adequacy ratio of 4%
(iv) Total assets of the RCCU before conversion of at least CNY 1 billion
(v) Non-performing loan ratio, before conversion, must be 15% or less

13. A short financial analysis highlighting the current financial condition, operational performance and recapitalization requirements of the RCCUs is presented below[24]. Weaknesses and inconsistencies in the financial data received limit the majority of this analysis to a general discussion of the RCCU operations as a group and their overall compliance with the eligibility criteria outlined above. The quality of individual financial data received from each RCCU was such that it was not a productive exercise to attempt to create a meaningful in-depth financial analysis on each institution. The analyst has necessarily limited investigation to a standardized group of spreadsheets, account highlights and performance ratios which are included in Appendix 3 of this report.

1. Diagnosis of Selected RCCUs in the IMAR

14. Collectively the nine RCCUs under study for conversion to RCB and/or RCOB operations in IMAR exhibit a very high rate of loan growth along with positive increases in their customer deposit base. However, it is noted that these encouraging trends are more than offset by the persistent high levels of non-performing loans (NPL) and only minimal increases in the capital account. Operational profitability during the period studied has also been very poor.

15. Unaudited financial reports as of 12/31/04 provide the following basic operating and performance data on these selected RCCUs:

Table B.1: Consolidated Statistics of 9 RCCUs Scheduled for Conversion to RCBs or RCOBs

	CNY 000s 2003	CNY 000s 2004	USD 000s 2003	USD 000s 2004	Change
Total Loans	4,351,329	5,469,914	527,658	663,301	25.71%
Total Customer Deposits	5,588,377	7,056,103	689,793	855,648	24.04%
Total Capital	317,934	412,338	38,554	50,002	39.69%

[22] The requirement of CNY 1billion in total assets is mentioned in State Document 15 but not carried through in the Provisional Regulations for RCBs and RCOBs.
[23] Hailar RCCU, Suburban RCCU of Hohhot, Manzhouli RCCU, Naiman RCCU, Yuanbaoshan RCCU and the merged Baotou Southern Suburb and Baotou Suburb RCCUs.
[24]The analysis uses data from the individual RCCU spread sheets and performance ratio calculations presented in Appendix 2.

Total NPLs	1,220,082	1,085,209	147,951	131,596	(11.05)%
Total Assets	11,016,456	13,478,967	1,335,895	1,634,508	22.35%
Average CAR	2.89%	3.06%	2.89%	3.06%	5.88%
Total Net Profits	5,015	25,762	608	2,121	413.70%

16. While loan growth and reported interest income were positive in 2004, the average of total profits declined during the year. Despite some decrease in the totals, the level of NPLs for these eight RCCUs remained very high at 20% of total loans and more than 2.5 times total capital. Net profits remained very low in 2004 and did not increase noticeably over 2003 results. The combined net profits for these 9 RCCUs yields a dismal 0.21% return on average assets for the year; several individual RCCUs reported a loss for 2004.

17. There was little change in the basic CAR[25] for these institutions which by any measure is well below international standards. If this ratio were to be calculated on a risk-weighted basis with proper adjustments for loan loss reserves, the net effect of operations on the balance sheet would be a significant decrease in the capital adequacy ratio for the group. This is due mainly to the fact that asset growth greatly outstripped capacity of the system for internal capital generation through profits and the negative impact of very high levels of NPLs. Consequently, some institutions[26] exhibit a very high average ROE in combination with an extremely low ROA; this despite an average net interest spread margin of almost 7%.

18. The paramount concern which appears when conducting a diagnosis of RCCUs operating in IMAR, is the extremely high level of NPLs which is endemic to all of these operations. While the precise definition of a non-performing loan varies in different countries; accepting the simple categories of *past due, idle and bad* that are set by CBRC regulations, reveals that the nine RCCUs under study have a total portfolio of NPLs (as of 12/31/04) of approximately CNY 1.1 billion (USD 131.5 million). Collectively, the average NPL/Total Loan ratio for these institutions is still almost 20% despite some reported success in loan collection efforts. While this represents a significant decrease from 57.1% in 2002 it must be attributed to very rapid rate of loan growth over the year rather than actual collection efforts.

19. The combined diagnosis also reveals that all of these RCCUs are severely undercapitalized, by international standards, before making any adjustments for the high level of NPLs. RCCUs tend to make loan loss reserves as a tax reduction tool rather than a risk management tool and limit reserves to 1.% of total loans which is the maximum allowed for tax purposes regardless of portfolio risk.

20. Collectively, the total of funded loan loss reserves (CNY 71,821) is less than 7% of total reported NPLs over the past two years under study; operating profits have been totally inadequate to fund the necessary level of reserves dictated by prudent management practices and international standards. Seven of the RCCUs under study would be technically bankrupt if international loss provisioning were applied and appropriate charges made against capital accounts.

[25] Basic CAR is the simple division of Total Capital by Total Assets without adjustment for LLRs or risk weighting of the assets.

[26] ROAA and ROAE for Dongsheng RCCU Erdos for 2004 was .41% and 19.6% respectively.

21. Table B.2 below, provides a summary of the capital account for each of the RCCUs along with their respective levels of NPLs and funded loss reserves. Calculations have been made to adjust the balance sheet to fund the additional loss reserves required under the Bank of International Settlements (BIS) formula. The table clearly illustrates the impact of the high level of NPLs and the low balance of existing loan loss reserves on any adjustment necessary to reserve against loss, on an already weak capital account. The final column shows the amount of additional capital that would be required to achieve 8% CAR as is considered the minimum for a sound financial institution under BIS rules. Table B.3 is a summary of the capital account for each RCCU when the much more liberal CBRC standards for loan loss reserves and risk weighting of assets is applied.

Table B.2: Summary of Capital Account Position for RCCUs Per BIS Standards
As of 12/31/04 CNY 000s

RCCU	Reported Capital	Balance of NPLs	Balance of LLR	Required LLR Per BIS	Balance Adjusted Capital**	Additional Capital for Risk-weighted CAR of 8%***
Horqin	77,188	220,092	14,444	98,964	(7,322)	101,633
Dongsheng	30,834	65,993	8,975	26,171	13,638	57,028
Hailar	23,747	114,309	5,034	60,766	(31,985)	77,668
Hohhot Suburban	75,483	184,146	17,376	93,456	(597)	133,495
Manzhouli	20,184	23,472	2,284	19,335	3,133	18,697
Naiman	37,436	66,715	4,767	43,505	(1,302)	28,800
Yuanbaoshan	39,475	69,864	5,512	37,485	7,502	30,116
Batou Consolidated	107,993	340,618	13,429	156,655	(35,233)	197,121
Totals	412,340	1,085,209	71,821	536,337	(52,176)	644,389

*BIS formula: Past due loans = 20%; Idle Loans = 50%; Bad Loans = 100% required LLR balance
** Adjusted Capital Balance = Reported Capital – Required LLR + Balance of LLR
*** Additional Capital needed = 8% of risk-weighted assets – Balance of Adjusted Capital

Table B.3: Summary of Capital Account Position for RCCUs Per CBRC Standards[27]
As of 12/31/04 in CNY 000s

[27] Risk Weighted assets are conservative estimates as insufficient detail of loan portfolio was provided. All short term loans were categorized as rural household loans with 50% weight, all medium and long term loans categorized as loans to business organizations with weight of 100%.

RCCU	Reported Capital	Balance of NPLs	Balance of LLR	Required LLR Per CBRC (1% of loans)	Balance Adjusted Capital	Additional Capital for Risk-weighted CAR of 8%
Horqin	77,188	220,092	14,444	9,736	81,896	3,972
Dongsheng	30,834	65,993	8,975	7,508	32,301	5,507
		Additional Capital for Risk-weighted CAR of 4%***				
Hailar	23,747	114,309	5,034	4,450	24,331	(12,175)
Hohhot Suburban	75,483	184,146	17,376	12,597	80,262	(29,379)
Manzhouli	20,184	23,472	2,284	1,773	20,695	(14,244)
Naiman	37,436	66,715	4,767	2,438	39,765	(29,523)
Yuanbaoshan	39,475	69,864	5,512	3,934	41,053	(26,532)
Batou Consolidated	107,993	340,618	13,429	12,256	109,166	(43,159)
Totals	412,340	1,085,209	71,821	54,962	429,469	(145,534)

*** Additional Capital needed = 4% of risk-weighted assets – Balance of Adjusted Capital

22. As indicated in the above tables, each RCCU currently under consideration for conversion to a RCB or RCOB suffers from extremely high levels of non-performing loans—in all case in excess of reported capital, which means that they are technically bankrupt. On a combined basis NPLs are almost 2.5 times the reported capital of these institutions, even after giving credit for the minimal amount of loss reserves that have been funded.

23. Current loan loss reserves are inadequate to cover the level of NPLs reported and proper adjustments would require additional charges against the balance of capital of each institution. In several cases the RCCU is technically bankrupt as such a charge would leave them in a negative capital position.

24. If the total amount of NPLs as reported by each RCCU were to be properly written off with the balance reserved against according to BIS prudential standards[28]; it is estimated that the total amount of <u>new</u> capital investment required to bring these eight RCCUs into compliance with an 8% risk-weighted CAR would be in excess of CNY 644 million, (approximately USD 78 million). To achieve 8% CAR for the two RCBs and 4% CAR for the six RCOBs would require CNY 395 million, (USD 48 million), based on BIS loan provisioning and risk weighting. This is far greater than the amount of financial support currently being discussed in the planned reform program which envisions the placement of approximately CNY144 million (USD17.5 million) in two-year redeemable bills. RCCUs need to raise significant amounts of new capital and resolve their NPLs to be considered sound institutions.

25. While RCCUs meet the very liberal CAR requirement set by CBRC, the high level of NPLs represent a significant impediment on earnings and indicate severe weaknesses in overall quality and profitability of the loan portfolio. Given the short term nature of the loan portfolio and the inadequacy of the financial statements provided, it was impossible to accurately calculate the total 'drag' on earnings represented by the NPLs in the loan portfolio.

26. The analyst has made a rough calculation of the amount of interest income that the NPLs for each RCCU *should have* earned at an assumed annual rate of 7% and included this

[28] The reserve requirements against NPLs as set by the CBRC are more liberal than the international standards set by the Basel Accords.

information in their individual spread sheets (Appendix 3). It is estimated that on a combined basis, the ‘historical burden’ would actually represent a minimum of ‘lost’ income totaling CNY 80.7 million for 2004 alone. Continued high level of NPLs and the fact that they have been on the books for such a long period of time without significant reduction or indication of a management-led collection effort; is also a strong sign of poor credit risk management practices and loan approval mechanisms of member RCCs.

27. Research has provided strong indications that most of the NPLs still on the books actually represent losses due to their long-term aging. Many loans classified as idle have not made scheduled payments for several years. Many of the remaining NPLs are now considered by the authorities as an ‘historical burden’ and are the result of directed credits and actions by the ABC, which upon withdrawing from rural markets, left their poorest credits on the books of the RCCs. These credits should rightly be re-classified as losses and written-off in full. Additionally, there is ample evidence that past state interventions over interest rates as well as directed credits have greatly contributed to the high level of non-performing loans and subsequent financial losses within the rural financial system.

28. Table B.4 below; provides some insight into the low levels of profitability for each RCCU which has been at least partially caused by loss of interest income on NPLs. Internal inefficiencies and high overhead expenses also contribute to low profitability of these RCCUs. It is interesting to note that profits are low despite relatively high interest margins exhibited in each RCCU. Their weak performance and under capitalization are further evident in their extremely low returns on average assets (RoA) vs. a higher return on equity (RoE) ratio.

Table B.4: Financial Performance of Selected RCCUs
As of 12/31/04, CNY 000s

RCCU	**Loan Interest Income**	**Total Operating income**	**Total Interest Expense**	**Net Spread %**	**Net Operating Income**	**Net Profit (loss)**	**RoA %**	**RoE %**
Horqin	68,211	87,713	25,849	5.86	(3,133)	(177)	(.01)	(.28)
Dongsheng	59,507	63,160	14,858	6.68	9,823	5,220	0.41	18.39
Hailar	23,437	27,166	12,225	3.65	(534)	(150)	(.02)	(0.72)
Hohhot Suburban	85,426	98,219	27,740	5.71	8,837	3,372	0.10	4.80
Manzhouli	15,640	17,755	6,139	7.19	150	506	0.13	2.97
Naiman	28,460	29,577	10,140	10.10	(701)	(644)	(0.10)	(1.96)
Yuanbaoshan	23,320	27,051	9,294	4.17	(244)	140	0.02	0.40
Batou Consolidated	95,233	117,586	35,211	6.16	23,229	17,494	0.57	18.20

29. The above data indicate that while all the RCCUs are experiencing a positive net spread, a collective average of 6.2%, their actual profits are extremely low. In several cases they have in fact lost money on operations during 2004. It is noted that interest income received on the loan portfolio accounts for over 80% of total operating income, indicative of the fact that RCCUs earn very little from non-interest sources such as fees and commissions.

30. Total interest expense, primarily interest paid on individual savings deposits, is quite low. On a combined basis interest paid on deposits averages a minimal 1.66% of average total deposits and only 29% of interest income earned on loans in 2004. This indicates that interest rates paid on deposits are well below rates charged on loans and that borrowing from other

financial sources is not a major part of the funding base. Most borrowing by RCCUs, with the exception of their inter-bank clearing and settlement transactions, is in fact at subsidized rates and sourced through various government sponsored loan programs to support the rural sector.

31. With such positive interest margins the operational inefficiencies and negative impact of the NPLs are all the more noticeable. On a combined basis Net Operating Income levels of these institutions averages less than 8% of Total Operating Income, a ratio that is severely impacted by the fact that the four of the nine RCCUs report losses on their operations. These poor results are also apparent in the calculations for return on average assets (RoA) which are extremely weak and in several cases negative. Consolidated RoA is only .21%

32. The primary conclusion that can be drawn from the data in this matrix is that RCCUs are poorly managed and exhibit poor underwriting skills with continued extension of weak credits that do not repay as agreed. Under their current operational inefficiencies and consequent poor profitability, they are simply are incapable of 'growing out' of their massive NPL problems nor increasing their capital account (through retained earnings) to meet prudential norms without considerable outside assistance.

33. It should be noted that financial results as reported by the RCCUs clearly indicate that the generally accepted rationale for their losses, i.e. low fixed interest rates on loans coupled with high funding costs, is not the primary cause of their losses. All of these institutions exhibit positive and healthy interest margins yet their operating profits are marginal at best. The true cause of their weak financial condition lies in their internal operating inefficiencies, high overhead expenses, and substantial levels of non-performing loans which are caused by a weak credit risk management system. Table B.5 below; presents additional selected operational performance ratios on the analyzed RCCUs for 2004 which further confirms the above conclusion.

Table B.5: Operational Performance Ratios for 2004

Expressed as Percentages

	Horqin	**Dong sheng**	**Hailar**	**Hohhot Sub urban**	**Man zhouli**	**Naiman**	**Yuan-baoshan**	**Merged Baotou**
Performance Ratios								
<u>Interest income</u> Average Earning Assets	9.04	12.45	5.90	4.80	8.18	10.89	7.17	7.56
<u>Net Interest Income</u> Average Earning Assets	6.37	9.52	3.18	3.44	3.23	7.16	4.69	5.81
<u>Fee Income</u> Average Total Assets	***	***	.02	.02	.01	***	.03	.04
<u>Fee Income</u> Operating Income	0.06	.02	.45	.48	.26	***	.60	.95

Deposit Interest Expense / **Average Total Deposits**	1.27	1.63	1.87	1.32	1.69	1.67	1.96	1.46
Total Interest Expense / **Average Earning Assets**	2.66	2.93	2.67	1.36	2.84	3.73	2.48	2.52
Net interest Income / **Gross Operating Income**	70.47	76.46	53.58	71.28	72.21	65.72	65.05	69.11
Operating Expenses / **Gross Operating Income**	69.08	50.17	51.24	68.06	59.44	69.45	64.01	51.88
Other Operating Expenses / **Average Total Assets**	.69	.52	.27	.33	.44	.78	.80	.67
Staff costs / **Gross operating Income**	28.94	17.37	29.12	25.20	24.49	26.65	24.49	24.85

*** Numerator is too small to achieve a meaningful calculation

34. A review of these ratios provides further insight into the operational inefficiencies of the RCCUs under study. It can readily be seen that although each of these institutions enjoys a positive, and in some cases fairly high, level of net interest income to average earning assets (indicating that they have a positive spread and are earning money on at least some of their loans); all suffer from a very high level of internal operating expenses.

35. A comparison of the ratios for Net Interest Income/Gross Operating Income and Operating Expenses/Gross Operating Income provides an indicator of the operating inefficiencies of these institutions.

36. The first ratio measures the percentage of gross operating income that is derived from the main source of revenue, net interest income earned. All RCCUs show a strong result in this area indicating that they have positive interest rate spreads and that they are obtaining most of their earnings from their main business, extending credits. However, the second ratio is a telling measurement on how much of their operating income is consumed by internal operating expenses and therefore provides a clearer picture of operating efficiencies. While net interest income averages a healthy 68% of gross operating income, operating expenses consume an average of 54% of this same income. This indicates low staff productivity, high overhead costs and operational inefficiencies, all of which negatively impact real profitability.

37. Virtually all income is derived from interest earnings on the loan portfolio as none of the RCCUs reports any significant fee income. Total staff expenses (salaries and benefits) also

represent a significant percentage of operating income in most cases and strongly imply that earnings are being consumed in a non-productive manner.

C. Redeemable Bill Program

38. The keystone to the reform program for the rural finance system in IMAR, and the methodology selected to partially recapitalize RCCUs is the issuance of two-year redeemable bills from PBOC. The plan calls for the use of these instruments to partially replace a pre-determined amount of NPLs on the balance sheet of RCCUs. The redeemable bills would be pay a nominal interest rate of 1.8% per annum and will be counted as performing assets and new core capital by the new banks. Upon achieving certain performance criteria, the receiving bank can theoretically convert the bills to cash two years after they are issued.

39. A national policy defining the eligibility criteria and use of these instruments has been established along with a formula that sets a pre-determined amount of redeemable bills that the RCCUs can receive as capital support. Under this plan the PBOC is to issue redeemable bills to RCCUs up a limit of 50% of the calculated 'insolvency amount'[29] based on their 12/31/02 financial statements. This approach is severely flawed because it only provides a limited amount of support and does not adequately address nor fully resolve either the NPL problem or the under capitalization of the new banks.

40. Based on the calculations provided by the IMFO, the total amount of insolvency among the 1,313 RCCs in IMAR was calculated at CNY 2.73 billion as of year-end 2002. Therefore, it is anticipated that these institutions will eventually be eligible for capital support for 50% of this amount or CNY1.37 billion, which could be used to cover the NPL charge offs. A report from the IMAR Reform Leading Group states that a total of CNY 930 million of non-performing loans and CNY 440 million of the open account operational losses which have been accumulated over the years can be 'replaced' or paid off through this support.

41. In the case of the 9 RCCUs which are to be the first pilot group in IMAR to benefit from this reform program, the total level of insolvency (based on 2002 financials) is calculated to be CNY 286.4 million and therefore the level of redeemable bills to be issued totals CNY 143.5 million. This figure is higher than what would currently be required as it effectively gives RCCUs credit for their earnings and decreases in reported NPLs levels since 2002, without any penalty for failure to increase their capital base. The analyst has recalculated the level of insolvency as of 12/31/04 and considers this to be a more realistic position from which to approach the true level of recapitalization required.

42. Use of such government-backed financial instruments[30] to recapitalize a financial institution has become a common practice in such situations and has been employed in the resolution of other financial crises. However, in the case PRCs rural finance system which is characterized by a chronically undercapitalized RCC network, this type of recapitalization plan includes a number of structural flaws which greatly jeopardize its ultimate success. Similar programs in other countries have shown that it is simply not possible to save an entire financial system which is so deeply impaired without fully recognizing actual losses and increasing the capital base with new cash investment.

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[29] Level of Insolvency = Actual Loss – [Owners Equity + Bad Debt Reserve]
Actual Loss = Σ [100% of bad loans + 40% of idle loans + 10% of past due loans + 10% invested assets + 50% collateral loans]

[30] These *Redeemable Bills* are actually a form of the government issued recapitalization bonds that have been used in a number of Asian countries, particularly following the multi-nation financial crisis of 1997

43. A primary weakness in the attempt to recapitalize the RCCUs through the proposed application of redeemable bills is that it does not fully address the actual losses already incurred, does not provide the liquidity needed to initiate new loan operations and only covers a minimal amount of the immense historical burden of NPLs. The new banks will still be structurally weak with a residual burden of NPLs that have not been adequately reserved for. This methodology is flawed as it allows the RCCU to continue to carry a high level of NPLs on the balance sheet without proper loss reserves. While the RCCUs meet local regulatory requirements for loan loss reserves, the requirement itself is in adequate as it does not address actual risk.

44. Under international accounting standards, the actual impact of redeemable bills on the capital account will be much less than expected by authorities. Firstly, these bills do not represent a cash injection to increase capital of the new banks. Use of such financial instruments is effectively an accounting mechanism whereby non-performing assets are replaced by government bills which have a future maturity and pay a nominal level of interest. The contra-account for these instruments is an addition to the capital account as an accounting balance only. This approach allows the government to write-off an amount of NPLs and appear to recapitalize the institution while further deferring the costs until actual maturity of the bills.

45. Experience has shown that bailing out financial institutions through such a 'recapitalization' program is not sufficient. The program does not address institutional weaknesses and additional problems become apparent including:

(i) Limited marketability of the bills do not provide any real liquidity to the institution and illiquidity limits new loan growth;
(ii) To the extent that government instrument is salable or convertible to cash, moral hazard and rent seeking activities become apparent;
(iii) Interest earned on these types of government bills is invariably below market rates resulting in limited income improvement;
(iv) The government bill does not provide enough interest income to positively impact net profits of the institution;
(v) Reform measures are incomplete and not all NPLs are included in balance sheet adjustments;
(vi) Required loan loss reserves, while satisfying local regulations, are not funded to generally accepted prudential l levels resulting in continued poor performance;
(vii) Bank management remains in place without significant change in past lending practices;
(viii) Reform program does not require increased collection efforts on remaining NPLs;
(ix) A continuation of poor risk management and corporate governance practices lead to further losses.

46. Under international prudential regulations such instruments can only be counted as Tier 2 capital and a maximum of 50% of the amount of the bills issued can be included in any CAR calculation. Because the NPL problem within the RCCs is so great and their capital base so low, this recapitalization plan as currently structured is really a case of 'too little, too late'.

47. Table B.1 below; presents a summary matrix of the level of redeemable bills that each of the RCCUs could receive as per the insolvency calculations made by the PBOC as of year-end

2002. These figures are compared to a similar calculation based upon 2004 year-end figures. This is a useful exercise in that it further reveals the structural weaknesses and extra costs incurred by the PBOC in the form of redeemable bills if the 2002 figures are used.

Table C.1: Summary of Redeemable Bill Eligibility

CNY 000s

	As of 12/31/02			As of12/31/04			
RCCU	**Level of Insolvency (as per PBOC)**	**Amount of Redeemable Bill**	**New Capital to meet 8% CAR**	**Actual Loss***	**Level of Insolvency ***	**Amount of Redeemable Bill****	**New Capital to meet 8% CAR**
Horqin	(82,039)	41,020	1,005	104,624	(12,868)	6,546	13,850
Dongsheng	(18,727)	9,634	32,481	22,971	16,838	0	37,163
		New Capital to Meet 4% CAR				New Capital to Meet 4% CAR	
Hailar	(44,989)	22,495	0	60,679	(31,898)	15,949	0
Hohhot Suburban	(49,674)	24,837	22,498	89,618	3,241	0	28,707
Manzhouli	(5,820)	2,910	227	16,934	5,534	0	958
Naiman	(23,069)	11,539	0	38,111	4,092	0	0
Yuanbaoshan	(18,330)	9,165	0	44,276	771	0	0
Batou Consolidated	(43,708)	21,854	20,168	154,599	(33,177)	16,589	22,800
Totals	(286,356)	143,454	76,379	529,812	(47,467)	38,972	91,008

* Calculated using PBOC formulae:

Actual Loss = Σ [100% of bad loans + 40% of idle loans + 10% of past due loans + 10% invested assets + 50% collateral loans]

Level of Insolvency = Actual Loss – [Owners Equity + Bad Debt Reserve]

** If the level of eligibility for a redeemable bill is 0 for 2004, then the 2002 amount has been used to calculate the CAR. This has in turn reduced the amount of new capital required to meet the 8% CAR requirement in 2004.

48. The amount of new capital needed to achieve the minimum capital adequacy ratio of 8% (on a risk-weighted basis) for RCBs and 4% for RCOBs has been calculated in both cases using the formula approved by the PBOC for the reform program. Under the proposed formula and using 2002 figures, it can be seen that despite issuing over 140 million in redeemable bills that the new banks will still require an additional 76.4 million in new capital to meet the CAR requirements. Under the internationally accepted standard of 8% CAR for all banks, a total of 119 million of new capital would have to be raised by the 8 banks. The obvious trade off when using the 2004 figures is that the total amount of redeemable bills that need be issued is reduced by 73% to 39 million while the required level of additional capital increases by 19% to a total of 91 million, if both types of banks were to meet the 8% CAR standard a total of 162 million in new capital would have to be raised.

49. It is important to note that for both 2002 and 2004, these calculations are based on the amount of capital in the RCCU as reported on year-end balance sheet; without further adjustment for funding of loss reserves against the remaining NPLs. If this adjustment were to be made, as mandatory under international accounting standards and theoretically required in the reform program, each of the new banks would require further increases capital to meet international norms. Table B.1 above includes a summary of the actual amount of additionally capital that would be required by each of RCCU when the NPL portfolio is fully provisioned and the required capital is calculated at a minimum of 8% of risk-weighted assets using year-end 2004 results. In this case the total new capital required exceeds CNY 640 million for all banks to achieve 8% CAR or CNY 400 million if the RCOBs only need to achieve 4% capital adequacy.

50. In addition to the structural inadequacies noted above, the proposed redeemable bill program also presents a significant moral hazard problem for IMAR authorities. As has been observed in pilot provinces where PBOC bills were issued, a false sense has developed among participants that these bills represent a cash windfall that can be quickly distributed to investors in the new rural banks. This reflects a fundamental misunderstanding of the true structure and purpose of these redeemable bills as well as a pervasive attitude of corruption of the process for personal gain.

51. Interviews conducted during research for this study revealed that a primary rationale of RCCU management for conversion to an RCB or RCOB is the opportunity to obtain access to the redeemable bill program. RCCU management has expressed the mistaken belief that these redeemable bills will actually become a cash payment into their institutions and that it will settle all their problems by simultaneously by,

(i) resolving the NPL problem and the structural financial weaknesses of the RCCU,
(ii) recapitalizing their new bank and,
(iii) providing a quick source of financial return to themselves and new investors. IMAR authorities have yet to issue any convincing statements to the contrary and there is evidence that some marketing efforts to raise new capital from private investors have been initiated based on promises of guaranteed returns in the form of below market-rate loans, and dividends.

52. IMAR authorities must put a quick end to this fundamental misconception and distortion of the reform process. It is incumbent on the PBOC, as issuers of these bills to ensure that the terms and conditions for eligibility are enforced. Performance criteria set for the new banks against the future redemption of these bills must be clearly explained and strictly enforced and new banks should be specifically prohibited using the redemption proceeds as payouts to shareholders in the immediate future.

53. It is strongly recommended that the conditions for conversion to an RCB or RCOB include a thorough review of the conditions for new shareholder investments and a moratorium on dividends until the new banks have fully cleared their NPL problems and have reported a net profit for at least three consecutive years. In any case no dividends should be allowed without the express approval from the PBOC and CBRC after their review of the annual financial performance of the bank.

APPENDIX 3: DETAILED FINANCIAL ANALYSIS OF SELECTED RCCUS

A. Horquin RCCU Capital Analysis

	December 2003	December 2004	Change
Performing Loans			
Short term loans	353,623	360,304	
Medium and L/T loans	78,779	393,222	
Total Performing Loans	**432,402**	**753,526**	
Increase in Active Loans			321,124
YOY Change in loan Portfolio			74.27%
Non Performing Loans			
Past Due Loans	49,912	45,013	
Idle Loans	190,467	170,237	
Bad Loans	5,162	4,842	
Total NPLs	**245,541**	**220,092**	
Decrease in NPLs			25,449
Total Loan Portfolio	**677,943**	**973,618**	
Total NPLs as % of Total Loans	36.22%	22.61%	
YOY Change in NPLs as % of Total Loans			-37.59%
Bad Debt Reserves (LLRs)	7,795	14,444	
Reserves as % of total loans	1.15%	1.48%	
Reserves as % of NPLs	3.17%	6.56%	
Paid in Capital	**52,565**	**79,186**	
Of which: shareholders equity	38,887	65,509	
Capital surplus	0	0	
Reserves	4,488	4,392	
Retaining earnings (loss)	-(5,562)	-(6,390)	
Total Capital	**51,491**	**77,188**	
Increase in Paid in Capital			26,621
Increase in Shareholders Equity			26,622
Increase in Capital Surplus			-
Total Increase in Capital			25,697
YOY % Change in Capital			49.91%
NPLS (less reserves) as % of Total Capital	462%	266%	
Total Assets	**2,024,804**	**2,266,256**	
CAR (Total Capital/Total Assets)	**2.54%**	**3.41%**	
Deposits Placed (Assets)			
Deposits in Central Bank	442,021	242,197	
Deposits in Ag Bank	18,083	52,006	
Total Deposits Placed	**460,104**	**294,203**	
YOY % Change in Deposits Placed			-36.06%
Deposits Received (Liabilities)			
Short term Deposits	245,219	327,771	
Short term Savings Deposits	501,829	547,252	
Deposits from correspondents	3,776	0	
Long Term Deposits	56,647	20,642	
Long Term Savings Deposits	267,515	292,529	

	December 2003	December 2004	Change
Current Portion of long term deposits	78,800	234,155	
Total Deposits Received	**1,153,786**	**1,422,349**	
YOY % Change in Deposits Received			23.28%
Total Loans/Total Deposits	58.76%	68.45%	

Horquin RCCU Loan Loss Reserve Analysis

LLR adjustments for NPLs as per International Standards

	December 2004
Past Dues 20% Minimum	9,003
Idle Loans 50% Minimum	85,119
Bad Loans 100%	4,842
Total LLR required	98,963
Less current LLR	14,444
Additional LLR required	**84,519**
Charge shortfall to Capital Account	
Current Capital	77,188
Less required LLR	84,519
Adjusted capital	**-(7,331)**

Balance of NPLs after Adjustments

	Stated Bal	Reserve	Adjusted Bal
Past Due	45,013	9,003	36,010
Idle	170,237	85,119	85,119
Bad	4,842	4,842	0
Total NPLs	220,092	98,963	121,129

NPLs as % of Total Loans after Adjustments	12.44%
NPLs as % of Capital after Adjustments	157%

Calculation of Actual Loss per PBOC Standards as at December 2004

Past Dues 10% Minimum	4,501
Idle Loans 40% Minimum	68,095
Bad Loans 100%	4,842
Invested Assets 10%	
Collateral loans under disposal 50%	27,286
Total	104,724

Insolvency per PBOC Calculation: *Insolvency = actual loss - owners equity - bad debt reserve.*

PBOC calculated insolvency as at 12/31/2002 = (82,039) therefore redeemable bills eligibility is 41,020. *Insolvency as at 12/31/2004 is (13,902) therefore eligibility for redeemable bills is 6,546*

Risk Weighted CAR (adjusted for NPLs and required reserves)

Total Risk Weighted Assets		1,178,892
Total Capital	**83,734**	

Capital for CAR Calculations

Tier 1:	
Paid in	79,186
Capital Surplus	0
Reserves	4,392

Retained Earnings (loss)	-(6,390)	
Tier 2:		
Redeemable Bills	6,546	(only 50% eligible for CAR Calculation)
Risk Weighted CAR per Basel Standard		**6.83%**
Risk Weighted CAR with 100% Tier 2		**7.10%**
Basel Minimum CAR		***8.00%***

Redeemable Bills

PBOC is to issue redeemable bills up to the limit of 50% of the calculated insolvency amount as of 12/31/02. The analyst recalculated this amount as of 12/31/2004 and considers this to be amore realistic amount from which to approach the true level of recapitalization required. Applying redeemable bills would leave an NPL balance of 179,029,000CNY if no other reductions are made. The new bank would have a total NPL ratio of 18.4% and an NPL /adjusted capital ratio of 236% (based on Basel Standard of Redeemable bills being Tier 2 capital

Horquin RCCU Performance Analysis

	December 2003	December 2004
Interest Income From Loans	52,885	68,211
Average Annual Loan Portfolio	629,737	825,781
Imputed Interest Rate Yield	8.40%	8.26%
Average Annual NPLS	268,966	232,817
Imputed Interest Income loss at 7%	18,828	16,297
Average Net Loans	**360,771**	**592,964**
Average Net RCCU Deposits		**377,154**
Interest Income from Deposits	7,072	9,745
Fees and Commissions Income	562	55
Other 'Interest' Income	7,049	9,702
Total Operating Income	**67,568**	**87,713**
Interest Expenses	**19,587**	**25,849**
Interest Paid on Deposits	11,302	16,341
Interest Paid on Borrowings	8,285	9,508
Fees and Commission Expenses	**2,731**	**1,530**
Net Interest Income	**47,419**	**61,809**
Interest Income/Interest Expense (times)	3.06	3.02
Average Member Deposits		**1,288,068**
Operating Expenses	**39,331**	**45,877**
Of Which Employee Expenses	**21,538**	**25,384**
Employee Salaries	15,457	17,899
Employee Benefits	3,890	4,942
Other Staff Related Expenses	2,191	2,543
Employee Expenses/Average net Loans	5.97%	4.28%
Other Operating Expenses	3,545	14,708
of which: Charges to Loan Loss Reserves	2,279	12,269
Operating Taxes Paid	2,889	2,481
Operating Profits (Loss)	-(515)	-(3,133)
Total Revenue	1,827	169
Non Operating Income	1,633	3,536
Less Income taxes paid	82	346

Net Profit (loss) for the year	**1,745**	**-(177)**
Average Earning Assets		**970,118**
Average Assets	**1,754,827**	**2,145,530**
Return on Average Assets (ROA)	0.10%	-0.01%
Average Equity	**48,376**	**64,340**
Return on Average Equity (ROE)	3.61%	-0.28%
Net Spread =Int earned/loans - int paid/deposits	6.82%	5.86%
Operating Income to Total Average Assets	3.85%	4.09%
Total Interest Income/ Average Earning Assets		9.04%
Net Interest Income/Average Earning Assets		6.37%
Fee Income/Average Total Assets		0.00%
Deposit Int Expense/Average Total Deposits		1.27%
Total Interest Expense/Average Earning Assets		2.66%
Net Int Income/Gross Operating Income		70.47%
Total Operating Expenses/Gross operating Income		69.07%
Other Operating Expenses/Average Total Assets		0.69%
Staff Costs/Gross Operating Income		28.94%

Dong Sheng RCCU Capital Analysis

	December 2003	December 2004	
Performing Loans			
Short term loans	305,876	630,033	
Medium and L/T loans	23,535	54,741	
Total Performing Loans	**329,411**	**684,774**	
Increase in Active Loans			355,363
YOY Change in loan Portfolio			107.88%
Non Performing Loans			
Past Due Loans	41,977	23,978	
Idle Loans	57,001	41,280	
Bad Loans	1,480	735	
Total NPLs	**100,458**	**65,993**	
Decrease in NPLs			34,465
Total Loan Portfolio	**429,869**	**750,767**	
Total NPLs as % of Total Loans	23.37%	8.79%	
YOY Change in NPLs as % of Total Loans			-62.39%
Bad Debt Reserves (LLRs)	4,320	8,975	
Reserves as % of total loans	1.00%	1.20%	
Reserves as % of NPLs	4.30%	13.60%	
Paid in Capital	**25,219**	**28,075**	
Of which: shareholders equity	19,399	23,246	
Capital surplus			
Reserves	782	2,013	
Retaining earnings (loss)	- 80	746	
Total Capital	**25,921**	**30,834**	
Increase in Paid in Capital			2,856
Increase in Shareholders Equity			3,847
Increase in Capital Surplus			
Total Increase in Capital			4,913
YOY % Change in Capital			18.95%
NPLS (less reserves) as % of Total Capital	371%	185%	
Total Assets	**985,254**	**1,554,234**	
CAR (Total Capital/Total Assets)	**2.63%**	**1.98%**	
Deposits Placed (Assets)			
Deposits in Central Bank	180,264	353,758	
Deposits in Ag Bank	37,122	44,964	
Total Deposits Placed	**217,386**	**398,722**	
YOY % Change in Deposits Placed			83.42%
Deposits Received (Liabilities)			
Short term Deposits	37,561	116,103	
Short term Savings Deposits	333,736	758,514	
Long Term Deposits	2,257	-	
Long Term Savings Deposits	19,089	24,389	
Current Portion of long term deposits	183,622	181,866	

Total Deposits Received	**576,265**	**1,080,872**	
YOY % Change in Deposits Received			87.57%
Total Loans/Total Deposits	74.60%	69.46%	

Dong sheng RCCU Loan Loss Reserves Analysis

LLR adjustments for NPLs as per International Standards

			December 2004
Past Dues 20% Minimum			4,796
Idle Loans 50% Minimum			20,640
Bad Loans 100%			735
Total LLR required			26,171
Less current LLR			8,975
Additional LLR required			**17,196**
Charge shortfall to Capital Account			
Current Capital			30,834
Less required LLR			17,196
Adjusted capital			**13,638**
Balance of NPLs after Adjustments			
	Stated Bal	Reserve	Adjusted Bal
Past Due	23,978	4,796	19,182
Idle	41,280	20,640	20,640
Bad	735	735	-
Total NPLs	65,993	26,171	39,822

NPLs as % of Total Loans after Adjustments	5.30%
NPLs as % of Capital after Adjustments	129.15%

Calculation of Actual Loss per PBOC Standards as at December 2004

Past Dues 10% Minimum	2,398
Idle Loans 40% Minimum	16,512
Bad Loans 100%	735
Invested Assets 10%	637
Collateral loans under disposal 50%	2690
Total	**22,972**

Insolvency per PBOC Calculation: *Insolvency = actual loss - owners equity - bad debt reserve.*

PBOC calculated insolvency as at 12/31/2002 = (18,727) therefore redeemable bills eligibility is 9,364. *Insolvency as at 12/31/2004 is 0, no eligibility for redeemable bills*

Risk Weighted CAR (adjusted for NPLs and required reserves)

Total Risk Weighted Assets			883,319
Total Capital	**28,821**		
Capital for CAR Calculations		**24,139**	
Tier 1:			
Paid in	28,075		
Capital Surplus	-		
Retained Earnings (loss)	746		
Tier 2:			
Redeemable Bills	9,364	(only 50% eligible for CAR Calculation)	

Risk Weighted CAR per Basel Standard	**2.73%**
Risk Weighted CAR with 100% Tier 2	**3.26%**
Basel Minimum CAR	***8.00%***

Redeemable Bills
PBOC is to issue redeemable bills up to the limit of 50% of the calculated insolvency amount as of 12/31/02. The analyst recalculated this amount as of 12/31/2004 and considers this to be amore realistic amount from which to approach the true level of recapitalization required. Applying redeemable bills would leave an NPL balance of 56,629,000CNY if no other reductions are made. The new bank would have a total NPL ratio of 7.5% and an NPL /adjusted capital ratio of 169% (based on Basel Standard of Redeemable bills being Tier 2 capital.)

Dongsheng RCCU Performance Analysis

	December 2003	December 2004
Interest Income From Loans	29,868	59,507
Average Annual Loan Portfolio	358,605	590,332
Imputed Interest Rate Yield	8.33%	10.08%
Average Annual NPLS	109,784	83,226
Imputed Interest Income loss at 7%	7,685	5,826
Average Net Loans	**248,821**	**507,106**
Average Net RCCU Deposits		**308,054**
Interest Income from Deposits	1,762	1,750
Fees and Commissions Income	35	11
Other 'Interest' Income	1,004	1,892
Total Operating Income	**32,669**	**63,160**
Interest Expenses	**7,915**	**14,858**
Interest Paid on Deposits	7,028	13,470
Interest Paid on Borrowings	887	1,388
Fees and Commissions Expenses	**2,084**	**1,775**
Net Interest Income	**24,719**	**48,291**
Interest Income/Interest Expense (times)	4.12	4.25
Average member Deposits		**828,569**
Operating Expenses	17,461	25,068
Of which Employee Expenses	**7,811**	**10,968**
Employee Salaries	4,941	8,204
Employee Benefits	2,605	2,415
Other Staff Related Expenses	265	349
Employee Expenses/Average net Loans	3.14%	2.16%
Other Operating Expenses	1,953	6,617
Of Which;Charges to Loan Loss Reserves	1,375	6,025
Operating Taxes Paid	1,635	1,952
Operating Profits (Loss)		
Total Revenue	1,930	9,823
Less Income taxes paid	1,202	4,603
Net Profit (loss) for the year	**728**	**5,220**
Average Earning Assets		**507,106**
Average Assets	**811,422**	**1,269,744**
Return on Average Assets (ROA)	0.09%	0.41%
Average Equity	**20,636**	**28,378**

Return on Average Equity (ROE)	3.53%	18.39%
Net Spread =Int earned/loans - int paid/deposits	5.73%	6.68%
Operating Income to Total Average Assets	0.00%	4.97%
Total Interest Income/ Average Earning Assets		12.45%
Net Interest Income/Average Earning Assets		9.52%
Fee Income/Average Total Assets		0.00%
Depost Int Expense/Average Total Deposits		1.63%
Total Interest Expense/Average Earning Assets		2.93%
Net Int Income/Gross Operating Income		76.46%
Total Operating Expenses/Gross operating Income		50.17%
Other Operating Expenses/Average Total Assets		0.52%
Staff Costs/Gross Operating Income		17.37%
Staff Costs/ Employee (000 CNY per annum)		40.622

Hailar RCCU Capital Analysis

	December 2003	December 2004	Change
Performing Loans			
Short term loans	225,082	295,377	
Medium and L/T loans	20,398	35,302	
Total Performing Loans	**245,480**	**330,679**	
Increase in Active Loans			85,199
YOY Change in loan Portfolio			34.71%
Non Performing Loans			
Past Due Loans	4,578	0	
Idle Loans	123,625	107,085	
Bad Loans	7,382	7,224	
Total NPLs	**135,585**	**114,309**	
Decrease in NPLs			21,276
Total Loan Portfolio	**381,065**	**444,988**	
Total NPLs as % of Total Loans	35.58%	25.69%	
YOY Change in NPLs as % of Total Loans			-27.80%
Bad Debt Reserves (LLRs)	4,392	5,034	
Reserves as % of total loans	1.15%	1.13%	
Reserves as % of NPLs	3.24%	4.40%	
Paid in Capital	**23,615**	**30,164**	
Of which: shareholders equity	15,627	22,296	
Capital surplus	655	655	
Reserves	1,355	1,402	
Retaining earnings (loss)	-(7,776)	-(8,474)	
Total Capital	**17,849**	**23,747**	
Increase in Paid in Capital			6,549
Increase in Shareholders Equity			6,669
Increase in Capital Surplus			-
Total Increase in Capital			5,898
YOY % Change in Capital			33.04%
NPLS (less reserves) as % of Total Capital	735%	460%	
Total Assets	**714,644**	**863,567**	
CAR (Total Capital/Total Assets)	**0**	**0**	
Deposits Placed (Assets)			
Deposits in Central Bank	116,297	149,000	
Deposits in Ag Bank	23,403	51,613	
Total Deposits Placed	**139,700**	**200,613**	
YOY % Change in Deposits Placed			43.60%
Deposits Received (Liabilities)			
Short term Deposits	69,393	76,003	
Short term Savings Deposits	83,515	120,821	
Long Term Deposits	4,808	6,500	
Long Term Savings Deposits	136,452	238,703	
Current Portion of long term deposits	192,188	225,741	
Total Deposits Received	**486,356**	**667,768**	

YOY % Change in Deposits Received			37.30%
Total Loans/Total Deposits	78.35%	66.64%	

Hailar RCCU Loan Loan Reserves Analysis

LLR adjustments for NPLs as per International Standards	December 2004
Past Dues 20% Minimum	0
Idle Loans 50% Minimum	53,543
Bad Loans 100%	7,224
Total LLR required	60,767
Less current LLR	5,034
Additional LLR required	**55,733**
Charge shortfall to Capital Account	
Current Capital	23,747
Less required LLR	55,733
Adjusted capital	**-(31,986)**

Balance of NPLs after Adjustments

	Stated Bal	Reserve	Adjusted Bal
Past Due	0	0	0
Idle	107,085	53,543	53,543
Bad	7,224	7,224	0
Total NPLs	114,309	60,767	53,543

NPLs as % of Total Loans after Adjustments	12.03%
NPLs as % of Capital after Adjustments	225%

Calculation of Actual Loss per PBOC Standards as at December 2004

Past Dues 10% Minimum	0
Idle Loans 40% Minimum	42,834
Bad Loans 100%	7,224
Invested Assets 10%	
Collateral loans under disposal 50%	10,621
Total	60,679

Insolvency per PBOC Calculation: *Insolvency = actual loss - owners equity - bad debt reserve.*
PBOC calculated insolvency as at 12/31/2002 = (44,989) therefore redeemable bills eligibility is 22,495. *Insolvency as at 12/31/2004 is (31,898) therefore eligibility for redeemable bills is 15,949*

Risk Weighted CAR (adjusted for NPLs and required reserves)

Total Risk Weighted Assets			571,038
Total Capital	**39,696**		
Capital for CAR Calculations		**31,722**	
Tier 1:			
Paid in	30,164		
Capital Surplus	2,057		
Retained Earnings (loss)	-(8,474)		
Tier 2:			
Redeemable Bills	15,949	(only 50% eligible for CAR Calculation)	
Risk Weighted CAR per Basel Standard			**5.56%**
Risk Weighted CAR with 100% Tier 2			**6.95%**
Basel Minimum CAR			***8.00%***
Redeemable Bills			

PBOC is to issue redeemable bills up to the limit of 50% of the calculated insolvency amount as of 12/31/02. The analyst recalculated this amount as of 12/31/2004 and considers this to be amore realistic amount from which to approach the true level of recapitalization required. Applying redeemable bills would leave an NPL balance of 98,630,000CNY if no other reductions are made. The new bank would have a total NPL ratio of 22.1% and an NPL /adjusted capital ratio of 310% (based on Basel Standard of Redeemable bills being Tier 2 capital.)

Hailar RCCU Performance Analysis

	December 2003	December 2004
Interest Income From Loans	14,919	23,437
Average Annual Loan Portfolio	348,473	413,027
Imputed Interest Rate Yield	4.28%	5.67%
Average Annual NPLS	141,403	124,947
Imputed Interest Income loss at 7%	9,898	8,746
Average Net Loans	**207,070**	**288,080**
Average Net RCCU Deposits		**170,157**
Interest Income from Deposits	2,342	3,221
Fees and Commissions Income	124	123
Other 'Interest' Income	482	385
Total Operating Income	**17,867**	**27,166**
Interest Expenses	**9,540**	**12,225**
Interest Paid on Deposits	7,834	10,793
Interest Paid on Borrowings	1,706	1,432
Fees and Commision Expenses	**557**	**502**
Net Interest Income	**7,845**	**14,556**
Interest Income/Interest Expense (times)	1.81	2.18
Average Member Deposits		**577,062**
Operating Expenses	**9,385**	**11,769**
Of Which Employee Expenses	**4,693**	**7,910**
Employee Salaries	3,385	5,901
Employee Benefits	1,159	1,865
Other Staff Related Expenses	149	144
Employee Expenses/Average net Loans	2.27%	2.75%
Other Operating Expenses	2,848	2,150
of which: Charges to Loan Loss Reserves	1,714	1,314
Operating Taxes Paid	1,134	836
Operating Profits (Loss)	-(1,508)	-(534)
Total Revenue	-(1,036)	-(27)
Less Income taxes paid	212	123
Net Profit (loss) for the year	**-(1,248)**	**-(150)**
Average Earning Assets		458,237
Average Assets	**665,532**	**789,106**
Return on Average Assets (ROA)	-0.19%	-0.02%
Average Equity	**17,285**	**20,798**

Return on Average Equity (ROE)	-7.22%	-0.72%
Net Spread =Int earned/loans - int paid/deposits	2.30%	3.65%
Operating Income to Total Average Assets	2.68%	3.44%
Total Interest Income/ Average Earning Assets		5.90%
Fee Income/Average Total Assets		0.02%
Depost Int Expense/Average Total Deposits		1.87%
Total Interest Expense/Average Earning Assets		2.67%
Net Int Income/Gross Operating Income		53.58%
Total Operating Expenses/Gross operating Income		51.24%
Other Operating Expenses/Average Total Assets		0.27%
Staff Costs/Gross Operating Income		29.12%
Staff cost/Employee (000 CNY per annum)		35.313

Hohhot Suburban RCCU Capital Analysis

	December 2003	December 2004	Change
Performing Loans			
Short term loans	423,049	669,648	
Medium and L/T loans	372,437	375,864	
Total Performing Loans	**795,486**	**1,045,512**	
Increase in Active Loans			250,026
YOY Change in loan Portfolio			31.43%
Non Performing Loans			
Past Due Loans	17,775	4,749	
Idle Loans	191,009	173,783	
Bad Loans	5,187	5,614	
Total NPLs	**213,971**	**184,146**	
Decrease in NPLs			29,825
Total Loan Portfolio	**1,009,457**	**1,229,658**	
Total NPLs as % of Total Loans	21.20%	14.98%	
YOY Change in NPLs as % of Total Loans			-29.35%
Bad Debt Reserves (LLRs)	11,179	17,376	
Reserves as % of total loans	1.11%	1.41%	
Reserves as % of NPLs	5.22%	9.44%	
Paid in Capital	57,226	66,209	
Of which: shareholders equity	38,507	47,490	
Capital surplus	1,967	2,001	
Reserves	5,932	7,272	
Retaining earnings (loss)	0	0	
Total Capital	**65,125**	**75,482**	
Increase in Paid in Capital			8,983
Increase in Shareholders Equity			8,983
Increase in Capital Surplus			34
Total Increase in Capital			10,357
YOY % Change in Capital			15.90%
NPLS (less reserves) as % of Total Capital	311%	221%	
Total Assets	**2,867,762**	**3,727,061**	
CAR (Total Capital/Total Assets)	**2.27%**	**2.03%**	

Deposits Placed (Assets)

Deposits in Central Bank	813,259	843,584	
Deposits in Ag Bank	4,510	40,022	
Total Deposits Placed	**817,769**	**883,606**	
YOY % Change in Deposits Placed			8.05%
Deposits Received (Liabilities)			
Short term Deposits	356,566	423,378	
Short term Savings Deposits	849,498	1,002,245	
Long Term Deposits	20,000	20,000	
Long Term Savings Deposits	325,381	297,027	
Current Portion of long term deposits	246,879	287,838	
Total Deposits Received	**1,798,324**	**2,030,488**	
YOY % Change in Deposits Received			12.91%
Total Loans/Total Deposits	56.13%	60.56%	

Hohhot Suburban RCCU Loan Loss Reserve Analysis

LLR adjustments for NPLs as per International Standards			
			December 2004
Past Dues 20% Minimum			950
Idle Loans 50% Minimum			86,892
Bad Loans 100%			5,614
Total LLR required			93,455
Less current LLR			17,376
Additional LLR required			**76,079**
Charge shortfall to Capital Account			
Current Capital			75,482
Less required LLR			76,079
Adjusted capital			**-(597)**
Balance of NPLs after Adjustments			
	Stated Bal	Reserve	Adjusted Bal
Past Due	4,749	950	3,799
Idle	173,783	86,892	86,892
Bad	5,614	5,614	0
Total NPLs	184,146	93,455	90,691
NPLs as % of Total Loans after Adjustments			7.38%
NPLs as % of Capital after Adjustments			120%
Calculation of Actual Loss per PBOC Standards as at December 2004			
Past Dues 10% Minimum			475
Idle Loans 40% Minimum			69,513
Bad Loans 100%			5,614
Invested Assets 10%			
Collateral loans under disposal 50%			14,451
Total			**90,053**

Insolvency per PBOC Calculation: *Insolvency = actual loss - owners equity - bad debt reserve.*

PBOC calculated insolvency as at 12/31/2002 = (49,674) therefore redeemable bills eligibility is 24,387. *Insolvency as at 12/31/2004 is 2,806 positive capital therefore eligibility for redeemable bills is 0*

Risk Weighted CAR (adjusted for NPLs and required reserves)

Total Risk Weighted Assets			1,661,228
Total Capital	**100,319**		
Capital for CAR Calculations		**87,901**	
Tier 1:			
Paid in	66,209		
Capital Surplus	2,001		
Reserves	7,272		
Retained Earnings (loss)	0		
Tier 2:			
Redeemable Bills	24,837	(only 50% eligible for CAR Calculation)	
Risk Weighted CAR per Basel Standard			**5.29%**
Risk Weighted CAR with 100% Tier 2			**6.04%**
Basel Minimum CAR			***8.00%***

Redeemable Bills

PBOC is to issue redeemable bills up to the limit of 50% of the calculated insolvency amount as of 12/31/02. The analyst recalculated this amount as of 12/31/2004 and considers this to be amore realistic amount from which to approach the true level of recapitalization required. Applying redeemable bills would leave an NPL balance of 154,309,000CNY if no other reductions are made. The new bank would have a total NPL ratio of 12.3% and an NPL /adjusted capital ratio of 176% (based on Basel Standard of Redeemable bills being Tier 2 capital.)

Hohhot Suburban RCCU Performance Analysis

	December 2003	December 2004
Interest Income From Loans	73,797	85,426
Average Annual Loan Portfolio	911,729	1,384,558
Imputed Interest Rate Yield	8.09%	6.17%
Average Annual NPLS	226,731	199,059
Imputed Interest Income loss at 7%	15,871	13,934
Average Net Loans	**684,998**	**1,185,499**
Net RCCU Deposits		**850,688**
Interest Income from Deposits	2,661	3,038
Interest on loans from other RCCUs	5,810	6,642
Fees and Commissions Income	303	471
Other 'Interest' Income	9,458	9,284
Total Operating Income	**91,726**	**98,219**
Interest Expenses	**28,317**	**27,740**
Interest Paid on Deposits	24,666	25,215
Interest Paid on Borrowings	3,651	2,525
Fees and Commissions Expense	**427**	**325**
Net Interest Income	**63,106**	**70,008**
Interest Income/Interest Expense (times)	3.24	3.76
Average Member Deposits		**1,914,406**
Operating Expenses	**50,722**	**55,924**
Of Which Employee Expenses	**21,601**	**24,748**
Employee Salaries	14,627	16,305
Employee Benefits	6,220	7,619

Other Staff Related Expenses	754	824
Employee Expenses/Average net Loans	3.15%	2.09%
Other Operating Expenses	4,548	10,919
of which: Charges to Loan Loss Reserves	1,850	7,949
Operating Taxes Paid	4,000	2,883
Operating Profits (Loss)		
Total Revenue	6,036	8,837
Less Income taxes paid	3,915	5,465
Net Profit (loss) for the year	2,121	3,372
Average Earning Assets		**2,036,187**
Average Assets	**2,403,381**	**3,297,412**
Return on Average Assets (ROA)	0.09%	0.10%
Average Equity	**61,943**	**70,304**
Return on Average Equity (ROE)	3.42%	4.80%
Net Spread =Int earned/loans - int paid/deposits	5.94%	5.71%
Operating Income to Total Average Assets	3.82%	2.98%
Total Interest Income/ Average Earning Assets		4.80%
Net Interest Income/Average Earning Assets		3.44%
Fee Income/Average Total Assets		0.02%
Depost Int Expense/Average Total Deposits		1.32%
Net Int Income/Gross Operating Income		71.28%
Total Operating Expenses/Gross operating Income		68.06%
Other Operating Expenses/Average Total Assets		0.33%
Staff Costs/Gross Operating Income		25.20%
Staff Cost/Employee (000 CNY per annum)		30.553

Manzhouli RCCU Capital Analysis

Performing Loans			
Short term loans	152,677	150,801	
Medium and L/T loans	3,560	3,004	
Total Performing Loans	**156,237**	**153,805**	
Increase in Active Loans			-(2,432)
YOY Change in loan Portfolio			-1.56%
Non Performing Loans			
Past Due Loans	703	53	
Idle Loans	20,925	19,324	
Bad Loans	4,439	4,095	
Total NPLs	**26,067**	**23,472**	
Decrease in NPLs			2,595
Total Loan Portfolio	**182,304**	**177,277**	
Total NPLs as % of Total Loans	14.30%	13.24%	
YOY Change in NPLs as % of Total Loans			-7.40%
Bad Debt Reserves (LLRs)	1,971	2,284	
Reserves as % of total loans	1.08%	1.29%	
Reserves as % of NPLs	7.56%	9.73%	
Paid in Capital	**15,394**	**21,451**	
Of which: shareholders equity	13,632	22,296	
Capital surplus	1,709	1,709	
Reserves	482	581	
Retaining earnings (loss)	-(3,667)	-(3,557)	
Total Capital	**13,918**	**20,184**	
Increase in Paid in Capital			6,057
Increase in Shareholders Equity			8,664
Increase in Capital Surplus			-
Total Increase in Capital			6,266
YOY % Change in Capital			45.02%
NPLS (less reserves) as % of Total Capital	173%	105%	
Total Assets	**339,640**	**454,834**	
CAR (Total Capital/Total Assets)	**4.10%**	**4.44%**	
Deposits Placed (Assets)			
Deposits in Central Bank	21,665	60,343	
Deposits in Ag Bank	2,778	38,012	
Total Deposits Placed	**24,443**	**98,355**	
YOY % Change in Deposits Placed			302.39%
Deposits Received (Liabilities)			
Short term Deposits	43,571	55,458	
Short term Savings Deposits	111,383	143,463	
Long Term Deposits		0	
Long Term Savings Deposits	22,779	27,152	
Current Portion of long term deposits	58,686	114,684	
Total Deposits Received	**236,419**	**340,757**	
YOY % Change in Deposits Received			44.13%
Total Loans/Total Deposits	77.11%	52.02%	

Manzhouli RCCU Loan Loss Reserve Analysis

LLR adjustments for NPLs as per International Standards			
			December 2004
Past Dues 20% Minimum			11
Idle Loans 50% Minimum			9,662
Bad Loans 100%			4,095
Total LLR required			13,768
Less current LLR			2,284
Additional LLR required			**11,484**
Charge shortfall to Capital Account			
Current Capital			20,184
Less required LLR			11,484
Adjusted capital			**8,700**
Balance of NPLs after Adjustments			
	Stated Bal	Reserve	Adjusted Bal
Past Due	53	11	42
Idle	19,324	9,662	9,662
Bad	4,095	4,095	0
Total NPLs	23,472	13,768	9,704
NPLs as % of Total Loans after Adjustments			5.47%
NPLs as % of Capital after Adjustments			48%
Calculation of Actual Loss per PBOC Standards as at December 2004			
Past Dues 10% Minimum			5
Idle Loans 40% Minimum			7,730
Bad Loans 100%			4,095
Invested Assets 10%			2500
Collateral loans under disposal 50%			2604
Total			16,934

Insolvency per PBOC Calculation: *Insolvency = actual loss - owners equity - bad debt reserve.*
PBOC calculated insolvency as at 12/31/2002 = (5,820) therefore redeemable bills eligibility is 2910. *Insolvency as at 12/31/2004 is 5,534 positive capital therefore eligibility for redeemable bills is 0*

Risk Weighted CAR (adjusted for NPLs and required reserves)			
Total Risk Weighted Assets			276,250
Total Capital	**23,094**		
Capital for CAR Calculations		**21,639**	
Tier 1:			
Paid in	21,451		
Capital Surplus	1,709		
Reserves	581		
Retained Earnings (loss)	-(3,557)		
Tier 2:			
Redeemable Bills	2,910	(only 50% eligible for CAR Calculation)	
Risk Weighted CAR per Basel Standard			**7.83%**
Risk Weighted CAR with 100% Tier 2			**8.36%**
Basel Minimum CAR			***8.00%***

Redeemable Bills

PBOC is to issue redeemable bills up to the limit of 50% of the calculated insolvency amount as of 12/31/02. The analyst recalculated this amount as of 12/31/2004 and considers this to be amore realistic amount from which to approach the true level of recapitalization required. Applying redeemable

bills would leave an NPL balance of 20,562,000CNY if no other reductions are made. The new bank would have a total NPL ratio of 11.6% and an NPL /adjusted capital ratio of 96% (based on Basel Standard of Redeemable bills being Tier 2 capital.)

	December 2003	December 2004
Interest Income From Loans	10,921	15,640
Average Annual Loan Portfolio	162,682	179,791
Imputed Interest Rate Yield	6.71%	8.70%
Average Annual NPLS	26,994	24,770
Imputed Interest Income loss at 7%	1,890	1,734
Average Net Loans	**135,689**	**155,021**
Average RCCU Deposits		**61,399**
Interest Income from Deposits	1,242	1,771
Fees and Commissions Income	22	46
Other 'Interest' Income	209	298
Total Operating Income	**12,394**	**17,755**
Interest Expenses	**3,958**	**6,139**
Interest Paid on Deposits	**3,184**	**4,889**
Interest Paid on Borrowings	774	1,250
Fees and Commission Expense	**11**	**21**
Net Interest Income	**9,188**	**12,820**
Interest Income/Interest Expense (times)	3.82	3.56
Average Member Deposits		**288,588**
Operating Expenses	**7,118**	**8,793**
Of Which Employee Expenses	**3,742**	**4,348**
Employee Salaries	2,908	2,927
Employee Benefits	732	1,327
Other Staff Related Expenses	102	94
Employee Expenses/Average net Loans	2.76%	2.80%
Other Operating Expenses	1,284	1,761
of which: Charges to Loan Loss Reserves	691	914
Operating Taxes Paid	593	847
Operating Profits (Loss)	-(771)	150
Total Revenue	12,973	18,279
Less Income taxes paid	226	425
Net Profit (loss) for the year	**-(402)**	**506**
Average Earning Assets		**216,420**
Average Assets	**314,850**	**397,237**
Return on Average Assets (ROA)	-0.13%	0.13%
Average Equity	**13,284**	**17,051**
Return on Average Equity (ROE)	-3.03%	2.97%
Interest earned/loans - interest paid/deposits	5.66%	8.46%
Net Operating Income to Average Total Assets	3.94%	4.47%
Total Interest Income/ Average Earning Assets		8.18%
Net Interest Income/Average Earning Assets		3.23%
Fee Income/Average Total Assets		0.01%
Depost Int Expense/Average Total Deposits		1.69%
Total Interest Expense/Average Earning Assets		2.84%
Net Int Income/Gross Operating Income		72.21%
Total Operating Expenses/Gross operating Income		59.44%
Other Operating Expenses/Average Total Assets		0.44%

Staff Costs/Gross Operating Income	24.49%
Staff Costs/Employee (000 CNY per annum)	28.234

Naiman RCCU Capital Analysis

	December 2003	December 2004	Change
Performing Loans			
Short term loans	57,539	160,766	
Medium and L/T loans	12,223	16,325	
Total Performing Loans	**69,762**	**177,091**	
Increase in Active Loans			107,329
YOY Change in loan Portfolio			153.85%
Non Performing Loans			
Past Due Loans	20,206	1,431	
Idle Loans	75,132	64,130	
Bad Loans	2,244	1,154	
Total NPLs	**97,582**	**66,715**	
Decrease in NPLs			30,867
Total Loan Portfolio	**167,344**	**243,806**	
Total NPLs as % of Total Loans	58.31%	27.36%	
YOY Change in NPLs as % of Total Loans			-53.07%
Bad Debt Reserves (LLRs)	1,917	4,767	
Reserves as % of total loans	1.15%	1.96%	
Reserves as % of NPLs	1.96%	7.15%	
Paid in Capital	**32,092**	**39,817**	
Of which: shareholders equity	19,083	26,339	
Capital surplus	0	0	
Reserves	178	3,184	
Retaining earnings (loss)	-(4,132)	-(5,565)	
Total Capital	**28,138**	**37,436**	
Increase in Paid in Capital			7,725
Increase in Shareholders Equity			7,256
Increase in Capital Surplus			-
Total Increase in Capital			9,298
YOY % Change in Capital			33.04%
NPLS (less reserves) as % of Total Capital	340%	165%	
Total Assets	**564,177**	**698,009**	
CAR (Total Capital/Total Assets)	**4.99%**	**5.36%**	
Deposits Placed (Assets)			
Deposits in Central Bank	134,698	119,283	
Deposits in Ag Bank		705	
Deposits in Correspondent Banks	19,297	22,369	
Total Deposits Placed	**153,995**	**142,357**	
YOY % Change in Deposits Placed			-7.56%
Deposits Received (Liabilities)			
Short term Deposits	38,302	72,425	
Short term Savings Deposits	170,346	156,224	
Deposits From Correspondents	23,790	19,465	

Long Term Deposits	0	1,080	
Long Term Savings Deposits	84,038	53,150	
Current Portion of long term deposits	39,137	98,520	
Total Deposits Received	**355,613**	**400,864**	
YOY % Change in Deposits Received			12.72%
Total Loans/Total Deposits	47.06%	60.82%	

Naiman RCCU Loan Loss Reserve Analysis

			December 2004
Past Dues 20% Minimum			286
Idle Loans 50% Minimum			32,065
Bad Loans 100%			1,154
Total LLR required			33,505
Less current LLR			4,767
Additional LLR required			**28,738**
Charge shortfall to Capital Account			
Current Capital			37,436
Less required LLR			28,738
Adjusted capital			**8,698**
Balance of NPLs after Adjustments			
	Stated Bal	Reserve	Adjusted Bal
Past Due	1,431	286	1,145
Idle	64,130	32,065	32,065
Bad	1,154	1,154	0
Total NPLs	66,715	33,505	33,210
NPLs as % of Total Loans after Adjustments			13.62%
NPLs as % of Capital after Adjustments			89%
Calculation of Actual Loss per PBOC Standards as at December 2004			
Past Dues 10% Minimum			143
Idle Loans 40% Minimum			25,652
Bad Loans 100%			1,154
Invested Assets 10%			
Collateral loans under disposal 50%			3,162
Total			**30,111**

PBOC calculated insolvency as at 12/31/2002 = (23,069) therefore redeemable bills eligibility is 11,535. *Insolvency as at 12/31/2004 is 12,092 positive capital therefore eligibility for redeemable bills is 0*

Risk Weighted CAR (adjusted for NPLs and required reserves)			
Total Risk Weighted Assets			343,729
Total Capital	**48,971**		
Capital for CAR Calculations		**43,204**	
Tier 1:			
Paid in	39,817		
Capital Surplus	0		
Reserves	3,184		
Retained Earnings (loss)	-(5,565)		
Tier 2:			
Redeemable Bills	11,535	(only 50% eligible for CAR Calculation)	
Risk Weighted CAR per Basel Standard			**12.57%**
Risk Weighted CAR with 100% Tier 2			**14.25%**
Basel Minimum CAR			***8.00%***
Redeemable Bills			

PBOC is to issue redeemable bills up to the limit of 50% of the calculated insolvency amount as of 12/31/02. The analyst recalculated this amount as of 12/31/2004 and considers this to be amore realistic amount from which to approach the true level of recapitalization required. Applying redeemable bills would leave an NPL balance of 55,180,000CNY if no other reductions are made. The new bank would have a total NPL ratio of 22.6% and an NPL /adjusted capital ratio of 128% (based on Basel Standard of Redeemable bills being Tier 2 capital.)

Additional new capital required to meet 8% CAR with 2002 insolvency calculation : CNY12,519
Additional new capital required to meet 8% CAR with 2004 insolvency calculation : CNY6,751

Naiman RCCU Performance Analysis

	December 2003	December 2004
Interest Income From Loans	19,553	26,536
Interest Income From Loans to Member RCCUs	1,449	1,924
Total Loan Income	21,002	28,460
Average Annual Loan Portfolio	168,132	205,575
Imputed Interest Rate Yield	12.49%	13.84%
Average Annual NPLS	125,556	82,149
Imputed Interest Income loss at 7%	8,789	5,750
Average Net Loans	**42,576**	**123,426**
Average Net RCCU Deposits		**148,176**
Interest Income from Deposits	606	1,192
Fees and Commissions Income	0	0
Other 'Interest' Income	1,714	1,849
Total Operating Income	**21,873**	**29,577**
Interest Expenses	**7,917**	**10,140**
Interest Paid on Deposits	5,114	6,299
Interest Paid on Borrowings	2,803	3,841
Fees and Commission Expenses	**432**	**549**
Net Interest Income	**13,956**	**19,437**
Interest Income/Interest Expense (times)	2.76	2.92
Average Member Deposits		**378,239**
Operating Expenses	**13,597**	**15,618**
Of Which Employee Expenses	**7,674**	**7,881**
Employee Salaries	5,219	5,380
Employee Benefits	1,820	1,806
Other Staff Related Expenses	635	695
Employee Expenses/Average net Loans	18.02%	6.39%
Other Operating Expenses	249	4,923
of which: Charges to Loan Loss Reserves	39	4,459
Operating Taxes Paid	729	809
Operating Profits (Loss)	391	-(701)
Total Revenue	733	-(644)
Less Income taxes paid	0	0
Net Profit (loss) for the year	**733**	**-(644)**
Average Earning Assets		**271,602**
Average Assets	**512,344**	**631,093**
Return on Average Assets (ROA)	0.14%	-0.10%
Average Equity	**27,054**	**32,787**

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Return on Average Equity (ROE)	2.71%	-1.96%
Net Spread =Int earned/loans - int paid/deposits	11.11%	10.10%
Operating Income to Total Average Assets	4.27%	4.69%
Total Interest Income/ Average Earning Assets		10.89%
Net Interest Income/Average Earning Assets		7.16%
Fee Income/Average Total Assets		0.00%
Depost Int Expense/Average Total Deposits		1.67%
Total Interest Expense/Average Earning Assets		3.73%
Net Int Income/Gross Operating Income		65.72%
Total Operating Expenses/Gross operating Income		69.45%
Other Operating Expenses/Average Total Assets		0.78%
Staff Costs/Gross Operating Income		26.65%
Staff Costs/Staff member (000 CNY per annum)		29.740

Yuanbaoshan RCCU Capital Analysis

	December 2003	December 2004	Change
Performing Loans			
Short term loans	162,290	210,596	
Medium and L/T loans	27,418	112,913	
Total Performing Loans	**189,708**	**323,509**	
Increase in Active Loans			133,801
YOY Change in loan Portfolio			70.53%
Non Performing Loans			
Past Due Loans	7,295	7,231	
Idle Loans	61,416	53,188	
Bad Loans	10,514	9,445	
Total NPLs	**79,225**	**69,864**	
Decrease in NPLs			9,361
Total Loan Portfolio	**268,933**	**393,373**	
Total NPLs as % of Total Loans	29.46%	17.76%	
YOY Change in NPLs as % of Total Loans			-39.71%
Bad Debt Reserves (LLRs)	2,963	5,512	
Reserves as % of total loans	1.10%	1.40%	
Reserves as % of NPLs	3.74%	7.89%	
Paid in Capital	**33,040**	**41,243**	
Of which: shareholders equity	23,248	31,452	
Capital surplus	408	408	
Reserves	2,098	2,116	
Retaining earnings (loss)	-(4,341)	-(4,292)	
Total Capital	**31,205**	**39,475**	
Increase in Paid in Capital			8,203
Increase in Shareholders Equity			8,204
Increase in Capital Surplus			-
Total Increase in Capital			8,270
YOY % Change in Capital			26.50%
NPLS (less reserves) as % of Total Capital	244%	163%	
Total Assets	**579,241**	**692,117**	
CAR (Total Capital/Total Assets)	**5.39%**	**5.70%**	
Deposits Placed (Assets)			
Deposits in Central Bank	115,577	110,023	
Deposits in Ag Bank	3,449	6,571	
Total Deposits Placed	**119,026**	**116,594**	
YOY % Change in Deposits Placed			-2.04%
Deposits Received (Liabilities)			
Short term Deposits	31,290	36,942	
Short term Savings Deposits	120,785	165,900	
Long Term Deposits	400	7,619	
Long Term Savings Deposits	62,308	70,002	
Current Portion of long term deposits	185,571	221,740	
Total Deposits Received	**400,354**	**502,203**	
YOY % Change in Deposits Received			25.44%
Total Loans/Total Deposits	67.17%	78.33%	

Yuanbaoshan Loan Loss Reserve Analysis

LLR adjustments for NPLs as per International Standards			December 2004
Past Dues 20% Minimum			1,446
Idle Loans 50% Minimum			26,594
Bad Loans 100%			9,445
Total LLR required			37,485
Less current LLR			5,512
Additional LLR required			**31,973**
Charge shortfall to Capital Account			
Current Capital			39,475
Less required LLR			31,973
Adjusted capital			**7,502**
Balance of NPLs after Adjustments			
	Stated Bal	Reserve	Adjusted Bal
Past Due	7,231	1,446	5,785
Idle	53,188	26,594	26,594
Bad	9,445	9,445	0
Total NPLs	69,864	37,485	32,379
NPLs as % of Total Loans after Adjustments			8.23%
NPLs as % of Capital after Adjustments			82%
Calculation of Actual Loss per PBOC Standards as at December 2004			
Past Dues 10% Minimum			723
Idle Loans 40% Minimum			21,275
Bad Loans 100%			9,445
Invested Assets 10%			
Collateral loans under disposal 50%			12,833
Total			44,276

PBOC calculated insolvency as at 12/31/2002 = (18,330) therefore redeemable bills eligibility is 9,165.
Insolvency as at 12/31/2004 is 771 positive capital therefore eligibility for redeemable bills is 0

Risk Weighted CAR (adjusted for NPLs and required reserves)			
Total Risk Weighted Assets			470,288
Total Capital	**48,640**		
Capital for CAR Calculations		**44,058**	
Tier 1:			
Paid in	41,243		
Capital Surplus	408		
Reserves	2,116		
Retained Earnings (loss)	-(4,292)		
Tier 2:			
Redeemable Bills	9,165	(only 50% eligible for CAR Calculation)	
Risk Weighted CAR per Basel Standard			**9.37%**
Risk Weighted CAR with 100% Tier 2			**10.34%**
Basel Minimum CAR			***8.00%***

Redeemable Bills

PBOC is to issue redeemable bills up to the limit of 50% of the calculated insolvency amount as of 12/31/02. The analyst recalculated this amount as of 12/31/2004 and considers this to be amore realistic amount from which to approach the true level of recapitalization required. Applying redeemable bills would leave an NPL balance of 60,699,000CNY if no other reductions are made. The new bank would have a total NPL ratio of 15.4% and an NPL /adjusted capital ratio of 139% (based on Basel Standard of Redeemable bills being Tier 2 capital.)

Additional new capital required to meet 8% CAR with 2002 insolvency calculation : CNY 0
Additional new capital required to meet 8% CAR with 2004 insolvency calculation : CNY 0

Yuanbaoshan RCCU Performance Analysis

	December 2003	December 2004
Interest Income From Loans	17,602	23,320
Average Annual Loan Portfolio	334,477	331,553
Imputed Interest Rate Yield	5.26%	7.03%
Average Annual NPLS	74,592	74,545
Imputed Interest Income loss at 7%	5,221	5,218
Average Net Loans	**259,885**	**257,008**
Average Net RCCU Deposits		**117,810**
Interest Income from Deposits	2,040	2,013
Fees and Commissions Income	73	161
Other 'Interest' Income	1,810	1,557
Total Operating Income	21,525	27,051
Interest Expenses	**7,984**	**9,294**
Interest Paid on Deposits	7,538	8,842
Interest Paid on Borrowings	446	452
Fees and Commission Expenses	**239**	**120**
Net Interest Income	**13,468**	**17,596**
Interest Income/Interest Expense (times)	2.46	2.73
Average Member Deposits		**451,279**
Operating Expenses	**10,723**	**12,245**
Of Which Employee Expenses	**6,800**	**6,626**
Employee Salaries	4,231	4,297
Employee Benefits	1,782	1,535
Other Staff Related Expenses	787	794
Employee Expenses/Average net Loans	2.62%	2.58%
Other Operating Expenses	1,934	5,071
of which: Charges to Loan Loss Reserves	944	4,047
Operating Taxes Paid	960	765
Operating Profits (Loss)	-(312)	-(244)
Total Revenue	328	193
Less Income taxes paid	163	53
Net Profit (loss) for the year	165	140
Average Earning Assets		**374,818**
Average Assets	**551,606**	**635,679**
Return on Average Assets (ROA)	0.03%	0.02%
Average Equity	**30,528**	**35,340**
Return on Average Equity (ROE)	0.54%	0.40%
Net Spread =Int earned/loans - int paid/deposits	4.66%	4.17%
Operating Income to Total Average Assets	3.90%	4.26%
Total Interest Income/ Average Earning Assets		7.17%
Net Interest Income/Average Earning Assets		4.69%
Fee Income/Average Total Assets		0.03%
Depost Int Expense/Average Total Deposits		1.96%
Total Interest Expense/Average Earning Assets		2.48%
Net Int Income/Gross Operating Income		65.05%
Total Operating Expenses/Gross operating Income		64.01%
Other Operating Expenses/Average Total Assets		0.80%
Staff Costs/Gross Operating Income		24.49%
Staff Costs/Employee (000 CNY per annum)		27.267

Batou Consolidated Capital Analysis

	Suburban RCCU Batou			Batou Southern Sub. RCCU			Batou RCCU Cons
	Dec 2003	Dec 2004	Change	Dec 2003	Dec 2004	Change	2004
Performing Loans							
Short term loans	469,386	337,355		343,620	315,240		652,595
Medium and L/T loans	39,123	141,513		60,632	121,701		263,214
Total Performing Loans	**508,509**	**478,868**		**404,252**	**436,941**		**915,809**
Increase in Active Loans			-(29,641)			32,689	3,048
YOY Change in loan Portfolio			-5.83%			8.09%	2.26%
Non Performing Loans							
Past Due Loans	3,639	5,747		7,614	40,837		46,584
Idle Loans	149,164	126,887		159,686	166,506		293,393
Bad Loans	1,258	350		292	291		641
Total NPLs	**154,061**	**132,984**		**167,592**	**207,634**		**340,618**
Decrease in NPLs			21,077			-(40,042)	-(18,965)
Total Loan Portfolio	**662,570**	**611,852**		**571,844**	**644,575**		**1,256,427**
Total NPLs as % of Total Loans	23.25%	21.73%		29.31%	32.21%		27.11%
YOY Chnge in NPLs as % of Total Lns			-6.53%			9.91%	1.694%
Bad Debt Reserves (LLRs)	6,901	6,675		5,955	6,754		**13,429**
Reserves as % of total loans	1.04%	1.09%		1.04%	1.05%		1.07%
Reserves as % of NPLs	4.48%	5.02%		3.55%	3.25%		3.94%
Paid in Capital	**40,469**	**46,446**		**38,700**	**48,849**		**95,295**
Of which: shareholders equity	20,179	25,757		24,226	34,374		60,131
Capital surplus	261	261		292	291		552
Reserves	4,046	9,383		1,030	2,817		12,200
Retaining earnings (loss)	0	0		-(511)	-(55)		-(55)
Total Capital	**44,776**	**56,090**		**39,511**	**51,902**		**107,992**
Increase in Paid in Capital			5,977			10,149	
Increase in Shareholders Equity			5,578			10,148	
Increase in Capital Surplus			-			-	
Total Increase in Capital			11,314			12,391	23,705
YOY % Change in Capital			25.27%			31.36%	28.31%
NPLS (less reserves) as % of Total Cap.	329%	225%		409%	387%		306%
Total Assets	**1,888,013**	**2,098,908**		**1,052,921**	**1,123,981**		**3,222,889**
CAR (Total Capital/Total Assets)	**2.37%**	**2.67%**		**3.75%**	**4.62%**		**3.65%**
Deposits Placed (Assets)							
Deposits in Central Bank	232,333	277,178		111,679	111,216		388,394
Deposits in Ag Bank	98,999	90,662		87,627	31,462		122,124
Total Deposits Placed	**331,332**	**367,840**		**199,306**	**142,678**		**510,518**
YOY % Change in Deposits Placed			11.02%			-28.41%	-8.70%
Deposits Received (Liabilities)							
Short term Deposits	439,917	450,902		156,883	138,905		589,807
Short term Savings Deposits	393,402	461,754		383,084	434,397		896,151
Long Term Deposits	3,224	1,784		0	0		1,784

Long Term Savings Deposits	298,800	299,737		186,800	196,939		496,676
Current Portion of long term deposits	78,944	93,307		86,767	68,985		162,292
Total Deposits Received	**1,214,287**	**1,307,484**		**813,534**	**839,226**		**2,146,710**
YOY % Change in Deposits Received			7.68%			3.16%	5.42%
Total Loans/Total Deposits	54.56%	46.80%		70.29%	76.81%		61.80%

Batou Consolidated Loan Loss Reserve Analysis

			December 2004
Past Dues 20% Minimum			9,317
Idle Loans 50% Minimum			146,697
Bad Loans 100%			641
Total LLR required			156,654
Less current LLR			13,429
Additional LLR required			**143,225**
Charge shortfall to Capital Account			
Current Capital			107,992
Less required LLR			143,225
Adjusted capital			**-(35,233)**
Balance of NPLs after Adjustments			
	Stated Bal	Reserve	Adjusted Bal
Past Due	46,584	9,317	37,267
Idle	293,393	146,697	146,697
Bad	641	641	0
Total NPLs	340,618	156,654	183,964
NPLs as % of Total Loans after Adjustments			14.64%
NPLs as % of Capital after Adjustments			170%

Calculation of Actual Loss per PBOC Standards as at December 2004

Past Dues 10% Minimum	4,658
Idle Loans 40% Minimum	117,357
Bad Loans 100%	641
Invested Assets 10%	8
Collateral loans under disposal 50%	31,935
Total	154,600

Insolvency per PBOC Calculation: *Insolvency = actual loss - owners equity - bad debt reserve.*

PBOC calculated insolvency as at 12/31/2002 = (43,708) therefore redeemable bills eligibility is 21,854. *Insolvency as at 12/31/2004 is (33,177) therefore eligibility for redeemable bills is 16,589*

Risk Weighted CAR (adjusted for NPLs and required reserves)

Total Risk Weighted Assets			2,023,598
Total Capital	**124,581**		
Capital for CAR Calculations		**116,287**	
Tier 1:			
Paid in	95,295		
Capital Surplus	552		
Reserves	12,200		
Retained Earnings (loss)	-(55)		
Tier 2:			
Redeemable Bills	16,589	(only 50% eligible for CAR Calculation)	
Risk Weighted CAR per Basel Standard			**5.75%**
Risk Weighted CAR with 100% Tier 2			**6.16%**
Basel Minimum CAR			***8.00%***

Redeemable Bills

PBOC is to issue redeemable bills up to the limit of 50% of the calculated insolvency amount as of 12/31/02. The analyst recalculated this amount as of 12/31/2004 and considers this to be amore realistic amount from which to approach the true level of recapitalization required. Applying redeemable bills would leave an NPL balance of 324,029,000CNY if no other reductions were made. The new bank would have a total NPL ratio of 26.4% and an NPL /adjusted capital ratio of 279% (based on Basel Standard of Redeemable bills being Tier 2 capital.)

Additional new capital required to meet 8% CAR with 2002 insolvency calculation : CNY40,335
Additional new capital required to meet 8% CAR with 2004 insolvency calculation : CNY45,600

	Suburban Batou		Batou Southern Suburban		Batou Consolidated December
	Dec 2003	Dec 2004	Dec 2003	Dec 2004	2004
Interest Income From Loans	35,982	52,763	34,901	42,470	95,233
Average Annual Loan Portfolio	558,700	602,076	507,997	607,944	1,210,020
Imputed Interest Rate Yield	6.44%	8.76%	6.87%	6.99%	7.87%
Average Annual NPLS	159,486	143,523	172,881	187,613	331,143
Imputed Interest Income loss at 7%	11,164	10,047	12,102	13,133	23,180
Average Net Loans	**399,215**	**458,553**	**335,116**	**420,331**	**878,877**
Average RCCU Deposits		**349,586**		**170,992**	**520,578**
Interest Income from Deposits	10,352	16,112	7,206	5,129	21,241
Fees and Commissions Income	508	866	74	246	1,112
Other 'Interest' Income					
Total Operating Income	**46,842**	**69,741**	**42,181**	**47,845**	**117,586**
Interest Expenses	**16,196**	**22,111**	**12,631**	**13,100**	**35,211**
Interest Paid on Deposits	13,906	20,187	9,604	10,187	30,374
Interest Paid on Borrowings	2,290	1,924	3,027	2,913	4,837
Fees and Commissions Expenses	**731**	**533**	**7,546**	**322**	**855**
Net Interest Income	**30,138**	**46,764**	**29,476**	**34,499**	**81,263**
Interest Income/Interest Expense (times)	2.86	3.11	3.33	3.63	3.37
Average Member Deposits		**1,260,886**		**826,380**	**2,087,266**
Operating Expenses	**23,767**	**27,097**	**16,752**	**23,645**	**50,742**
Of Which Employee Expenses	**14,366**	**14,947**	**9,314**	**14,279**	**29,226**
Employee Salaries	9,088	9,178	5,719	8,704	17,882
Employee Benefits	4,824	5,307	3,143	5,112	10,419
Other Staff Related Expenses	454	462	452	463	925
Employee Expenses/Average net Loans	3.60%	3.26%	2.78%	3.40%	3.33%
Other Operating Expenses	5,771	7,461	3,377	2,805	10,266
of which: Charges to Loan Loss Reserves	1,443	1,161	2,273	1,886	3,047
Operating Taxes Paid	1,938	1,708	1,896	1,394	3,102
Operating Profits (Loss)					
Total Revenue	898	15,957	504	7,272	23,229
Less Income taxes paid	119	3,327	110	2,408	5,735
Net Profit (loss) for the year	**779**	**12,630**	**394**	**4,864**	**17,494**
Average Earning Assets		**808,139**		**591,323**	**1,399,455**
Average Assets	**1,459,132**	**1,993,461**	**938,906**	**1,088,451**	**1,540,956**
Return on Average Assets (ROA)	0.05%	0.63%	0.04%	0.45%	0.57%
Average Equity	**44,438**	**50,433**	**36,771**	**45,707**	**48,070**
Return on Average Equity (ROE)	1.75%	25.04%	1.07%	10.64%	18.20%
Interest earned/loans - interest paid/deposits	4.29%	7.08%	4.92%	5.37%	6.16%
Net Operating Inc to Average Total Assets	3.21%	3.50%	4.49%	4.40%	3.82%
Total Interest Inc/ Average Earning Assets	3.18%	3.46%	4.48%	4.37%	7.56%
Net Interest Inc/Average Earning Assets				5.83%	5.81%
Fee Income/Average Total Assets	0.03%	0.04%	0.01%	0.02%	0.07%
Deposit Int Exp/Average Total Deposits		1.60%		1.23%	1.46%
Total Interest Exp/Average Earning Assets		2.74%		2.22%	2.52%
Net Int Income/Gross Operating Income	64.34%	67.05%	69.88%	72.11%	69.11%
Total Operating Exp/Gross operating Inc	63.06%	49.55%	47.72%	55.28%	51.88%
Staff Costs/Employee (000 CNY per annum)		32.635		33.207	32.921

APPENDIX 4: NPL RESOLUTION STRATEGIES FOR IMAR RCCUS

1. The NPL ratio in IMAR RCCs at the end of 2002 was 57.1 % or CNY 8.3 billion. At September 2004 the NPL portfolio was reported to have declined to 28.4%, however loan balances grew by 85% over the same period so the ratio reduction was largely due to loan growth not resolution of NPLs. The balance of NPLs as at September 2004 was 7.7 billion so the real NPL reduction was only over a two year period was only 7%. Most RCCU officials suggested that the easy NPLs have been collected, the remaining portfolio is 'hard core'.

2. An effective NPL resolution strategy requires that the structure of the NPL portfolio is clearly understood. RCCU officials and literature about the RCC system attribute the majority of NPLs to an 'historical burden' inherited from the ABC when the RCCs were under ABC management. This statement needs to be carefully examined and challenged; its perpetuation is a convenient explanation that discourages actively addressing underlying problems that continue to plague the RFI system.

3. For purposes of determining government support for RCCUs the historical burden is defined as the accumulated losses to year end 2002. The actual historical burden, however, applies to loans and losses incurred prior to 1996 when RCCs were under administration of the ABC.

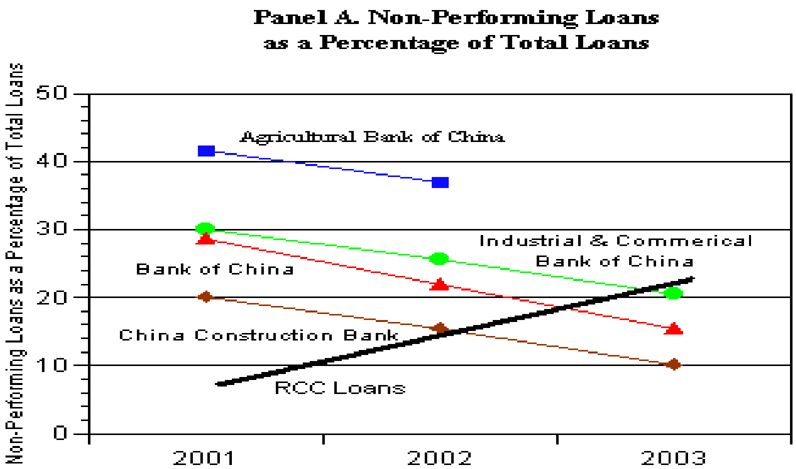
4. Bairin Right Banner RCCU of Chifeng stated that its NPLs have increased by 105% since 2002. This increase was attributed to draught in the banner, but staff of the UNDP micro finance project working in the same villages said the draught has had little effect on loan repayment. The micro finance project reports an NPL ratio of 0.7% as of March 2005. An RCC in Wuchuan County reports that its entire 25% NPL portfolio is due to micro loans. As the micro loan program was not introduced until 1999, these are clearly not part of the real historical burden.

5. An official of the IMAR working group on RCC reform and several RCCU leaders confidently assert that the risk in their NPL portfolios is actually much less than the numbers suggest. These statements are based on the belief that they are collecting interest on 98% of the NPLs, the NPLS are largely due to mismatches between the cash flow cycle and loan terms and that farmers and herder are very honest. Again this indicates that many of the NPLs are more recent. Based on interviews with various RCCU officials the writer intuitively suggests that the historical burden in IMAR is probably less than 20% of NPLs. While this is significant, it is not the major cause of NPLs.

6. The graph below[31], confirms that non performing loans as a percentage of the total portfolio has been growing at a constant rate since 2001 in RCCs while the non performing loans of commercial banks declined steadily over the same period. This would indicate that the majority of NPLs in the RCC system are in fact not a historical burden, but are newer loans, of which policy loans are a big part. Therefore replacing half of accumulated losses to 2002 without addressing current lending practices and pressures to meet the social and economic goals of local governments, regardless of their viability, will only result in further losses.

[31] Wall Street Journal, March 2004

CHINA: NON-PERFORMING LOANS, 2001-2003



Source: *The Wall Street Journal*, March 12, 2004, p. A13, based on data from the Chinese banks

7. An effective NPL resolution strategy, first and foremost, requires a realistic assessment of the problem. Appendix 5. The structure of the NPL portfolio needs to be understood to resolve the current situation and to learn from it to enhance future risk management. An objective review of individual NPL portfolios should be undertaken to properly age the credits, classify NPLs as to cause of default, and assess recoverability within a reasonable time frame.

8. Realistic assessment of the recoverability of many idle loans may result in their reclassification as bad loans. It has been reported in some cases that local governments have substituted non earning assets as collateral for directed loans where the original enterprise has gone bankrupt and the assets have little value. Unless the new collateral offered is saleable or is able to earn income to recommence loan payments such collateral substitution is value less and these should be considered bad loans. Upon identifying bad loans, legal steps should be pursued immediately to write them off. With current loan loss provisioning requirements, maintaining bad loans on the books overstates the value of the institution and presents a false picture to potential investors. They are also a psychological drain on staff morale.

9. Those loans that have become past due or idle simply because of a mismatch between the loan cycle and cash flow cycle, but are otherwise fundamentally sound, that is the project funded by the loan is profitable and the borrower has integrity, should be restructured to match the cash flow cycle and brought current.

10. The vast majority of NPLs will likely remain in the idle loan category. These loans need to be worked. Many RCCU officials and a member of the IMAR working group on RCC reform believe that the majority of loans can be repaid. That statement begs the questions “if RCCU officials are confident that borrowers can repay their loans, why don’t they ask for repayment?” There are many international examples of large NPL portfolios being resolved simply by asking for repayment and setting a clear example that repayment is expected. So RCCs have to contact borrowers and request payment. The key to NPL management is quick action when a

loan goes into arrears. Repayment probability declines in direct proportion to the length of time the loan goes into arrears.

11. There appears to be a fairly prevalent practice of not demanding loan repayment as long as borrowers are willing to continue to make interest and penalty payments. In fact some RCCUs see this as a means of increasing effective interest rates. This practice in the interest of RCC staff as it reduces their workload in having to write new loans, and gives the appearance of increasing profitability. It is in the interest of the borrower as they do not have to rejoin the queue to apply for loans when they know the institution has limited liquidity. Not requiring borrowers to repay loans even if they are keeping interest and penalty payments up to date is bad practice for the following reasons:

(i) The RCC doesn't really know if the borrower really has repayment capacity because it isn't tested;
(ii) Likelihood of repayment declines the longer a loan remains in arrears;
(iii) A borrowers' repayment ability can be affected by external events, particularly in the agriculture sector where environmental and market hazards are prevalent; and
(iv) Non payment of loan principle limits the circulation of funds within the customer base and denies credit access to other worthy borrowers, which in turn, limits economic community development over the long term and ultimately RFI potential.

12. While there is no definitive research as yet to support this statement, it is generally felt by outside observers that the market penetration of the RCC system is greatly overstated, largely due to the practice of not demanding principle loan repayments and circulating loans.

13. Finally, it must be recognized that many NPLs are simply unrecoverable and should be written off. Understanding the origination of NPLs is critical to prevention of recurrence and risk management in future. While the historical burden is likely overstated, the practice of directed credits and policy loans still continues and will lead to continued high levels of NPLs in future if not addressed.

14. "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"iii The current reform process has not and will not change local government influence over RFIs as the shareholders do not have real decision making power in the institutions and this influence is the biggest obstacle to NPL resolution and future risk management.

APPENDIX 5: RURAL FINANCE POLICY ENVIRONMENT IN IMAR

A. Government Policies and Plans

1. The State Council Document 15, July 2003 issued the 'Pilot Scheme to Deepen Reform of Rural Credit Cooperatives'. Subsequent documents 48 [2004] and 66 [2004] and provincial or autonomous region plans support and clarify the aims of Document 15. Document 15 represents the third significant reform program for RCCS in a decade. RCCs were part of the ABC network until 1996 when they were separated and placed under the control of the PBOC. The stated intent of this reform was to turn RCCs into real cooperatives serving their members and supporting agriculture and to make RCCS more financially viable.

2. The reform program did introduce a micro loan scheme through an onlending window from the PBOC that increased access to credit for rural households from 2001. The micro loan scheme is effectively a line of credit that is popular with qualified households. While the scheme did increase access for RCC members and support agriculture it did not, at the outset, help to make RCCs more financially viable as the interest rate ceiling made the loans unprofitable to deliver in more remote areas and the default rate is quite high. Non performing loans in Right Banner of Chifeng, for example, have increased 105% since 2002 of which 60% are household loans.

3. While the reform program changed the administrative organ for RCCs no changes were made to the organizational and governance structure of the RCCs. Members were not given any greater role in managing and setting the policies for their RCCs so there was no progress in converting RCCs to real cooperatives.

4. During the second reform in 2002, the PBOC began to experiment with interest rate reform in 8 pilot counties. RCCs were permitted to float loan rates up to 100% of the base rate. This enabled RCCs to attract or retain more deposits and improved financial viability. By April 2003, interest rate liberalization was expanded to all RCCs in the country. However, none of the IMAR RCCUs visited by the TA team during March and April of 2005 were floating loan rates higher than 85%. Most RCCUs had set loan rates for agriculture loans 20 points lower than for commercial loans.

5. The current round of reform began in July 2003 with a pilot in 7 provinces and 1 municipality. The main objectives of the reform are to:

- (i) clarify the ownership structure and strengthen corporate governance; and
- (ii) transfer administrative responsibilities to provincial governments as well as resolve the historical financial burdens.

6. Clarifying ownership structure has in fact been interpreted rather broadly to include changing ownership and organizational structure and increasing investment in RCCs. Within IMAR, RCCUs have been classified into four categories based on the potential to achieve capital adequacy targets and equity targets by the end of 2005. IMAR proposes to restructure the RCCUs based on their categorization.

- (i) RCCUs with minimum capital adequacy of 8% and minimum registered share capital of 50 million CNY will be converted to RCBs;
- (ii) RCCUs with minimum capital adequacy of 4% and minimum registered share capital of 20 million CNY will be converted to RCOBs

(iii) RCCUs with minimum capital adequacy of 2% and minimum registered share capital of 10 million CNY will be converted to RCCUs with unified legal person status. That is the member RCCs will no longer have legal status and wiil become branches of the RCCU. These are referred to as unified RCCUs in this document.

(iv) RCCUs with minimum capital adequacy of less than 2%, regardless of total registered share capital, will continue to operate as before with individual RCCS each having independent legal person status as members in an RCCU that also has independent legal person status. These are identified as RCCUs with a two person structure in this report.

7. Within this classification the IMAR government has selected 2 RCCUs to be converted to RCBs and 7 RCCUs to be converted to RCOBs by the end of 2005. Two of the RCCUs in Batou are to be merged into one prior to conversion to an RCOB so that by the end of 2005 IMAR will have 8 new rural banks. Of the remaining 79 RCCUs, 29 are expected to become unified legal persons by the end of 2005, 23 are expected to apply for legal person status by mid 2006 and 27 RCCUs with less than 2% capital adequacy are expected to qualify for legal person status by the end of 2006. The medium term goal is to have all RCCs become branches of a unified RCCU rather than have independent status.

8. Under the guideline for provisional regulations for the administration of RCBs, RCOBs and unified RCCUs, the ownership structure will change substantially. Recommended minimum share requirements in the new legal structures are beyond the capacity of most of the current shareholders, rural households, to meet. Therefore the current member owners will lose their participation rights. Primarily staff, private business and other enterprises (state owned organizations) and other financial institutions will purchase new shares. There are, however; provisions for unified RCCUs to set minimum share requirements below the recommended 1000 shares per natural person according to local conditions which may retain some of the current shareholders if the provision is implemented.

9. Decentralizing RCC administration is a key goal of the current reform but it adds another two layers of administration through the creation of provincial or autonomous region RCCUs as well as including provincial or autonomous region governments in the structure. Document 48 not only transfers administrative responsibilities to provincial or autonomous region governments it also transfers deposit risk. Whereas state acceptance of deposit risk was previously implicit, the responsibility for deposit risk by the IMAR government is now explicit with a requirement for the government to take a loan from the PBOC to cover any outstanding debts of failed RFIs.

10. Historical losses for loans and inflation proof deposits are being addressed through several different avenues. The PBOC will offer concessionary loans to provincial governments with maturities of 3-8 years based on local conditions, to cover 50% of deficits calculated as at year end 2002, or the PBOC will provide redeemable bills to individual RCCs on the same basis. Acceptance of redeemable bills places the responsibility for performance with the RCC whereas concessionary loans make the IMAR government responsible for repayment. The IMAR government has selected the redeemable bills option for dealing with historical losses.

11. The PBOC will also reimburse RCCs for losses caused by ‘inflation proof savings’ from 1994-1997. During this period RCCs were required to increase savings rates to mitigate inflationary impacts on deposits but were not permitted to increase loan rates to offset their

costs resulting in operational losses. The reimbursement of savings losses will be over two years in the form of cash payments.

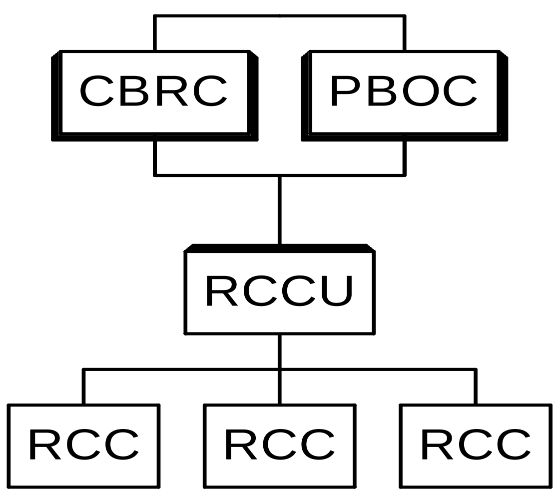
12. To improve profitability and strengthen capital RCCs will also be exempt from income taxes from January 2004 to December 2006. Additionally the IMAR government has decided to set up a risk management fund based on taxes paid by RFIs in excess of the threshold established as at December 2004.

13. Some policy decisions of the state council may have short term beneficial impacts on RCCs such as tax holidays, and replacement of losses. However if accountability is not increased and daily operating practices of RFIs do not fundamentally change then over the long term these policy supports will delay addressing the structural weaknesses of the system and increase the magnitude of the losses. Additionally there is a strong likely hood that restructuring the RCCUs into RFIs will decrease access for rural households and weaken support for the agriculture sector rather than strengthen access and support as is intended. The IMAR government should pay close attention to the lessons learned in the 8 pilot regions to avoid repeating mistakes and ensure effective implementation in IMAR. For effective reform the IMAR government needs to promote reducing NPLs and increasing investment as good business practice rather than simply as a means to obtain redeemable bills.

B. System Structure

14. Prior to reform, the RCC system was effectively a homogenous two tier structure with two channels of supervision and administration. RCCs were the foundation, representing and providing services to rural households at village and township level. Most RCCs were members of a county RCCU which provided services and limited administration to RCCs. Both RCCs and RCCUs were subject to supervision and administration by the CBRC (after 2003). The PBOC, retaining some of its responsibilities from prior to the separation of the PBOC and CBRC, was also supporting the RCCs and RCCUs through on lending funds and providing limited administration and supervision on liquidity reserves and inter RCC lending.

System Structure Before Reform



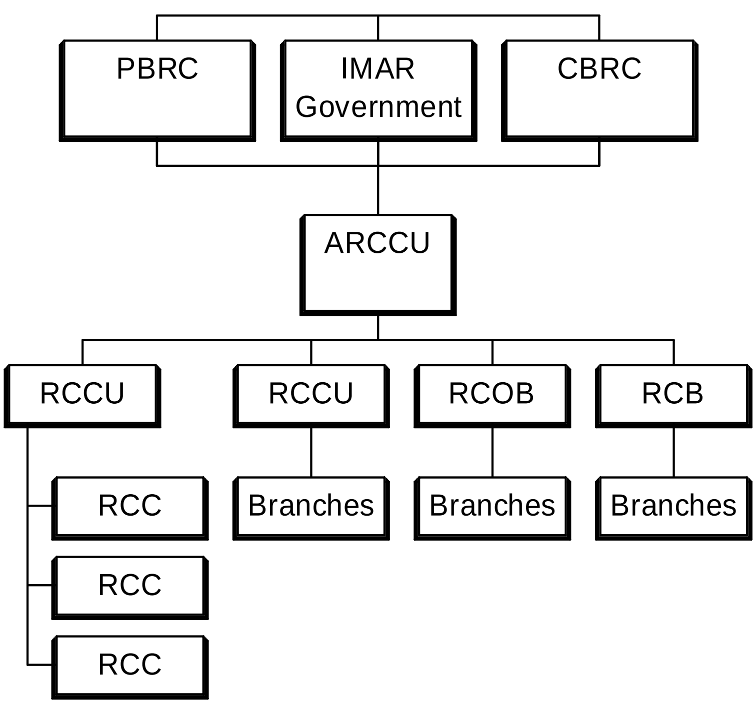
15. The current reform complicates the structure by introducing different legal formations at the primary level and adding a third and fourth tier, an autonomous region RCCU (ARRCCU),

which is expected to take on supervision and administration roles while not lessening the supervision and administrative roles of the CBRC and the PBOC, and involving the IMAR government. The ARRCCU may itself be subject to supervision by the CBRC and PBOC. In addition to creating a new ARRCCU, the IMAR government has been given direct responsibilities in the administration and supervision of the primary level. Risk has also been downloaded to the IMAR government, changing previously implied debt (deposit) liability from the central government to explicit debt (deposit) liability for the IMAR government.

16. Relationships between the various agencies and their roles are not clearly defined. Lack of role definition between the four 'supervisory' agencies has efficiency implications in terms of financial and human resource allocations. There may be competition between organizations to attract skilled staff, or organizations may not be able to effectively carry out their responsibilities due to lack of competent staff. The cost of supporting additional layers will impact negatively on the performance of the primary agencies, at least in the short term, when they are most vulnerable. There is a very high risk that liberal interpretation of guidelines will lead to over regulation and excessive interference in the operations of the RFIs that will greatly increase their administrative burden without positive effect on their operations. Overlap and competition between higher level agencies has been reported in the Jiangsu pilot causing confusion in the RFIs and allowing them to play one agency off against another.

17. It is important that inter agency relationships are clearly defined at the institutional level and not left open to interpretation by individual officers within the agencies. To institutionalize appropriate roles and functions it is recommended that the agencies develop Memorandums of Understanding to avoid duplication of resources and increase effectiveness of the individual agencies and subsequently the RFIs. Specialization by agencies should give rise to consideration of revenue sharing based on existing fees from the RFIs rather than levying new fees to support redundant structures.

System Structure After Reform



C. Supervisory and Regulatory Environment

18. The supervisory and regulatory environment for RFIs has become less clear with the latest reform initiative. Prior to this reform, RFIs were mainly under the supervision of the CBRC but were also supervised by the PBOC for specific purposes such as liquidity reserves and PBOC onlending. The current reform potentially subjects RFIs to four different authorities, the PBOC, the CBRC, the IMFO and the ARRCCU without delineating specific responsibilities for those agencies. Without clarification of roles, supervision will be weakened rather than strengthened; "when everyone is responsible, no one is responsible".

19. The law on Banking Regulation and Supervision places the responsibility and authority for supervision and regulation of the RCC system with the CBRC. The CBRC has established a Cooperative Finance Supervision Department (CFSD) that is responsible for the supervision of urban and rural credit cooperatives. The CFSD not only supervises and regulates RCCs it continues to implement some of the administrative functions from its predecessor, the PBOC, including approval of large value loans, selection of staff and establishing internal policies such as lending policies.

20. Loan approval authority compromises the integrity of the supervisory authority in a number of ways. First, with current round of reform, responsibility for loan losses has been shifted to provincial governments, but a national organization still has authority to make decisions that could increase risk to the provincial governments. Effective management requires authority to be balanced with responsibility; in this case the CBRC has authority without responsibility or risk. Secondly, if the CBRC authorizes loans through RCCs and those loans become non performing, the CBRC loses moral authority.

21. State Council Document 15, 2003 requires provincial governments and ARRCCUs to assume supervisory and regulatory responsibilities for RCCs and State Council Document 48, 2004 goes further to include RCBs and RCOBs within this framework. The provincial government and the ARRCCU are charged with the responsibilities for making regulations which could lead to contradictions with the CBRC. For example the ARRCCU is required to develop regulations with regard to staff employment however the CBRC currently takes a direct role in determining staff numbers and eligibility.

22. The supervisory role of the PBOC is primarily concerned with protecting its interest as far as the placement and encashment of redeemable bills is concerned. However, as the PBOC is also responsible for supervising clearance and interbank lending, it will remain involved in the activities of the RFIs and the new ARRCCU after the redeemable bills are no longer a factor.
The greatest confusion arises in the roles of the ARRCCU the IMFO and their relationship to each other and the CBRC and PBOC. The requirements of the ARRCCU and IMFO to formulate and implement regulations are vague and open to interpretation. It is unclear which organization would take precedence in situations where their responsibilities overlap.

23. In addition to supervisory roles the ARRCCU and IMFO are given administrative duties within the new RFIs. In some cases these administrative duties duplicate those currently undertaken by the CBRC such as the evaluation of senior managers and establishing internal policies. The matrix below indicate overlapping areas of responsibility and authority between the three agencies; CBRC, IMFO and ARRCCU. The PBOC is not included in the matrix as its role is fairly clearly defined.

24. For effective supervision and regulation the CBRC should discontinue any administrative role within the RFIs and focus strictly on supervision. Conversely the ARRCCU should not be involved in supervision and should focus on providing support services to RFIs.

Roles of CBRC, IMAR Government and ARRCCU defined by Doc. 48

CBRC	**Autonomous Regional Government as represented by the Financial Office**	**Autonomous Region RCCU**
The CBRC shall assume regulation and supervision of RCCs, whose responsibilities include:	The State Council requires that the administration of RCCs is the responsibility of the local government. Therefore the provincial government should be responsible for the administration and risk disposal of RCCs.	The provincial RCCU performs the function of administration to the RCCs. The provincial RCCU is mainly responsible for the guidance and supervision of the internal control and operational mechanism of the RCCs.
i) **Formulation of regulations** over RCCs in accordance with state laws and regulations;	i) Under the requirements of the State Council, the provincial government exercises administration, direction, coordination and services for RCCs through the provincial RCCU. It mainly makes the decision over policies of development and reform, and big issues such as the goals and plans of the RCCs, with respect to the local practicalities.	i) **Formulation of regulations** and supervision. The provincial RCCU is responsible for the formulation of the regulation rules in the following aspects: operation, auditing, staff employment, distribution system, and operational mechanisms. **It also takes the supervisory responsibility of the RCCs.**
	ii) The provincial government **supervises** the implementation of national financial laws, administrative regulations and financial polices of the RCCs, encourages RCCs to serve for the rural sectors (i.e. the rural economy, rural communities and farmers), (continued as item vii below)	
	iii) According to relevant laws and regulations, the provincial government helps the ARRCCU to formulate the regulations of self-managements of the local RCCs and **supervises** the implementation of the regulations.	
Comments: Overlap of supervisory responsibilities between 3 agencies weakens rather than strengthens supervision and is inefficient. "When everyone is responsible, no one is responsible". The ARRCCU will be involved in banking transactions if it acts as a clearer or funds manager for RCCUs and therefore should not be involved in supervision but should be subject to supervision. A more efficient division of responsibilities may be as follows; ARRCCU formulates **model policies** in accordance with CBRC regulations that are then **adapted to local circumstances by individual RFIs**, and subsequently **approved by the IM FO**, and **supervised by the CBRC**. A key component of supervision is to ensure that an institution follows its own policies and that is best done by an objective 3rd party.		

<table>
<tr><th>CBRC</th><th>Autonomous Regional Government as represented by the Financial Office</th><th>Autonomous Region RCCU</th></tr>
<tr><td>ii) authorize the establishment, change and suspension of (rural finance) institutions as well approve their business scope;</td><td>iv) The provincial government guides RCCs with restructuring and withdrawal from the market.</td><td>ii) The ARRCCU guides RCCs to set up sound corporate governance structures and internal control system, which will eventually lead to sound operational mechanisms in which decision-making, execution, and supervision are in a balance, with proper stimulation and incentive system.</td></tr>
<tr><td colspan="3">Comments: Roles are logical and complementary steps for creating new institutions or closing existing institutions</td></tr>
<tr><td>iii) conduct on-site examinations and off-site surveillance, collect statistical information and conduct risk evaluation, as well as investigate and penalize violation of laws and regulations;</td><td>v) The provincial government investigates over the various cases of RCCs with help from the ARRCCU and correspondent institutions. It decides punishments of principals of the ARRCCU, and supervises implementation of punishments of criminal activities exercised by the ARRCCU.</td><td></td></tr>
<tr><td colspan="3">Comments: The ARRCCU may act as a financial institution in some capacities, ie liquidity management and settlements, officials should be subject to the same penalties as other financial institution officials as prescribed by the CBRC. Provincial government may investigate irregularities but should be referred to CBRC for decision and punishment.</td></tr>
<tr><td>iv) conduct fit-and-proper test of senior managers;</td><td>vi) The senior managers of the ARRCCU are chosen through a series of procedures: they must be recommended by relevant departments, and their qualifications must be approved by the CBRC. The provincial government is responsible for administration and evaluation of senior managers of the ARRCCU.</td><td>iii) ARRCCU will supervise the election and appointment of RCC Senior Management and Directors.</td></tr>
<tr><td colspan="3">Comments: Fit and proper tests for senior managers should be conducted before officials are permitted to assume office, Any officers not meeting education or experience requirements should be given a limited time period in which to bring themselves up to standard.
Recommendation and supervision and election of senior management and directors removes the responsibility of shareholders to hold managers accountable and continues the top down culture which nullifies efforts and strengthening governance and clarifying ownership structures.</td></tr>
</table>

v) provide regulatory data and relevant information to provincial governments, provide early-warning on risky institutions and assist provincial governments in dealing with risks;	vii) provides information on local economic developments, guides RCCs to provide better financial services, and evaluates daily operations and management on a regular basis with help from other departments. (From original text of item ii above.)	iv) The ARRCCU provides business guidance and information exchanges. It offers timely information for capital demand, and encourages floatation of loans between RCCs.
Comments: Information exchange is important for RFIs to operate effectively in a changing market. Comparative performance data should also be provided to RFIs to encourage best practices. Data on early warnings and risk institutions needs to flow downward as well as upward and be shared between RFIs..		
CBRC	**Autonomous Regional Government as represented by the Financial Office**	**Autonomous Region RCCU**
vi) provide training to specialized managerial staff designated by provincial governments and		v) The ARRCCU is responsible to provide trainings and supervision for business operations, financial activities, staff employment and social securities issues. The ARCCU should provide more training for external shareholders, representatives of RCC members, members of the board of directors and management staff to enhance their ability in decision-making.
Comments: Training should cover all levels of staff, directors and RCC representatives. Training is an urgent need to improve operational efficiency and reduce risk. External shareholders should receive regular information updates but training is unnecessary.		
vii) evaluate performance of provincial governments in managing RCCs and report findings to the State Council.	viii) The provincial government helps RCCs with collection of loans and punishment of bad loans to make a stable rural financial market and a sound credit environment for the RCCs.	vi) The ARRCCU is responsible for the protection of the legal rights of RCCs.
Comments: Roles are appropriate. The ARRCCU may act as a representative not only to protect legal rights of RCCs but to strengthen their voice with government and industry. For example negotiating priority agreements with dragon head companies, attracting insurance companies etc.		
		vii) The ARRCCU is responsible to provide technical assistance for payments systems and settlements of local RCCs to improve their efficiency in transactions clearance and management. The ARRCCU also transacts funds transfers and settlements for RCCs.
	ix) When an RCC is closed, the provincial government is responsible for asset realization of the RCC and pays for lawful debt. If assets are insufficient in paying off debt, the provincial government will apply for a temporary loan from PBOC.	
Comments: It should be very clear to investors that their shares are not lawful debt and are not protected by the IMAR government.		

		Additional ARCCU responsibilities assigned by CBRC a) Supervise implementation of state economic policy initiatives through RCCs b) Establish regulations for codes of conduct and conflict of interest for employees c) Direct development of electronic networks d) Develop audit standards, appoint professional auditors and carry out regular audits of RCCs
Comments: ARRCCU should consider approving external audit firms for use by RCCUs, RCCs etc, rather than establishing in house audit services.		

25. The CBRC has issued three provisional regulations in respect of the rural finance reform program; Administration of Rural Cooperative Banks, Administration of Rural Commercial Banks, Administration of Provincial or Autonomous Regional or City Rural Cooperative Union as well as guidelines for unified RCCUs. The provisional regulations are based on the Law of the Peoples Republic of China on Commercial Banks or the Regulation Governing Capital Adequacy of Commercial Banks although there are some significant differences. The matrix below compares some fundamental structural issues.

Comparative Legal Frameworks of RFIs and Commercial Banks

	PRC Law on Commercial Banks 1995	**Provisional Regulation for RCB**	**Provisional Regulation for RCOB**	**Provisional Regulation for ARRCCU**	**Guidelines for Unified RCCUs**
Shareholding limits Qualification Shares	Not Applicable	Not applicable	Max shares per natural person 5% of shares Max shares per legal person 10%of shares but purchase > 5% require prior approval of CBRC Article 20	Only RCCUs, RCOBs, and RCCs may hold shares. Maximum shareholdings per unit 10% of shares Article 18	Maximum shares per natural or legal person is 5% of shares III.3.c
Shareholding Limits Investment shares	Purchase of >10% of shares by legal or natural person requires prior approval of CBRC Article 28	Maximum shares per natural person 5%of shares Maximum share per legal person 10% of shares Article 18	No Limit Article 20		Total investment and qualification shares limited to 5% of shares for both natural and legal persons. III.3.c

Minimum Shares	No minimum	No Minimum IMAR Gov requires 5,000 per natural person Article 18	Qualification shares 1,000 per natural person 10,000 per legal person Article 19	Minimum 1 share (100,000RMB) No RFI may invest more than 30% of own capital. Article 18	Recommend Qualification shares 1,000 per natural person 10,000 per legal person. May be adjusted for local conditions III.3.c
Registered Capital	Rural Commercial Cooperative Bank minimum registered capital 50 million RMB Article 13	Minimum registered capital 50 mill RMB Article 8	Minimum registered capital 20 mill RMB Article 9	No requirement	Minimum registered capital 10 mill RMB II.d
Capital Adequacy	8% Article 39	8% Article 8	4% Article 9	No requirement	2% Based on BASEL II.2
Dividend Restrictions	CBRC may restrict dividends if capital adequacy requirements are not met. Law in Banking Supervision and Regulation Arcticle 37				**Dividends must be paid before applying reserves to capital II.2**
Borrower Concentration	Max loan per borrower 10% of capital CBL Article 39.4[32]	Max loan per borrower 10% of capital CBL Article 39.4	Max loan per borrower 20% of capital Article 47.c	Not Applicable	Silent
Branching Requirements	No CAR Requirement	No CAR Requirement	No CAR Requirement	Not Applicable	Silent

26. In keeping with the desire to have broad based participation in the rural banks, maximum shareholdings per individual or legal person are somewhat more restrictive than for other commercial banks. The law on commercial banks does not prescribe minimum shares per shareholder and neither do the administrative guidelines for RCBs however the IMAR government has established minimum shares for natural persons at 5000 for RCBs. No minimum has been established for legal persons purchasing RCB shares.

27. The provisional rules for RCOBs provide liberal guidelines for borrower concentration in allowing one borrower to take up to 20% of capital. While this limit considers that RCOBs have a smaller capital requirement and therefore the absolute loan value is likely less than for RCBs, it is cause for concern on several fronts. From an international perspective the lesser CAR for RCOBs based on very liberal risk weighting standards is imprudent. The impact of the potential

[32] CBL Commercial Banking Law

loss of 20% of capital against an already weak capital base is a serious risk factor. Individual RCOBs should be encouraged to establish internal lending policies that are more conservative than the guidelines and set absolute value limits for individual borrowers regardless of the capital base. In addition to impeding risk management the 20% single borrower cap may limit funds circulation and restrict the organizations outreach.

28. No borrower concentration limits are included in the guidelines for unified RCCUs. It is recommended that borrower concentration limits be established and that they be in line with the requirements for commercial banks at 10%. While 10% is a liberal concentration limit the stricter loan loss reserve requirements for unified RCCUs somewhat mitigate the lower capital requirements.

29. Branching is allowed under the provisional guidelines for RFIs as well as the Law on Commercial banks. While the amount of operating funds that can be appropriated to establish a new branch is restricted to 60% of capital, there is no minimum CAR requirement for branching. Branching is a costly and often destabilizing undertaking. Branching should be restricted unless the RFI has met minimum CAR and has sufficient additional capital to absorb up to 3 years of operational losses. International experience is that new branches require 5 years on average to achieve profitability.

30. None of the provisional regulations nor the Law on Commercial banks has a compulsory dividend payment restriction in the event of inadequate CAR, although the Regulation Governing Capital Adequacy for Commercial Banks allows the CBRC to restrict dividend payments, if they feel it is necessary. The provisional guidelines for unified RCCUs goes further and states that dividends must be paid before earnings can be applied to capital.

31. This is a fundamental shortcoming in the legal environment. A strong capital base is essential for risk management, growth and profitability. Allowing, much less requiring, dividend payments when an institution does not have adequate capital further decapitalizes the institution, thereby reducing earnings capacity and contributing to a downward spiral. Further, a review of the 8 pilot regions[iv] indicates that the main objectives of shareholders are to access loans at preferential rates. In this case the shareholders can be in a situation of having non performing loans while still earning dividends on their investment while the IMAR government maintains the risk of institutional failure. This is a win/win for shareholders and a lose/lose for the IMAR government.

32. The legal environment should be strengthened to absolutely forbid dividend payments if the institution does not meet minimum CAR requirements or posts an operating loss.

D. Tax Policy

33. The reform program includes a three year income tax holiday for RCCUs covering the financial years from 2004 to 2006. Revenue tax was also reduced from 5% to 3% from January 1, 2004. The existence of a revenue tax, however; is problematic as it means that RFIs must pay taxes even when they have a net loss. Paying the revenue tax increases losses even further and pushes RFIs closer to bankruptcy.

34. This tax policy was perhaps not as onerous in the past when the RCCUs were effectively state institutions and the state government also bore all of the risk for the institutions. Under the current reform, a revenue tax discourages private investment in RFIs and increases risk for the IMAR government. Similar to the ability of investors to receive dividends while having non

performing loans, the state is provided with a revenue stream while at the same time its tax policy undermines the viability of the institution.

35. In the interest of mitigating risk and attracting private investment the IMAR government should lobby for tax reform in respect of RFIs. The policy of a gross revenue tax should be reconsidered as should the deductibility limits of loan loss reserves. The current tax policy does not encourage prudent management of financial institutions, which results at best in desultory performance of RFIs and at worst leads to bankruptcy. Both situations reduce tax revenue in the long term; bankrupt RFIs can not pay taxes, and RFIs that are unable to support economic development limit growth in the overall tax base.

E. Implications of Rural Finance Reform

1. Corporate Governance

a. Ownership Structure

36. Changing the legal structure of the RCCUs profoundly changes not only the ownership structure but also who the owners are and whom the new institutions serve. The effect of restructuring RCCUs either as banks or as unified legal persons is to make them even less like true cooperatives and reduce local input and the voice of small farmers in management of the organization. There is a very real danger that restructuring RCCUs will result in reduced access to services for remote and village households as resources are first allocated to those who have greater physical access, and therefore a louder voice, to the RFIs at county level.

37. Reduction of services to village remote households will be even more dramatic in the new rural banks and unified RCCUs as the current members are unable to meet the new investment requirement for qualification shares and the private and institutional investors who do purchase shares demand services, especially loans, in return for their investment. These new rural banks can easily meet their agriculture support requirement by giving loans to larger agriculture enterprises rather than small holding farmers. This is already the case in Dongsheng where 67% of its agricultural loans are to agriculture enterprises rather than agricultural households.

38. The minimum shareholdings for individuals in RCOBs is set at 1000 shares. Unified RCCUs may set share requirements in accordance with local conditions but the recommended amount is also 1000 shares. This requirement was set in accordance with the concern that having too many shareholders would result in control of the organization by staff members. However, staff control of an organization far outweighs their voting rights so the ability of the staff to own up to 25% of the shares will likely result in staff control of the organization in any case. Therefore setting a high share requirement does little to limit staff influence over the organization, as they represent a small minority of individuals who can actually afford to invest at the new levels. There is also evidence that staff are being coerced into buying shares which may promote zealousness in regard to controlling the RFI.

39. Setting a 1000 share minimum for membership in an RCOB effectively excludes the majority of the rural households who are now the main shareholders and primary customers of the RCCs and may ultimately lead to reduced services to farmers and micro entrepreneurs. The larger shareholders will seek return on investment in the form of dividends and loan access, both of which will put pressure on the institution to do fewer small loans in remote areas in an

effort to contain costs as well as having liquidity available to satisfy the borrowing requirements of the shareholders.

40. The current shareholders who are unable to meet the minimum share requirements will have their shares redeemed for cash. Not only does this affect the ability of rural household to influence the direction of their RFI, it greatly increases the need for RCCUs wanting to convert to RCOBs to raise new capital. Consideration should be given to 'grandfathering' existing shareholders. That is, existing shareholders are permitted to retain their shares and given a limited period of time, say 3 or 5 years, to bring their shareholdings to the minimum amount. In the meantime provisions can be made to have these minority shareholders represented through a delegate system that allows them to vote in blocs. Voting blocs can be established on the basis of villages or smaller units that represent at least 1000 shares.
Rules can be established to reduce the possibility of coercion of minority shareholders by limiting the number of votes a delegate can carry. There are many international precedents of delegate voting systems that ensure fair representation. The main reason for a delegate system to represent rural households is to ensure their concerns are heard at annual general meetings. While the provisional rules for RCOBs and RCBs require appointment of at least one independent director to represent small shareholders, this does not address the issue of current members who are disenfranchised due to economic discrimination. For unified RCCUs appointing an independent director is optional so current members of RCCs will be relegated to voiceless customers.

41. The RCOBs and unified RCCUs are hybrid organizations that attempt to blend the one member, one vote principle of cooperatives with the company norm of one share, one vote. Establishing different qualification share requirements for natural and legal persons that are voted on the basis of one member one vote and allowing additional voting rights based on investment shares, does this. RCCU officials indicate that potential investors are dissatisfied with the high investment requirements for legal persons in RCOBs and some legal person investors would like to vote on the basis of one share one vote. The required investment ratio of legal persons to natural persons is 10:1 for both qualification and investment shares. Given the differing economic capacity of individuals versus enterprises, the ratio is appropriate and somewhat mitigates enterprise control of the institutions.

42. There is no limit on investment shares investment shares in RCOBs. This is not an oversight, but is explicitly stated in Article 20 of the Provisional Guidelines. This interesting loophole theoretically permits a single large investor to buy the institution by investing a large amount in investment shares. It may be an attractive loophole for institutional investors looking to increase market penetration in IMARS rapidly industrializing cities.

b. Governance Structure

43. Strengthened governance is critical to improving the operations of RFIs to increase their financial capacity and ability to expand services to rural areas.

44. A fundamental variation between the stated desire to clarify ownership structure and strengthen corporate governance is the method of selecting directors. Under the guidelines for RFIs, the general assembly elects directors but does not select them; shareholders in effect ratify the selection of directors, made by the IMAR or local governments. This causes tensions in the accountability of directors who should be accountable to the shareholders of the financial institution; instead they are accountable to local officials who may be more concerned with achieving policy goals than financial sustainability.

45. Inclusion of bank staff on the Board of Directors and Supervisory Board also weakens corporate governance. Staff ownership of up to 25% of the RFIs shares and the ability to hold 33% of Board and Supervisory seats gives staff far greater control than those numbers suggest. Including staff on the Supervisory Board means they are supervising themselves and their superior officers, which influences objectivity and accountability and discourages transparency. As major shareholders it is appropriate that staff have Board representation but they should be prohibited from the Supervisory Board.

46. Under the new guidelines the Chairman of the Board and the Manager of the institution may not be the same person. This is a positive step. However the practice is that directors and especially the chairman are actively involved in the day to day operations of the institution. In order to achieve accountability there must be effective separation between governance and management with emphasis on professional skills for management staff and the freedom to take management decisions as required based on sound business imperatives.

APPENDIX 6: RISK MANAGEMENT STRATEGIES FOR IMAR RURAL FINANCE

1. Risk is a part of doing business. Financial institutions risks include governance, credit, liquidity and investments, asset/liability management, capital, new business decisions (such as branching) and internal controls. Risk management should be a cross cutting theme in all activities of any financial institution and must be built into the corporate culture. Underlying successful risk management is a commitment to transparency, accountability, awareness, and skills development. The following section addresses the most common risks experienced by RCCUs.

A. Governance Risk

2. Despite changes to ownership and governance requirements, RCCUs still express concern that they will be pressured by local authorities to engage in policy loans. This sort of interference in the operations in RCCUs is a major cause of the existing NPLs and there do not appear to be many deterrents to recurrence. The reform process is not changing the method of selecting directors, which is effectively appointments by local government officials which are then rubber stamped by the general assembly. In addition, several local governments are promising to subsidize dividends for the newly restructured RCCUs in order to attract investment. This sets the stage for further influence, as local governments will expect consideration for their investment.

3. Inclusion of bank staff on the Supervisory Board creates a governance risk. Including staff on the Supervisory Board means they are supervising themselves and their superior officers. This practice influences objectivity and accountability and discourages transparency. The provisional regulations and guidelines for the RFIs limit the number of staff on the Supervisory Board to no more than 30%, however there is no minimum requirement for staff participation. RFIs should set internal regulations to prohibit staff from serving on the Supervisory board and should include a requirement for some members of the supervisory board to have an financial, accounting or audit background.

B. Credit Risk

4. Risk recognition is the first stage of risk management. The high level of NPLs, coupled with low loan loss provisions, indicates that credit risk recognition is lacking. Perhaps more importantly there does not appear to be much sense of responsibility for risk management in credit practices of RFIs at present. Recognition of credit risk requires good credit analysis (which includes monitoring the economy and industry trends) and underwriting skills, monitoring and follow up. Aged listing of NPLs should be updated daily and the aging categories should be increased to provide better analysis of portfolio risk. As soon as a loan is more than 90 days in arrears it should be carefully assessed, interest accruals should cease and a realistic provision based on asset quality should be made.

5. The guidelines for unified RCCUs recommend loan loss reserves similar to international standards at 1% of performing loans, 20% for past due loans, 50% for idle loans and 100% for bad loans. All RFI's should work toward this level of provisions over 3 years.

6. Credit risk management also entails having and implementing sound policies to encourage portfolio diversification in terms of borrowers and projects supported as well as maintaining a good balance of repayment terms and loan maturities. Credit officers should receive upgrade training to improve their analysis and underwriting skills.

7. Loan repayments must be matched to cash flow rather than to arbitrary deadlines. The current practice is to mature all PBOC onlending at December 31 as that is when PBOC requires repayment. Agriculture loans should be maturing earlier as matched to crop cycles or should be given longer terms for asset acquistion. In the case of dairy cattle for example, the initial investment is too large for most households to repay within a year, on the other hand a dairy cow produces daily income and therefore longer term loans of 2 or 3 years with monthly repayment, (with holidays for dry seasons), rather than lump some payments at the end of term are more effective. Matching agriculture loan repayments to PBOC requirements also results in short term high liquidity that is difficult to invest productively and reduces profitability. More balanced payment cycles will reduce liquidity swings and improve profitability.

8. RCCUs write loans with maturities that they know will result in NPLs as the payment cycle doesn't match the cash flow cycle. While they are confident that they have little risk in these transactions, it muddies the NPL status and leads to a laissez faire approach to delinquency management. Given the rising levels of NPLs in many RCCUs it appears this confidence is misplaced and the misplaced confidence is hidden in ambiguous NPL portfolios.

C. Management

9. Management risk is the risk that officers and employees of the financial institution will not perform as expected or not have the necessary competencies for effective management. Demonstrable minimum education and experience requirements for new hires or promotions, clear job descriptions and effective performance standards and management systems are effective tools to ensure that officers and employees are competent and committed.
Management risk includes the risk of losing key employees without an appropriate succession plan in place. The best strategy to mitigate this risk is to cross train employees for various positions and to continually upgrade employee skills.

10. Conflict of interest is another serious management risk were officers and employees use their position within the institution in their own best interests rather than that of the institution. This risk is particularly high under the current structure where employees can own up to 25% of shares and hold 33% of the Board and Supervisory Committee seats.

11. Relatively high employee to operational cost ratios suggest that there is room for efficiency improvements. As RCCUs are restructured and consolidated, opportunities to improve human resource capacity and efficiency should be sought. An assessment of employee skills and aptitudes should be conducted. There will inevitably be redundant positions as a result of consolidations. The strongest incumbent for a given position should be retained and others should be assessed and redeployed in other areas. Retraining may be required and is a worthwhile investment.

D. Capital

12. A solid capital base is key to institutional sustainability. Capital is required to finance growth, ensure institutional flexibility, maintain profitability, attract investment and provide a cushion against external shocks. The first step in building and protecting the capital base of RFIs is to disallow the payment of dividends when the institution does not meet capital requirements or experiences an operating loss.

13. The second step in protecting the capital base is to ensure that adequate allowances are made for risks such as non performing loans and investments. The loan loss reserve limits imposed by the Ministry of Finance for tax purposes and the onerous requirements for writing off bad loans discourage adequate loan loss reserves and endanger institutional capital. The CAR

requirements established by the CBRC and the risk weighting methodology are very liberal and do not ensure adequate capital accumulation. Regulations for loan loss reserves must be strengthened and efforts should be made to reform tax policy to be more supportive of prudent RFI management.

E. Risk Fund

14. The IMAR government will establish a risk fund using tax revenue received from RFIs in excess of the threshold established by tax receipts to year end 2004. RCCs paid CNY58.5 million in taxes at year end 2004. Tax revenues collected in excess of CNY58.5 million for the next 10 years beginning at year end 2005 will be allocated to a risk fund. The IMAR government anticipates achieving a fund of CNY330 million by 2015. On a straight line basis, achieving a fund balance of CNY 330 million in 10 years requires additional tax revenues of CNY29 million per year at a yield of 2.25% per annum assuming that no demands are made against the fund.

15. The IMAR government is to be commended for establishing a risk fund and doing it in a painless fashion in the short term. However, the creation of a risk fund also gives rise to moral hazard. The seamless manner in which the fund is being created increases the hazard. Establishing a fund on excess tax revenue may be considered a passive risk management tool. It has the potential to build the fund fairly quickly without increasing the burden on struggling RCCUs. These are important considerations in the short term given the present vulnerability of RCCUs in IMAR. At the same time it is important that RFIs and RFI investors take responsibility for risk management so the fund should be built visibly with active involvement of the RFI.

16. To encourage responsible management from RFIs and responsible oversight from RFI investors, RFIs should be required to make direct contributions to the fund in the medium term. Fund contributions should be instituted through a risk based levy. RFIs that exceed prudential norms are less likely to cause a claim on the fund and therefore should be rewarded with a reduced levy. Institutions that do not meet prudential requirements are more likely to cause claims against the fund and should, accordingly face higher levies. Levies should be calculated on average assets to encourage responsible growth and reflect potential claim size. When RFIs begin to contribute the risk fund, the earnings of those funds contributed to RFIs should be reinvested in the fund and used to offset risk mitigation services such as audit and training. Earning from funds contributed by RFIs should not become part of the IMAR governments' general revenue.

17. High borrower to loan officer ratios coupled with high NPLs indicate that redirecting redundant employees toward loan management and collection should be a priority. All RCCUs have indicated that in general their staffs do not have the skills required to meet the needs of today's financial environment. The system must invest in training, but must also set performance standards to ensure that training is effective. Employees who do not demonstrate positive change in behaviour and performance after receiving training should be denied further training opportunities so that those resources can be directed toward more committed employees.

18. Training opportunities must be based on needs assessment with respect to both the institution and the employee. Position and seniority should be minor considerations when determining access to scarce intellectual capacity development resources.

APPENDIX 7: ACHIEVING INTERNATIONAL STANDARDS

The matrix below summarizes recommendations to assist the IMAR government to work within current constraints while moving toward international standards. The matrix presupposes that the IMAR government, ARRCCU and RFIs are serious about reforming RFIs to be stronger institutions with better capacity to provide financial services to rural households and thereby improve economic capacity. This requires that all parties take a long term view and set aside personal interests which are in fact better served by maintaining the status quo. Implementing these steps will raise questions and difficulties in the short term. For example, changing the classification of NPLs and making appropriate allowances will make the structural weaknesses very clear and that will make it difficult to attract investors in the short term. In the medium term however, with stronger balance sheets, RFIs will be able to attract more investors.

Transitional Steps to International Standards

	Current Situation	Comments	Transitional Steps	International Practices or Standards
Loan Portfolio Quality				
Loan Loss Reserve Requirement	1 -1.50% of assets Recommended guidelines are for	Does not consider actual portfolio risk or asset quality. Improper loan loss reserve may result in overpaying dividends and de-capitalization of the institution.	Set target for RCCUs to achieve LLR reserves according BIS Standard over 3 years. Year 1 achieve 25% of BIS Year 2 achieve 50% of BIS Year 3 achieve 100% of BIS	LLR based on recoverability of individual impaired loans or; BIS Past due Loans - 20% Reserve Idle Loans - 50% Reserve Bad loans – 100% Reserve
	Unified RCCUs to establish LLR in keeping with BASEL standards, plus a general reserve of 1%	Guidelines for Unified RCCUs close to international standards		
NPL Reduction Targets	NPLs to reduced to 50% of 2002 ratio	Setting target as a ratio rather than numerical target can increase portfolio risk by encouraging RCCs to reduce ratio through unsound loan growth.	Change target to reduce NPLs to by 50% of the actual NPL balance at YE2002 within 2 years. Realistically assess all non performing loans under the criteria for bad debts and write off uncollectible loans	WOCCU standard for NPLs in credit unions is <5%
	Maintain NPLs < 15%	15% ratio of NPLs is inefficient and puts considerable drag on earnings. Ratio may be acceptable for special loans such as micro finance loans to encourage outreach.	Reduce NPL target for all loans except micro loans to below 5%	International bank standards for NPLs is < 2%.

	Current Situation	Comments	Transitional Steps	International Practices or Standards
NPL Classification	Past due Loan – > 1< 90 days, principle and or interest arrears Idle Loan - > 90 days in principle only Bad Loans – six possible qualification criteria, no time period	Recovery of non performing loans become less likely over time. Tighter NPL classification accompanied by standard procedures for collection will greatly reduce NPLs and depositor risk	Increase Bad loan criteria to include loans > 1 year in arrears to trigger investigation and action based on current Bad Loan Criteria.	Five to Seven Categories of Loans in Arrears 1 -30 days 31 – 60 days 61- 90 days 91-180 days 180- 270 days 271 – 365 days > 365 days
Loan Policies	Loans decisions (except micro finance loans) are made primarily on the basis of collateral or personal relationships.	Most loans are effectively unsecured as there is extreme reluctance to act on collateral and limited market for collateral. Character assessment (personal relationships) are critical to any lending decision but must be supported by objective verification and analysis of the business case.	Improve loan policies to require cash flow analysis with minimum cash flow coverage requirement regardless of collateral values or personal relationships. Computerize loan analysis to allow for sensitivity analysis on business loans. Train at least one person in each RCCU or RCC to carry out cash flow and sensitivity analysis.	Policies tailored to local economic conditions and institutional capacity. First criteria for credit granting is repayment capacity not collateral. Lending authority of staff based on experience and sectoral expertise
Capacity of Credit Staff	Most RCCU and RCC staff have had very little formal training for loans analysis. Each credit officer is responsible for 300 – 500 files in more remote areas and 500-800 files per credit officer in more urban areas..	Financial markets and consumers of financial products are becoming increasingly more sophisticated but key RCCU staffs are not keeping up with new developments causing lost business opportunities and vulnerability to opportunists thereby increasing portfolio risk. High ratio of clients per credit officer leads to poor analysis, insufficient follow up on arrears and high levels of NPLs	At least one operational person in each RFI should receive intensive credit granting and monitoring training. RCCUs with two person structure should require member RCC's to submit loan applications over a specified threshold to the expert at RCCU level for review. Experts should be required to upgrade their training at least bi-annually.	Credit officers received upgrade training to improve skills and efficiency and to learn new methodologies. Average clients per credit officer for micro finance institutions is 160 -280

	Current Situation	Comments	Transitional Steps	International Practices or Standards
Deposit Portfolio				
Deposit Insurance	No specific deposit insurance program but insurance is implied through central government support of RCCUs. Some RCCs display a poster declaring that the central government will protect deposits. Responsibility to protect deposits downloaded to Provincial Government, will be required to take loans from PBOC to cover shortfalls if necessary.	Confidence in the government to protect deposits removes the need for members/shareholders to take an interest in the sound management of their institution and encourages poor business practices as the management of the RCCU is relieved of their primary responsibility to protect member deposits.	Risk fund is a proxy for deposit insurance, after 5 years require direct contributions from RFIs to the Risk Fund through the use of risk based fees	Deposit insurance schemes are varied but most included a limitation on the amount of deposits insured per individual deposit. Deposit schemes may be entirely industry funded or have government support with some level of industry funding. Deposit insurance does not insure member shares.
Unauthorized use or classification of member deposits	In the past members deposits have been used to purchase capital assets and recorded as paid in capital on the balance sheet. The member deposits are then 'repaid' by applying the depreciation to deposits. The practice of using member deposits for RCCU operations has been stopped however these deposits are still classified as "Paid in capital" on the balance sheet are permissible for calculating core capital.	Use of deposits for operations is considered fraud in most jurisdictions and person responsible for such actions would be removed from their positions as well as face financial and legal penalties.	The portion of paid in capital created through improper use of deposits that is not replaced by full depreciation of the accompanying asset should be removed from the capital account. All RCC staff should be made aware of their responsibility to protect member deposits and sanctions should be swiftly applied against any individuals abusing that responsibility.	Acquisition of capital assets that cannot be funded through retained earnings are funded through loans and are clearly identified as such on the balance sheet. Loans funded by shareholders are recorded under equity as shareholders loans not paid in capital.
Capital Structure				
Dividends for RCB's and RCOBs	Local governments are promising to pay dividends on investments whether or not RCB, RCOB is profitable.	There is concern that no one will invest in new banks if no dividend is received until institutions are profitable.	Government subsidized dividends should not be fully paid in cash. Majority of dividends paid as additional shares (recommend 80%) until bank achieves profitability.	Dividends may not be paid unless financial institution is profitable and minimum capital requirements are met.
Dividends in RCCUs and RCCs that will not be converted	Most RCCs and RCCUs are unable to pay dividends.		Dividends should not be paid as shares until RCCU achieves minimum CAR and covers old losses.	Dividends may not be paid unless financial institution is profitable and minimum capital requirements are met.

	Current Situation	Comments	Transitional Steps	International Practices or Standards
Minimum Share Requirements for RCOB and RCBs	Minimum natural person share requirement in RCB is CNY 5000 Minimum natural person share requirement for RCOB is CNY1000 Recommended minimum shares for natural persons in unified RCCUs is CNY1000.	RCCUs planning to convert to RCBs or RCOBs are paying out shares to existing members who are unable to meet the new minimum share requirements, resulting in decapitalization of the institution. Current members lose any say in their RFI.	Create a 3rd class of non voting shares to grandfather existing shareholders, allowing them to maintain their shareholdings but without individual voting rights. Set up delegate voting system for 3rd class of shares	Varying classes of shares have varying voting rights. Delegate voting systems are used to address special circumstances
Policy Environment Administration Fees	CBRC is discussing whether to levy a fee on RCCUs based on .002% of asset or .08% of equity.	An asset based fee structure has limited inherent risk management properties. An equity based fee structure discourages capital accumulation and increases risk.	Choose a fee based on average assets.	Most international regulatory and support organizations levy fees based on average assets.
	CBRC currently levying fee of 2% of revenue, IMAR government discussing addition fee of 2.5% of revenue to support ARRCCU	Total fees to RFIs 4.5% of revenues. This has significant operational impact on RFIs.	Agencies should strive to reduce administration costs by avoiding duplication of services and seeking ways to share revenues. Consider risk based fees levies to encourage prudent management and reduce supervisory requirement.	
Tax policy	Taxes based on revenues and income	Revenue taxes must be paid even when RFIs is unprofitable, decreasing viability of RFIs	Lobby for removal of revenue taxes	Taxes based on income only with limitations on deductable expenses.
	Allowable loan loss reserves is flat rate	Discourages realistic loan loss reserves, decreases viability of RFIs	Lobby for change to deductability of LLRs. Encourage LLR based on actual risk rather than tax policy.	Tax policy encourages prudent provisioning for NPLS. LLRs based on risk not tax policy. Corporate financial statements and tax filings are different.

	Current Situation	Comments	Transitional Steps	International Practices or Standards
Minimum Share Requirements for RCOB and RCBs	**Minimum natural person share requirement in RCB is CNY 5000** Minimum natural person share requirement for RCOB is CNY1000 Recommended minimum shares for natural persons in unified RCCUs is CNY1000.	Minimum share requirements for new institutions are too high for most farmers. While the law allows RCBs and RCOBs to lend to non members the current practice is to lend only to members. Therefore the increased share requirement decreases credit access for the same population these institutions were created to serve.	Create a 3rd class of non voting shares to grandfather existing shareholders, allowing them to maintain their shareholdings but without voting rights. Establish representative voting system for Class 3 shareholders	Delegate systems used to represent accommodate special circumstances.
Governance				
Ownership Structure of RCBs & RCOBs	Personnel (Staff and Directors) are permitted to hold up to 25% of shares	The influence of personnel is disproportionate to there shareholdings especially when they are effectively appointed by government.	RCBs & RCOBs should establish internal policies with a clear strategy to reduce personnel proportion of shareholders over time.	Not usually an issue due to broad based share holdings of commercial banks. XAC Bank, Mongolia limits employee shareholding to 15%.
Supervisory Committees	Staff may hold up to 33% of seats on Supervisory Committee	Conflict of interest, staff are supervising themselves and superior officers	Establish internal bylaws prohibiting staff from Supervisory Committees	Staff are not members of Supervisory Committees
Selection of Directors & Senior Management	Directors and Senior Management are selected by government authorities and ratified by members	Removes shareholders responsibility to make Directors and Managers accountable for performance. Continues top down structure and increases interference from local authorities	Allow shareholders to nominate and elect Directors and Senior Management. Government authorities veto unqualified directors after nomination.	Selection of Directors and Management done by shareholders. Interested parties such as government or large investors may reserve the right to occupy a minority of board seats.

APPENDIX 8: ROLE OF AUTONOMOUS REGION RCCU

1. State council documents envision wide ranging roles for the ARRCCU, roles that overlap with those of the CBRC, IMFO, PBOC and the RFIs themselves. While there is value in having a central organization to promote and assist RFIs at the autonomous region level care needs to be taken that the organization does not overwhelm its members. It is common for federations to try to be all things to all members and as a result become cumbersome, unwieldy, ineffective and very expensive. The cost of adding another layer to the RFI network needs to be carefully considered in light of cost and benefits.

2. ARRCCU is contemplating financing its operations with a levy of up to 2.5% of operational revenue on member RFIs. In addition the CBRC is discussing whether it will change its levy to a fee of .2% on assets or .8% on equity (levies against equity should be avoided as they discourage capital accumulation and as a result have a multiple risk factor). CBRC currently levies a fee of 2% on revenue. An additional fee of 2.5%, to support the ARRCCU, on operational income applied to the consolidated results of the 9 RCCUs selected for conversion in 2003 would have resulted in a reduction of net profitability of 179% and a consolidated net loss. Applying a 2.5% fee against 2004 consolidated net income would have resulted in a reduction of 46% on already marginal net profitability.

3. Cost containment must be a primary concern of the ARRCCU. Every effort must be made ensure that the operations of the ARRCCU are as efficient as possible. Only services that add value to the RFIs should be undertaken and those services should be contracted where possible instead of developing a large infrastructure. The ARRCCU should also develop in a phased fashion, prioritizing needs and developing capacity in those areas before adding other layers. Setting up duplicative structures at league, prefecture, county or banner level should be avoided.

4. One of the purposes of the ARRCCU is to help reduce the risk to the IMAR government this. This can be accomplished through a funding strategy that encourages RFIs to operate prudently by providing financial incentives such as a risk based fees levy.
Interviews with RCCU officials indicate that the two most urgent needs are training and financial services such as liquidity management, inter institution clearings and sourcing capital. RCCUs also expressed an interest in representation, for example having the ARRCCU negotiate on their behalf with milk processing companies.

A. Training

5. Training is a key need to sustain development of the RFI movement. The World Bank identifies new management as a critical success factor of restructured financial institutions. The reason for this is that organizational culture usually needs to be changed to achieve sustainable results. In the absence of changing management personnel, upgraded skills, methodologies and technology are essential. Organizational culture can rarely be changed through training, but skills and methodologies can.

6. The financial sector and the needs of customers are changing rapidly but there has been little or no investment in training RFI staff to keep up with the changing environment. Based on interviews with RCCUs and reviewing their financial statements, it is clear that there is urgent

need for improved accounting skills, underwriting practices, delinquency management, risk management, asset/ liability management as well as marketing and product development and human resource management.

7. The RCC system in IMAR has more than 18,500 employees. The financial and time cost of retraining such a workforce is enormous. Targeting at least 5 people in each RFI to receive training in the first year in key areas is a manageable goal. Each RCCU should have at least one accounting expert, 1 commercial lending and 1 micro lending expert, a marketing expert and a human resource expert. RCCUs that remain under the two person structure should have experts on staff to act as a resource person for member RCCs.

8. In most cases it is not effective for an organization like an ARRCCU to develop in house trainers as their skills quickly become outdated if they are not active in the industry. Instead the ARRCCU should contract specialists from professional organizations to deliver training as required, such as accounting and banking institutes or firms.

9. The most immediate training needs are for accounting and underwriting skills. Accurate, timely and meaningful financial records are essential management and marketing tools. To attract and retain investors, RFIs must produce financial statements that are transparent, understandable and present a fair picture of the institutions financial condition. Management similarly requires detailed and truthful financial information to effectively manage their institutions.

10. Improved underwriting at primary level is the most effective risk management tool available to the IMAR government. Financial resources invested in training credit officers today will be returned in multiples over the long term in the form of reduced NPLs, better outreach and improved profitability. Credit management skills should emphasize cash flow lending as opposed to collateral lending. Cash flow lending is important not only for commercial lending but to enable the RFIs to reach out to poorer households and youth who are asset poor.

B. Strategy and Policy Development

11. Part and parcel of training is good internal policies to guide the operations of the institution. IMAR is a large and diverse area; policies that are effective in industrialized areas are not effective in remote, sparsely populated areas. Larger institutions require different policies than smaller ones. The ARRCCU should develop model policies that are then customized by each RFI based on the institutions capacity and environment.

12. The most critical policy in any financial institution is its Investment and Lending Policy. Model Investment and Lending policies should address all aspects of lending from loan purposes, sizes, terms, to credit analysis including cash flow analysis, to collateral evaluation, to character assessment to credit follow up including periodic site visits, and phased collection activities. The Investment and Lending policy also needs to address loan concentrations or investment concentrations in particular industries or institutions to ensure portfolio diversification and reduce risk. Environmental considerations are also a factor as supporting activities that increase environmental degradation can be self destructive or impact negatively on other borrowers, for example increasing livestock concentrations in a marginal grazing area.
Customized Investment and Lending Policies should be reviewed for prudence and filed with the IMFO. The CBRC should then conduct its examinations in light of the RFIs internal policies as well as CBRC regulations and relevant laws.

13. Standardized policy frameworks simplify examinations and make it easier to carry out benchmarking and peer analysis. Other areas where RCCUs require policy assistance are standardized accounting policies, human resource and performance management policies including standardized job descriptions with minimum qualifications, terms of reference for Supervisory Committees, and risk management procedures.

C. Central Financial Facility

14. Accessing outside liquidity, move liquidity around the RFI network in IMAR and maximizing return on temporary liquidity are all roles that the ARRCCU can play. The ARRCCU can maximize return on temporary liquidity by pooling funds and negotiating large deposits. The ARRCCU can also intermediate with other financial institutions and investors, including international investors to obtain better credit conditions.

15. Technology is an important part of managing and effective payments system. Representing the entire RFI network, the ARRCCU is in a better position to facilitate acceptance of compatible electronic transaction systems for processing payments and improving inter-institution and interbranch transactions. Technology prices can be reduced by negotiating on the basis of volume discounts.

16. Financial intermediation on behalf of a disparate member network with limited liquidity is rarely a profitable enterprise. The ARRCCU must have appropriate financial resources and competencies to undertake financial and technological intermediation.

D. Representation

17. RCCU officials expressed a need for a regional level institution to represent them on a national level and with large private sector or para-statal organizations. RCCU officials do not feel that they have sufficient status to effectively influence organizations such as the large milk processors. It would be of benefit to RFIs and to rural households for the ARRCCU to lobby on their behalf for such things as direct payments or assignment of proceeds to support loans, for example.

18. Another example of where the ARRCCU would be more effective than individual RFIs is to lobby for changes to the tax policy or interest rate liberalization for micro finance programs. The ARRCCU can also negotiate on behalf of the system with suppliers of such things as technology, stationery, audit services etc. In this respect the ARRCCU would truly be acting as a member driven organization rather than a government organization.

E. Staffing requirements

19. Staff and travel are the main costs associated with establishing an ARRCCU. To avoid increasing the cost burden on RFIs staffing at the ARRCCU should be kept at a minimum. The most effective way of doing this is to contract services when ever possible. Contracting services has benefits beyond mere cost savings.

20. One of the responsibilities assigned to the ARRCCU is audit. This can be achieved more effectively through hiring professional audit firms than through setting up league, county or banner level offices with audit staff as has been done in all of the pilot regions. The advantages of hiring professional audit staff are many. Firstly skills of professional auditors tend to be higher

and are upgraded on a continuous basis. Audits are performed quickly as a private firm is naturally incented to be efficient. When the auditors are based in the same locality as the client they become ‘part of the family’ and there is a tendency to develop empathy which often leads to less critical audit practices. Professional auditors are exposed to practices in many different settings and can as a result share best practices and introduce new ideas to clients during the course of the audit.

21. RFIs may be held directly responsible for costs of employing professional auditors and that tends to promote improved practices as RFIs quickly find they can reduce costs by maintaining better records and practices. ARRCCU may subsidize audit costs for smaller RFIs if necessary but this is still more cost effective than maintaining an inhouse audit structure.

22. The ARRCCU should develop a roster of authorized audit firms which the RFIs can engage and require professional independent audits instead of setting up internal structures to perform this function. If there are not enough audit firms in IMAR to meet the need, the ARRCCU can encourage firms to expand their practices into IMAR knowing they have customer base. To encourage efficiency and cost effectiveness, the Supervisory Committees of the RFIs should tender audit work to 2 o 3 suppliers and audit firms should be changed periodically.
Most training services should be similarly contracted from professional institutions such as the CBRC, accounting institutions, management institutions and banking training centres. The ARRCCU then needs to employ only 1 or 2 people to coordinate training activities, engage trainers and maintain records.

23. The most urgent staffing requirements of the ARRCCU are training coordinators who can assess training needs, source appropriate external resources to deliver required training and organize critical training programs. The ARRCCU also requires a treasury and payments systems expert to facilitate liquidity management, payment and settlement systems and contract additional resources for RFIs.

APPENDIX 9: REVIEW OF EIGHT PILOT REGIONS

1. Following the issuance of the "Experimental Scheme for RCC Reform in June 2003, the program was piloted in 8 regions; Zhejiang, Shandong, Jiangxi, Guizhou, Jilin, Shaanxi and Jiangsu provinces and Chongqing city. None of the pilot regions were willing to provide information to the TAR on developments within their regions so the following discussion is based on information that is publicly available and unofficial discussions with interested parties.

2. Wu Xialoing, Vice President, PBOC reviewed the progress of RCC reform at a symposium on February 27, 2005. Madame Wu indicated that reform in the 8 pilot regions is a good beginning and there were significant achievements:

(i) Capital adequacy increased rapidly, achieving a ratio of 8.7% in the 8 pilot regions;
(ii) NPLs have been reduced by 13.3% as compared to 2002 *(when redeemable bills are removed from the equation, NPLs were only reduced by 2.82%)*;
(iii) All RCCs in the 8 pilot regions made profits in 2004 and their profits amounted to 66.9% of profits earned by all RCCs nationally;
(iv) There has been a significant increase in loans and deposits in RCCs in the 8 regions and loans to the rural sector have increased significantly as well. *(The choice of words suggests that the increase in loans to rural areas was not in line with the increase of loans to urban areas.)*

3. Madam Wu also noted that in general neither the RCCs in the 8 pilot regions, nor the 21 follow up provinces made any real progress in improving management structures, transformation of operational mechanisms or strengthening internal controls. Further, realizing the targets prescribed in State Council Document No. 15 which requires that RCCs should have a clear ownership structure, sound regulation systems, and better financial service will require significant improvement in systems, mechanisms and management. Major problems still facing RCC reform are:

(i) Some provinces are too concerned with setting up institutions and getting government monetary support rather than with improving ownership structures, improving operational mechanisms, strengthening internal controls, decreasing operational costs and resolving NPLs;
(ii) RCCUs are basing their capital and membership drives on improper, occasionally unethical means such as, promising dividends, treating shares as deposits, disposing of unqualified assets illegally, falsely reporting increased capital amounts, false advertising and forcing people to invest in RCCs,
(iii) Rapid loan growth, which in the short term appears to reduce NPLs but increases risk in the long term.

4. Other sources indicate that the CNY6.9 billion reported profits for 2004 represent an increase of CNY0.1billion over 2002. Increased profitability is attributed to 3 main factors;

(i) Increased loan portfolio;
(ii) Reduced tax burden (1.69 billion less operating tax and 1.63 billion less income tax); and,
(iii) Replacement of deposit interest losses caused by inflation proof policy, of CNY0.89 billion.

5. When the reduced tax burden and interest loss replacement are taken into consideration RFIs in the 8 pilot regions actually earned CNY3.1 billion less profits than in 2002. Given the increase in assets over the year and the increased margin on loans since 2002 this indicates severely deteriorating operational performance and return on assets.

6. Deteriorating performance may be partly due to increased costs of actively pursuing NPL repayment and the costs of conversion, but it certainly supports Wu's assertion that operating costs are not being controlled. There is also anecdotal evidence that in some cases NPLs have been replaced with non earning fixed assets.

7. In Jiangsu, the provincial RCCU has established a business unit, Nanchung RCC, to engage in regular RCC business with a view to producing revenue to support the provincial RCCU. This model should not be copied as it diverts the attention of the provincial RCCU from its main task and causes it to be in competition with its own members.

8. Results from pilot provinces support the concern that without genuine efforts to resolve NPLs and improve operational efficiency, RFI reforms, including replacement of old debt, will not significantly improve RFI performance.

APPENDIX 10: MICRO FINANCE SERVICES IN IMAR

A. Micro Finance Services Provided by RCCs

1. Since the beginning of the new century, micro-loans have become an important financial instrument for RCCs in IMAR to support farm production and to reach out to individual farmers and herders. With the ever growing savings deposits and agricultural on lending support from the PBOC, RCCs in IMAR have greatly increased their loan portfolios to the rural household sector and achieved a high credit outreach.

2. Basic statistics of sampled RCCs in IMAR are presented in Table A.1. Information was gathered through interviews and surveys from Tuzuo Banner, Wuchuan and Togtoh counties in Hohhot; Hailer district in Hulun Buir; Yuanbaoshan District, Ningcheng County and Bairin Right Banner in Chifeng, Wushen Banner in Erdos and Tuquan in Hinggan League. The microfinance specialist visited RCCUs, RCCs and households in Tuzuo, Wuchuan, Hailer, Yuanbaoshan, Bairin Right Banner. Hailer and Yuanbaoshan are urban-based RCCUs and the rest are rural-based RCCUs.

Table A.1. Basic Statistics of Micro-loans in Selected Counties
(Million CNY Year end 2004)

County RCCU	Members[1]	% HH[2]	Total Assets	Shares[3]	Total Loans	Loan/ deposit %[4]
Hailer					454.9	68.6
Yuanbaoshan			704.45	31.45	393.4	78.3
Tuzuo					269.1	72.9
Wuchuan					204.8	68.6
Ningcheng					704.2	79.2
Right Banner	31,111	93.5	263.41	17.26	158.7	86.1
Wushen	15,370	66.6	374.19	12.79	140.2	67.3
Togtoh	36,634	92.6	580.92	21.16	201.3	66.2
Tuquan	50,207	86.2	357.98	15.09	124.7	70.4

Note: 1. Total number of RCC members in a county. 2. RCC members as a percentage of total number of rural households in a county; 3. The share capital from RCC members; 4. The ratio of loans to deposits at year end; Note that the ratio will be higher in the middle of a year.

3. Table A.1 indicates that a high proportion of rural households are RCC members with share capital in their RCCs. The ratio of loans to deposit varies across RCCUs, from 66 per cent in Togtoh to as high as 86 per cent in Right Banner. In general the loan deposit ratios of RCCUs are higher during the busy agricultural seasons from May to September/October.

Table A.2. Composition of RCC Loans to Rural Households in Selected Counties
(Million CNY, Year End 2004)

	HH loan Portfolio [1]	% Total [2]	Outreach [3] %	Loan types as percentage of loan portfolio			Loan Types as Percentage of Number of Loans		
				MLC % [4]	Group Loan %	Other %	MLC % [4]	Group Loan %	Other %
Hailer	72.75	16.0	61.2	4.0	0.03	95.97	22.0	1.07	76.9
Yuanbaoshan	142.81	36.3	40.1	10.4	65.00	24.60	70.4	12.2	17.4
Tuzuo	177.03	66.0	77.0	7.0	2.00	91.00	72.0	6.0	22.0
Wuchuan	122.32	59.7	48.2	23.0	33.00	44.00	49.0	26.0	25.0
Ningcheng	441.19	62.7	41.0	28.2	49.80	22.00	36.2	18.8	45.0
Right Banner	102.51	65.0	76.0	18.8	41.30	39.90	41.5	47.0	11.5
Wushen	99.63	71.0	47.0	11.6	11.80	76.60	19.2	24.7	56.1
Togtoh	125.69	62.4	67.0	38.0	16.00	46.00	47.4	6.9	45.7
Tuquan	101.20	81.1	59.0	36.3	33.50	30.20	75.8	24.7	-0.5
Average	153.90	57.8	57.4	19.7	28.00	52.30	48.2	18.6	33.2

Note: 1. Total portfolio to rural households; 2. Percentage of rural household loans to total loan portfolio of the RCCU; 3. Outreach is defined as the ratio of the number of rural households that have RCC loans to total number of rural households in a county; 4. MLC – micro-loans on credit to the households; 5. Of the number of rural households that have RCC loans.

4. Following implementation of the micro-loan program, RCCs in IMAR have increased their loans to the household sector. As shown in Table A.2, except for urban-based Hailer and Yuanbaoshan, the ratio of RCC household loans exceeded 50 per cent, with over 80 per cent for Togtoh.It is generally acknowledged that compared with loans to enterprises and government institutions, household loans have a better loan quality.

B. Loan Expansion Over Time

5. RCCs not only reached out to a large number of rural households in IMAR, they also expanded their loan portfolios quickly (Table B.1). In the two years from 2002 to 2004, both RCC deposits and loans increased, on average, by over 50 per cent. In Togtoh and Ningcheng, the overall loan portfolio increased by 109 per cent and 81 per cent respectively. Loans to the household sector, as well as unsecured micro-loans and group loans expanded more rapidly than the overall loan portfolio. From 2003 to 2004, on average, micro-loans on credit for the 10 RCCUs nearly doubled, and three RCCUs more than doubled their unsecured micro-loans .

6. A number of factors are responsible for the introduction and rapid expansion of RCC micro-loans. Firstly a political decision to support agriculture in the context of 'the three representatives theory' advocated by the former Party's Secretary General Jiang Zemin, in response to low agricultural prices and incomes and a lack of formal credit supply in rural China resulted in increased loan support to the sector. This is partly the reason why many RCCs regard micro loans as policy loans. Secondly the agricultural support on-lending (ASOL) from PBOC facilitates the micro-loan programs of RCCs; particularly those in the areas where RCCs have a high proportion of non-performing loans. Many RCCs which have a high proportion of non-performing loans or have a small deposit base, would have no funds for lending if the ASOL is suspended by the PBOC. Last but not least, the introduction of the credit rating system and automatic loan access to individual households is a RCC response to the policy of expanding

small size of loans to the rural household sector. The credit rating system partially overcomes operational constraints faced by RCCs such as the low staff to borrower ratio, control on certain expenses, such as travel and subsidies for loan officials going to villages which make it difficult for RCCs to assess and monitor individual loans.

Table B.1 Increases in RCC Deposits and Loans Since 2002 (%)

	Total Deposit		Total Loan Portfolio		Household Loans		Unsecured Micro Loans		Group Loans	
	03-04	02-04	03-04	02-04	03-04	02-04	03-04	02-04	03-04	02-04
Hailer	53.6	21.2	44.0	19.5	26.2	16.1	145.0	56.4		0.0
Yuanbaoshan	25.4	40.9	46.3	42.7	151.9	165.1	135.0	114.3	71.4	71.4
Tuzuo	25.9		35.7		52.9		-19.0		-43.3	
Wuchuan	33.6		26.9		25.6		71.3		11.0	
Ningcheng	27.5	67.0	35.3	81.4	110.6	189.3	451.0	261.6	7.4	35.4
Right Banner	15.6	29.0	5.1	11.5	1.5	1.1	-13.1	-27.7	8.4	56.9
Wushen	38.6	85.4	25.6	47.4	46.2	101.5	30.2	24.7	529.9	11680.0
Togtoh	26.0	63.9	8.7	109.9	11.4	-74.1	17.0	259.0	118.2	103.6
Tuquan	22.3	52.0	47.1	63.4	40.2	58.9	22.7	89.2	254.1	152.6
Average	29.8	51.3	30.5	53.7	51.8	65.4	93.3	111.1	119.6	1728.6

C. RCC Micro-loan Mechanisms

7. As discussed above, RCC micro-loans can be divided into unsecured micro-loans and group loans. A household credit rating system is used to determine eligibility for unsecured micro loans. RCCs rate individual households and offer them a credit card (with a credit limit) according to their income and assets (including number of animals owned) and past loan repayment records. Rating is carried out by a credit rating working group, consisting of RCC loan officials (including RCC directors), village officials and village representatives.[33] An individual household is then supposed to have automatic access to RCC loans up to the credit limit specified on the card, providing that previous loans have been repaid. The credit rating is re-assessed by RCCs every one or two years.[34]

[33] In some cases, the township government officials are also involved in the process. The decisions are usually made by RCC directors or loan officials.

[34] RCC credit rating and borrowing cards are similar to the credit cards issued by commercial banks in terms of loan access. However, a borrowing card holder can only borrow from the RCC that issued the card.

Table C.1. Unsecured Micro-loans by Sample RCCUs
(CNY, Year End 2004)

	Tuzuo	Wuchuan	Hailer	YBS[1]	Ningcheng	Right Banner	Wushen	Togtoh	Tuquan
Total Rural HHs[2]	74,000	31,635	3,516	34,341	141,000	33,277	23,087	39,546	58,232
Total Rated HHs[3]	42,369	22,145	1,380	14,201	91,847	26,455	6,878	20,230	26,015
% Total HHs Rated	57.3	70.0	39.2	41.4	65.1	79.5	29.8	51.2	44.7
Grade 1[4]									
Loan Ceiling ¥	5,000	10,000	20,000	3,000		5,000	10,000	10,000	
No. Households	21,184	5,536	1,110	4,567		7,640	813	2,231	8,778
% Rated HHs	50.0	25.0	80.4	32.2		28.9	11.8	11.0	33.7
Grade 2[4]									
Loan Ceiling ¥	3,000	5,000	5,000	2,000		3,000	6,000	5,000	
No. Household	12,711	9,965	170	5,020		11,600	1,647	10,762	9,957
% Rated HHs	30.0	45.0	12.3	35.3		43.8	23.9	53.2	38.3
Grade 3[4]									
Loan Ceiling ¥	1,000	3,000	3,000	1,000		1,000	3,000	3,000	
No. Households	8,474	6,644	100	4,614		7,215	4,418	5,144	7,280
% Rated HHs	20.0	30.0	7.2	32.5		27.3	64.2	25.4	28.0
Grade 4[4]									
Loan Ceiling ¥								2,000	
No. Households								2,093	
% Rated HHs								10.3	
Group Loans									
Loan Ceiling ¥			20,000	30,000	30,000	30,000			
Grade 1 HHs ¥						30,000			
Grade 2 HHs ¥						20,000			
Grade 3 HHs ¥						5,000			

Note: 1. Yuanbaoshan; 2. Total number of rural households in the county (banner); 3. Household with a borrowing card allows them access to RCC micro-loans. 4. With the credit rating, individual households are rated into 3 grades, and in the case of Togtoh, into 4 grades.

8. Tables C.1 and C.2 indicate that RCCs have achieved large outreach with borrowing card services but there is a lack of basic principles and standards behind the household credit rating conducted by RCCs. As shown in Table C.1, except urban-based RCCUs of Hailer, Yuanbaoshan and Wushen, the RCCUs in the sample have provided over half of rural households in their counties with a borrowing card. The loan limit for the same grade of households varies considerably. For example, credit limits for Grade 1 households vary from CNY 3,000 in Yuanbaoshan to CNY 20,000 in Hailer. There is little correlation between loan limits and levels of household incomes across counties.[35] Moreover, the proportion of households in each grade to rated households also varies from one county to another. Finally, credit limits for the group loans (RCC group loans are provided to individual household with group guarantee) are much higher than limits for unsecured micro-loans. Variations in credit limits could have been caused by liquidity, the type of production in a county (whether it is a farming or a herding area), and the extent of local government intervention on RCC lending. In general, credit limits for herding areas are larger than those for major cropping areas, and

[35] As shown in TableA 2.1, Wuchuan and Hailer have a higher credit ceiling for each grade of households but neither county have better loan quality, nor have they higher per capita incomes in rural households. Apparently, across counties credit rating has not been linked to incomes and repayment capacity of loan applicants or the risks of loans.

counties with more local government intervention in loan decisions tend to have a high loan limit.

Table C.2. Criteria for Credit Rating by Sample RCCUs in IMAR

Item		Hailer	Bairin Right Banner	Wushen	Togtoh	Tuquan
Grade I	Income ¥			¥ 50,000	¥ 2,000	¥ 20,000
	Asset 1	30 cattle	Current assets> ¥ 8,000	¥ 80,000		¥ 50,000
	Asset 2			200 Animals		50 Sheep
	Other		No defaults			
			RCC Shares > 500			
Grade II	Income			¥ 30,000	¥ 2,000	¥ 10,000
	Asset	20 cattle	Current assets > ¥6,000	¥ 50,000		¥ 30,000
				100 animals		30 sheep
	Other		No defaults			
			RCC Share>¥300			
Grade III	Income			¥10,000	¥1,000	¥8,000
	Asset	10 cattle	Liquid assets > ¥4,000	¥30,000		¥20,000
				80 Animals		10 sheep
	Other		No defaults			
			RCC Shares > ¥100			
Grade IV	Income				¥500	
	Asset					
	Other					
Group Loans						
	Income			¥50,000		¥5,000
	Asset 1			¥80,000		¥15,000
	Asset 2			Animal 150		
	Group Loans					
	Grade 1		Current assets> ¥40,000			Yes
	Grade 2		Current assets> ¥30,000			Yes
	Grade 3		Current assets> ¥20,000			Yes

9. Criteria for credit rating also differ from one county to another (Table A.2.2). The income threshold for Grade I household vary from CNY 2,000 in Togtoh to CNY 50,000 in Wushen; for assets. Differing rating units used ranges from total household assets, measured in CNY to the number of large animals, cattle and sheep. Table C.2 also indicates that holding of RCC shares is one criterion for RCCU in Bairin Right Banner. It was noted in the field investigation that in general membership with RCC shares and no loans past due are two necessary conditions for rural households to borrow from RCCs. This policy should be examined in light of the movement to redeem shares of households that are unable to meet the new qualification share requirements of restructured RCCUs.

1. RCC Group Loans

10. In principle, group loans, loans provided to a group of borrowers with group guarantee, are a powerful tool for the lenders. Micro finance institutions (MFIs), often use group lending methodology to reach out to the poor in the remote areas for which the MFI does not have sufficient information, and loan monitoring is very costly.[36] Nevertheless, a group guarantee does (should) not replace credit screening of loan applicants and monitoring by lenders. As

[36] When MFIs face problems of adverse selection and moral hazard, group guarantee is a good mechanism for credit screening and peer monitoring. Group loans also have a number of shortcomings.

group loans usually target micro-entrepreneurs and small farmers, group loans are usually small in size and progressive.[37]

11. RCC group loans are different from group loans practices of NGO MFIs in China and in other parts of the world. The limit for a group loan to each household is much larger than unsecured micro-loans. As shown in Table C.2., loan ceilings for group loans in the sample counties are from CNY 20,000 to CNY 30,000, compared with that for micro-loans on credit of CNY 1,000 to CNY 10,000 for Grade I-III rated households. Hailer, an urban-based RCCU, is the exception. The group size of 3-10 households in a group is also larger than a normal group of five. According to RCCs interviewed, the larger loan size is mainly because of the group guarantee. Finally, in most cases, group loans are provided to rated households only, particularly Grade I households, which simply increases loan limits to the rated and top rated households. This indicates that group loans are being used to increase credit to better off households as opposed to being used as an instrument to reach poorer households who lack collateral and capacity as is the usual target of group loans.

2. Outreach and Sustainability of RCC Micro-finance

12. Two common criteria for measuring the performance of MFIs: outreach and financial sustainability, can be applied to analyse the micro-loan programs of RCCs.
Outreach for MFIs shall include the following six aspects:[38]

(i) Whether clients have benefited, rather than simply been indebted, by micro-loans
(ii) The real costs of the micro-loans to clients

Depth of Outreach: a) Loan size is a depth indicator, in general, the smaller the size, the better is the outreach; b) The depth of poverty, women, ethnicity, level of education, housing, etc, average land owned and land quality

Width of Outreach: the number and proportion of households reached and whether loans have revolved through the community, or stayed with the same groups of households

Length: the length of time of services or the duration of the MF program

Scope: the varieties of the products provided.

13. Except for width of outreach, there is insufficient evidence that RCCs have achieved or are going to achieve other aspects of outreach. Clearly, RCC micro-loans, including unsecured micro-loans and group loans, have reached a great number and a high proportion of rural households in IMAR (Table C.1). In terms of width of outreach, it is however unclear whether RCC loans have revolved within the same groups of households or revolved throughout the community. Field investigations indicate that in some counties RCCs have refinanced loans, this would indicate greater revolution within the same households rather than the community. The credit rating and borrowing card system also suggests that the micro-loans on credit and group loans tend to stay with the same groups of households. Further investigation and household surveys are required to clarify the real extent of outreach.

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[37] Progressive here means the loan size grows over time, with the successful repayment of previous loans.
[38] Outreach used here includes certain elements of impact. Impact studies can be separated from outreach.

14. Depth of outreach by RCCs is doubtful, as the loan size of RCC micro-loans is not small, compared with NGO MFIs in China and RCC micro-loans target household heads (usually men), rather than women. Field investigations suggest that RCCs have targeted the clients with relatively high levels of incomes and assets. The credit rating criteria in Table C.2 clearly discriminate against the poorer households and poorer communities. The impact on clients, as to whether clients have benefited from RCC loans and the real costs to the clients is also unclear, as a very small number of rural households and RCCs were investigated. The length of services provision will be discussed in the sustainability section.

15. RCC micro-loans have been exposed to high credit risks. First and foremost, micro-loans for agricultural support are often regarded as policy loans. RCCs and loan officials are do not feel responsible for overdue loans. For some RCCs, loan officials do not think they have to collect loans, as rated households are supposed to repay their loans automatically for future loan access. Generally, credit rating and limits offered to individual households are based more on stated credit need and the policy of supporting agriculture and farmers and credit fund constraints, than on the effective demand from households for RCC loans backed by loan repayment capacity. It is not unusual for a RCC to decide on the number of borrowing cards to be issued and credit limit for each rated grade in the township by calculating the total credit funds available to the RCC. That is, savings deposits plus PBOC agricultural on-lending minus requirements for PBOC reserves and liquidity reserves.

16. Risks for RCC micro-loans increase significantly when RCCs stack unsecured micro-loan and group loans to the same household. Several households in a pool grouping loan funds, for use by one or two households in the group, increases risk. This is normal practice by rural households in China. It is important to realize that a group guaranteed loan is also a loan without any physical collateral. There is no legal guarantee if a household or a group of households decide not to repay. The incentive to default, or not to repay but refinance repeatedly, is high when a household has a large debt from pooling an unsecured micro-loan with a group loan of his own plus loans borrowed by other households, when there is no physical collateral and it is known that the RCC has limited liquidity to ensure future access. Finally, RCC micro-loans, which could be regarded as a product of the central government intervention, also subject to intervention on lending decisions from local governments, mainly the county and township governments. The policy nature of the loans and unclear responsibility for loan repayment are major risk areas needing urgent attention.

17. Unsecured micro loans, with a credit rating system as a product have not yet been independently evaluated. Standard procedures for measuring operational costs, risks, and repayment performance of unsecured micro loans have not been developed. RCC credit rating is similar to credit scoring. However, with credit scoring, the MFIs use the historical information to assess the risks of different groups of borrowers and then use these results to assess loan applications for different groups of borrowers. Historical trends help loan officials to determine the amount of loans that could be granted, time, and effort spent on assessment of loans and rates of interest. Credit scoring does not replace the process of loan application and assessment but provides a guide for decisions. In comparison, micro-loans of RCCs have granted automatic credit access to rated households, with little further assessment and approval. Moreover, RCC credit rating does little to assess the risks for loan repayment for different groups of loan applicants.

18. Credit scoring is only one mechanism used by MFIs and Micro Finance Programs (MFPs). There are many other mechanisms, which may applicable to different conditions, and

some mechanisms can be applied together. Other means include small and progressive loans, loans to groups instead of group guaranteed loans for individuals, installment loans, targeting women, mandatory savings or self insurance pools, and interest rebates to encourage repayment. RCCs have employed few other means than household credit rating.[39] Credit rating should not replace loan monitoring and enforcement, which are very important for the on time repayment. Thus the RCC credit rating system, while having some characteristics of credit scoring, is incomplete in that it does not employ the risk management components of credit scoring.

19. In addition to the large size, RCC group loans differ from the group guarantee practised by NGO MFIs in China and MFIs in other parts of the world in a number of important ways. First of all, the size of a group is usually 5 to 7, whereas the group size for RCC group loans could be as large as 10 households. When the group gets bigger, there is less incentive for credit screening, peer monitoring becomes less effective, and groups will become more a means for loan access than a credit guarantee. Second, there is no group risk fund with RCC group loans, if the group fails to repay. Finally, there is no 2-2-1, or 2-1-2 order of loan disbursement for RCCs. A 2-2-1 or 2-1-2 system is a loan disbursement methodology that increases peer pressure for repayment. Under a 2-2-1 system only 2 persons of a 5 person group receive a loan, once they have repaid the second 2 persons receive a loan and the remaining person waits until the second group have successfully repaid their loan. International experience indicates that some of these mechanisms are important for repayment of loans with group guarantee.

20. Micro-loans of RCCs are not financially viable at current rates of interest and loan quality. The donor-funded micro finance pilots in China indicate that a well functioning MFI in China needs to charge a lending rate of 14-16 per cent to survive: 3-4 per cent for fund costs, 7-8 per cent for operational expenses and 2-3 per cent for loan losses. In general, RCC loan quality, including the quality of their micro-loans, is not as good as that of well functioning NGO MFIs in China. In addition, RCCs have to pay sales taxes and the fees to the CBRC, both levied on RCC revenues, so their costs could be higher than MFPs and their revenue opportunity is lower. RCCs charge a lending rate of 7-10 per cent per annum for their micro-loans, which can hardly cover the costs, let alone to produce profit for growth.

21. There have however been some positive developments with RCC unsecured micro-loans in IMAR. For example, the RCCU in Tuzuo Banner introduced a responsibility system for loan officials for the collection of micro-loans. The responsibility system means individual loan officials will be partly responsible for micro-loan defaults, if the loan collection ratio below 80 per cent (a very lax criteria, but better than nothing), the loan officer faces financial penalties. With the responsibility system in place, there would be more effort from loan officials to collect accurate information about rural households, proper rating and loan monitoring, and enforcement in loan repayment.

22. It is however important to note that the problems with micro-loans discussed above does not necessarily mean that the loan quality and outreach of micro-loans is worse than other RCC loans. For many RCCs, their quality of micro-loans appears to be better than other loans, partly because of the poor loan quality of other loans and partly because of rapid growth in the

[39] Group guarantee does not apply to unsecured micro-loans.

portfolio.[40] It is therefore important to improve the design and quality of micro-loans and to develop loan products that better meet household demand for loans.

D. Micro finance Pilots by Non Financial Institutions in IMAR

1. An Analysis of the Demand for Micro-Credit in IMAR

23. Demand for credit from rural households is closely related to their type of production, income generation and consumption patterns. IMAR is an autonomous region with different patterns of farm production, from herding, to mixed animal and cropping production, to complete cropping. Mixed cropping and animal production, and fodder production following grassland degradation and drastic measures taken by government for grassland protection are becoming dominant in IMAR. Changing farming patterns affect household credit demand.

24. Due to time constraints this analysis is based on mission visits to a small number of households in Wushen Banner of Erdos and Right Banner of Chifeng. A questionnaire survey was conducted for households in Wushen. The households surveyed are not representative of households in IMAR, as the sample selected is too small, and both the areas and households selected are biased. For example, in Wushen, we interviewed more Mongolian women, as we participated in a large group meeting for a SPPA project that targets Mongolian women. Nevertheless, the results of the survey could reveal some aspects of the household use of credit and their demand for credit in IMAR.

25. In Wushen, the mission interviewed 4 households in Red Flag Village of Huang-tao-le-gai Xuang and 10 households from Bayingele Village of Wulantaolegai Township. The latter village is a UNICEF SPPA project village and has 36 project members in a large group. The households in Wushen are mainly engaged in the mixed cropping and animal production, and producing maize as animal feed. Many households need to buy grain for home consumption and animal feed. Basics conditions of households interviewed are shown in Table D.1.

Table D.1. Basic Conditions of Households Visited in Wuhai

Code[1]	Sex	Age	Ethnicity	Education[2]	Population	Labourers	MW[3]
1	M	43	Han	7	6	6	4
2	M	42	Han	9	4	3	1
3	M	57	Han	6	3	2	0
4	M	33	Han	9	3	2	0
5	F	47	Mongol	9	4	2	0
6	F	26	Mongol	12	2	0	0
7	F	49	Mongol	6	5	4	0
8	F	29	Mongol	12	5	4	2
9	F	67	Mongol	6	7	5	1
10	F	50	Mongol	6	4	3	0
11	F	60	Mongol	6	8	5	0
12	F	49	Mongol	9	4	2	0
13	F	42	Mongol	8	4	2	0
14	M	56	Mongol	6	5	4	1
Means		46.4		7.9	4.6	3.1	0.6

[40] The ratio of non-performing loans as reported by RCCs is not a complete picture of loan quality for RCCs, as part of the performing loan portfolio loans refinanced and rescheduled loans. The mission does not know the exact extent of refinancing and rescheduling as this data is not segregated by the RCCs.

Notes: 1. Code – The code for households visited. 1-4 are households from Red Flag Village of Huang-tao-le-gai Xuang and 5-14 are households from Bayingele Village of Wulantaolegai Township. Code 5-13 are UNICEF SPPA project members and Code 14 is a non project member. 2. Education: the years of formal education received; 3. Migrant workers employed outside the township.

Table D.2. Major Family Assets

Code (1)	Grass-land	Arable Land	Total Assets	The Value of Animal Stocks (CNY 000's)							Farm Equip.	Family House
	(Mu)	(Mu)	(CNY)	Pigs	Cow	Cattle	Other [2]	Sheep	Goat	Total	(CNY)	(CNY)
1	440	25	124,500	35.0	0	8.0	0	10.0	1.5	54.5	50,000	20,000
2	500	27	110,000	50.0	0	14.0	0	10.0	0	50.0	6,000	30,000
3	30	15	37,500	20.0	0	0	1.5	6.0	0	20.0		10,000
4	200	28	115,000	40.0	0	0	0	7.0	16.0	40.0	17,000	35,000
5	900	20	63,500	4.0	0	10.5	0	27.0	0	4.0	12,000	10,000
6	150	8	55,000	20.0	0	6.0	0	9.0	0	20.0		20,000
7	800	63	71,900	46.9	0	9.0	0	24.9	0	13.0	7,000	18,000
8	800	23	70,500	30.5	0	4.5	0	15.0	0	11.0	10,000	30,000
9	1,400	20	63,500	52.0	0	4.0	0	30.0	0	18.0	6,500	5,000
10	800	20	126,400	110.0	0	4.0	0	14.0	0	92.0	6,400	10,000
11	1,200	13	76,500	69.9	14.0	13.5	40.0	2.4	0	0	1,600	5,000
12	700	15	54,400	39.0	0	20.0	0	15.0	0	4.0	400	15,000
13	500	23	45,800	25.0	0	4.0	1.5	10.0	0	10.0	300	20,000
14	500	5	12,800	10.0	0	0	0	10.0	0	0	800	2,000
Means	637	22	73,379	48.5	1.0	6.7	3,.1	13.6	1.3	22.6	9,833	16,429

Notes: 1. Code – The code for households visited. 1-4 are households from Red Flag Village of Huang-tao-le-gai Xuang and 5-14 are households from Bayingele Village of Wulantaolegai Township. 2. Donkeys and mules.

26. As shown in Table D.1, the level of education for households is not low for women and men in their 40s, with an average of around 8 years formal education. Most labourers stay on the farm, with 0.6 migrant workers from each household on average.[41] In the field survey, we also noted that educational levels of some Mongolian women interviewed is higher than their husbands.

27. Major family assets for sample households consist of contracted land areas (collective land, household use rights for 30-50 years), animals, farm machines and farmhouses (Table D.2). Without taking contracted land into account, the value of animals made up over half of the household physical assets (about 66 per cent). Arable land is used mainly for crop production. Red flag village is a village specializing in pig production, and the other village specialises more in sheep and cattle production.

[41] Migrant workers here are defined as workers work away from the banner for more than 6 months.

Table D.3. Family Income and Expense
CNY 000

Code [1]	Total Family Assets	Total Income [2]	Income % Asset	Income from Animal	%	Major Expenses (CNY) Crop	Animal Feed	Educ	Medical Exp	Wedding	Net HH Inc.
1	124.5	101.4	81.4	81.0	80	2.5	31.5		1.0	40.0	26.4
2	110.0	70.0	63.6	70.0	100	6.0	11.0	20.0			33.0
3	37.5	50.0	133.3	40.0	80	2.9	6.0		.2		41.0
4	115.0	110.0	95.7	85.0	77	5.0	51.0	2.0	1.3		50.7
5	63.5	24.0	37.8	18.0	75	1.6	7.5	8.0	.5		6.4
6	55.0	18.5	33.6	12.0	65	.9	10.5		1.0		6.2
7	71.9	20.0	27.8	12.0	60	25.6	5.5		3.0		(14.1)
8	70.5	10.0	14.2	4.0	40	1.4	.5	20.0	.2		(12.0)
9	63.5	20.0	31.5	6.0	30	2.4	6.5		15.0		(3.9)
10	126.4	17.0	13.4	10.0	59	2.4	6.5		2.0		6.1
11	76.5	16.0	20.9	15.0	94	1.7	1.5	15.0	1.0		(3.2)
12	54.4	20.0	36.8	20.0	100	2.5	2.0	30.0			(14.5)
13	45.8	18.0	39.3	18.0	100	2.7	3.2	23.0			(10.9)
14	12.8	10.0	78.1	3.0	30	.7	.7				8.6
Mean	73.4	36.1	50.5	28.1	71	4.2	10.3	14,8	2.5	40.0	8.6

Notes: 1. Code – The code for households visited. 1-4 are households from Red Flag Village of Huang-tao-le-gai Xuang and 5-14 are households from Bayingele Village of Wulantaolegai Township. 2. Total Household cash incomes.

28. A basic family income and expense balance sheet is shown in Table D.3. The major incomes are from the sales of animal production (71 per cent on average). There is generally no cash income from grain because grain (predominantly maize) is mainly for feeding household animals. The ratio of family incomes to assets is about one half, but varies widely. Cash incomes from animal production account for about 70 per cent of family cash incomes. The major family expenses are farm inputs, education, and medical expenses.

29. Negative income is closely related to education expenses for children (HHs 8, 11, 12 and 13) and medical expenses (HHs 7 and 9). For those households that have educational expenses, the average expense is more than CNY14,000, about the same amount as farm inputs. Four of the seven households with educational expenses have a negative income balance. Of the four, educational expenses are higher than cash incomes for three households, and one is about the same as cash incomes. It was found in field investigations that the annual family expense for a student at an university and a higher education institute is around CNY15,000; CNY8,000 for high schools (year 10-12) when boarding, and CNY3,000-5,000 for middle schools (year 7-9). A family will be in debt for a number of years when it has one or two children at the schools and universities. A household can be quickly thrown into debt with an increase in educational expenses. High education and medical expenses forced many households to increase the number of animals, which requires increased cultivated land areas for feed.

30. Sample households borrowed from all available sources, including RCCs, UNICEF/SPPA, and informal sources (moneylenders, relatives and friends). The ratio of loans to annual household incomes is high and the highest reached 222.5 per cent of annual income (HH 12), followed by HH 8 household (194 per cent), then HH 7 and 11. There is a possibility

that some households may have over borrowed, especially those with higher educational expenses. Apparently, large amount of borrowing in relation to family income is caused primarily by high family expenses in education and health and facilitated by borrowing from more than one source. In the non-UNICEF project area, loans are predominantly from RCCs and informal sources. Average household borrowings less where UNICEF loans are unavailable due to lack of access or higher loan rates charged by informal lenders.

Table D.4. Loans Composition of Selected Households in Wushen Banner
April 2005 (CNY)

Code [1]	Total Income	Total Loans [2]	Loan as % of annual Income	RCC Loans	%	SPPA loans	%	Informal Loans	%
1	101,350	20,000	19.7	0	0	0	0	20,000	100
2	70,000	22,000	31.4	22,000	100	0	0	0	n/a
3	50,000	7,000	14.0	7,000	100	0	0	0	n/a
4	110,000	3,000	2.7	3,000	100	0	0	0	n/a
5	24,000	9,400	39.2	7,000	74	2,400	26	0	n/a
6	18,500	16,000	86.5	5,000	31	1,000	6	10,000	63
7	20,000	28,400	142.0	12,000	42	1,400	5	15,000	53
8	10,000	19,400	194.0	8,000	41	1,400	7	10,000	52
9	20,000	20,900	104.5	6,000	29	2,400	11	12,500	60
10	17,000	14,000	82.4	9,000	64	2,400	17	2,600	19
11	16,000	22,000	137.5	4,000	18	2,400	11	15,600	71
12	20,000	44,500	222.5	22,000	49	14,500	33	8,000	18
13	18,000	17,000	94.4	10,000	59	7,000	41	0	n/a
14	10,000	3,400	34.0	1,400	41	0		2,000	59
Means	36,061	17,643	86.0	8,314	54	2,493	11	9,570	35

Notes: 1. Code – The code for households visited. 1-4 are households from Red Flag Village of Huang-tao-le-gai Xuang and 5-14 are households from Bayingele Village of Wulantaolegai Township. 2. Loans outstanding at the time of field investigation, 26 May 2005.

31. The UNICEF SPPA has a savings program. When a member joins the program, she is required to save CNY100 to access the project loan, and then each month she needs to deposit CNY10 with the project as group funds. According to the Project Director, different from other UNICEF SPPA in China, the large groups have been allowed to use the group fund for lending. (Large groups consist of 5-6 lending groups.) Group members manage loans from the group fund. Other SPPA programs have simply put the savings in a bank or in RCCs. The Banner PMO regulates firstly that the maximum rate of interest for the group fund is 24 per cent per annum and the maximum term is 6 months.[42] Next, that the funds shall be lent only to group members, and that it shall be interest free if the loans are used for children's education and for paying medical bills. With insufficient demand from group members, the group can lend to households in the same village. Finally, lending authority is with the large group. In addition, a loan application will be rejected if three or more members of the six small group leaders disapprove the loan application. Within the broad regulations above, group members themselves determine loan size, repayment methods, and rates of interest. Interest incomes are pooled back into the group, owned by group members.

32. As of April 2005, SPPA in Wushen has accumulated about CNY400,000 in group funds, which has generated an interest income of CNY120,000 so far. Ninety per cent of the group fund has been lent out for interest bearing loans. In many large groups, members set the

[42] The purpose of setting the 6 months limit is to reduce the risks of borrowers moving out of the area before loans are repaid.

lending rate at 24 per cent per annum. According to the SPPA county director, since 1998, there is not a single case of default for loans from group funds.

33. At the time of the mission visit, large groups in villages we visited had accumulated CNY40,170 of savings, of which, CNY840 is savings and CNY580 is interest earned by each member. Savings by group members themselves exceed loan funds from the UNICEF project. Interest incomes so far have been pooled back into the fund for loans. Group members in this village have decided on the following loan conditions for their own savings funds (other village groups use different loan conditions):

(i) <u>Borrowers</u>: strictly limited to the group members.
(ii) <u>Loan size</u>: min ¥1,000 and maximum ¥ 3,000.
(iii) <u>Lending Rate of interest</u>: 12 per cent per annum
(iv) <u>Loan terms</u>: 6 months
(v) <u>Interest payment frequency</u>: every three months.
(vi) <u>Lending authority and approval</u>: by group discussion

34. Interest incomes are pooled back into the fund for lending, and will be returned to the saver when she quits the program. However, since 1998, no women have quit the program. At the time of the survey, all the funds are lent out to 29 group members with the following distribution:

(i) ¥ 1,000 Loans to 15 households
(ii) ¥1,000-2,000: 6 households
(iii) ¥2,000-3,000: 4 households
(iv) ¥ 3,000 (+) to 4 households

Table D.5. Savings, Loan Amounts and Rates of Interest For Selected SPPA Households in Wushen

Code [1]	Savings	Total Loans Outstanding	Project Loans [2]	Interest Rate % [3]	Loans from Savings Pool [4]	Current Interest Rate %	Interest Elasticity [5]		Rate
							15%	18%	20%
5	1,420	2,400	1,000	9.6	1,400	12	1	1	1
6	180	1,000	1,000	9.6	0	12	1	1	1
7	1,300	1,400	1,400	9.6	0	12	1	1	1
8	1,200	1,400	1,400	9.6	0	12	1	1	1
9	1,420	2,400	1,000	9.6	1,400	12	1	1	1
10	1,420	2,400	1,000	9.6	1,400	12			
11	1,420	2,400	1,000	9.6	1,400	12	1	1	1
12	1,420	14,500	10,000	9.6	4,500	12	1	1	1
13	1,420	7,000	5,000	9.6	2,000	12	1	2	2

Notes: 1. Code – The code for households visited. 5-13 are households from Bayingele Village of Wulantaolegai Township. 2. The loans provided by UNICEF SPPA. 3. Annual rate of interest; 4. Loans drawn from the savings of group members. 5. Whether a household will borrow if the rate of interest for the project is raised to 15%, 18% and 20%, 1 represents yes, and 2 represents no.

35. The higher lending rates the women are willing to accept are related to the higher rates of interest on the informal markets (Table D.6). It is also understandable that many large groups set their rate at 24 per cent per annum in keeping with maximum rates of the informal market.

36. Households 12 and 13 have larger loans because Household 12 is the chair and Household 13 is the secretary of the large group. According to the county director, a CNY10,000

loan for household 12 was approved specially by the county PMO. Apparently, larger loan size is used by the project as an incentive for the large group chair and other officials of the large group.

37. There are considerable regional differences in terms of incomes and farmers' demand for credit in IMAR. Compared with Wushen, households in Right Banner of Chiefeng have less grassland area (10-20 mu) and 10-30 mu of cultivated land area. Many households do not have grassland so become mainly involved in animal fattening. The maximum amount of loan from the UNDP project is CNY3,000. Their loan to income ratio is much lower than those in Wushen, however specific data is unavailable.

Table D.6. Rates of Interest from Informal Sources

Code	Lender	Loans (CNY)	Terms	Interest Rate %
1	Relative	20,000	Not set	0
2				
3				
4				
5				
6	Relative	10,000	12 months	21.6
7	Relative	15,000	12 months	18
8	Relative	10,000	36 months	Same as RCC
9	Moneylender	12,500	12 months	24
10	Moneylender	2,600	12 months	24
11	Moneylender	15,600	12 months	24
12	Relative	8,000	Not set	18
13				
14	Relative	2,000	Not set	21

Notes: 1. Code – The code for households visited. 1-4 are households from Red Flag Village of Huang-tao-le-gai Xuang and 5-14 are households from Bayingele Village of Wulantaolegai Township.

E. Lessons from Micro finance Pilots by Non Financial Institutions

1. Micro finance Program in Chifeng City of Inner Mongolia

38. The Chifeng Project is an UNDP project managed by China International Centre for Economic and Technical Exchange (CICETE).[43] Chifeng City is the name of the administrative division, to date the program has only targeted rural women but is considering urban women as a future market. Under Phase I of the UNDP Chifeng Human Development Project, the first group of micro-loans was disbursed in 1999 and the overall project completed in December 2000. Phase II, Sustainable Micro Finance to Assist the Poor (SMAP) providing further technical assistance to four best UNDP micro finance programs in China. Chifeng was selected by UNDP/CICETE as one of 3 SMAP projects. When the transfer from Phase I to Phase II occurred at the end of December 2000, the project had a loan portfolio of CNY1,372,722 and its bank deposits reached CNY2,081,556. Project progress up to the end of 2003 is presented in Table E.1. Since the transfer of the project from Phase I to Phase II, as shown in Table E.1, the overall loan portfolio of the program has increased steadily from CNY1.37 to over CNY3.4 million, and the number of centres, groups, and active borrowers increased accordingly.
The Prefecture Women's Federation of Chifeng implements the micro finance program as it targets women. The loan products of the program are shown in figure E1.1 below.

[43] The MFP has a small grant from Japanese Government and Grameen Trust, the main fund and technical support are from UNDP/CICETE.

Table E.1.1 Project Progress Reports in Chifeng

Item	2000	2001	2002	2003
Number of Centres	130	161	144	188
Number of Groups	531	623	653	700
Active Borrowers	2,575	3,108	3,268	,517
Female Clients	2,575	3,108	3,268	3,517
Total Disbursement ¥	2,750,700	4,772,300	6,106,000	7,710,800
No. Loans Disbursed	2,619	3,868	4,659	5,680
Total Loans repaid ¥				
Loan Portfolio ¥	1,372,722	1,920,630	2,949,580	3,448,280

Figure E .1 Loan Products of Chifeng UNDP MFP

<u>1. Regular Loans (80 per cent of the Loan Portfolio)</u>

Target Market Female farmers in the project area

Loan Conditions	No collateral and guarantee required except for group guarantee; no specific requirement for borrower investment
Loan Size	Loan ceiling is CNY3,000, the ceiling for the initial loan is CNY1,500, loan size increases with successful loan repayment in CNY500 increments;
Loan use	Income generation activities, both capital investment and working capital.
Loan Term	1 Year
Group Guarantee	Yes
Group Fund	5 per cent of the loan principal;
2-2-1 Loan disbursement	Abolished
Loan Repayment	For regular loan: bi-weekly repayment.
Grace Period	Two weeks after loan disbursement.
Centre Meetings	Bi-weekly centre meetings, last for about one hour,
Compulsory Savings	Yes, CNY2 for loans <=CNY1000, CNY4 for loans of CNY1000-2000, And CNY6 for loans of CNY2000-3000
Interest Rate	Nominal lending rate is 8%. The effective rate is around 16 per cent per annum.

<u>2. Seasonal Loans (started in early 2001)</u>

Eligibility:	Have a regular loan and with good loan repayment record.
Loan Duration:	140 days.
Maximum Loan size:	CNY1,000
Interest Rate:	Deduct CNY35 at the time of loan disbursement Effective interest rate is 9.53% per annum
Frequent Loan Repayment	Every 4 weeks

<u>3. Term Loans (Starting in early 2003)</u>

Eligibility	Applicant has had regular loans but no seasonal loans
Loan Duration	84 days, 3 months,
Max Loans	CNY1,000
Interest payment	Deduct CNY35 upfront, effective interest rate 14.50% p.a.

a. Financial Sustainability

39. Key financial indicators in Chifeng are shown in Tables E.1.2 and E.1.3. The productivity and outreach indicators are shown in Tables E.1.4 and E.1.5.

Table E.1.2. Adjusted Profit and Loss Statements, UNDP MFP Chifeng

	2000	2001	2002	2003
1. Unadjusted operating expenses in local currency	283,124	294,955	374,436	462,164
2. Inflation adjustment*				
Cost of fund at market rate (a)	108,607	108,936	98,734	98,734
Cost of fund at profit statement (b)	67,833	34,509	67,461	96,071
2. Subsidized cost of funds adjustment (a-b)	40,774	74,427	31,272	2,663
3. Unadjusted Provision for bad loans (BS)		0		
Provision for bad loans at profit statements		19,206		13,340.00
Provisions needed				
Adjustment made				
4. Appreciation allowed				
5. In-kind donation adjustment				
a. Personnel	20,000	20,000	18,000	12,000
b. Other	15,000	16,000	18,000	18,000
6. Adjusted operating expenses (sum of lines 1–4)	358,897	405,382	441,708	494,827
7. Adjusted operating profit (loss)	(173,122)	(67,085)	(59,473)	16,289

Table E.1.3. Key Financial Performance Indicators, UNDP MFP Chifeng

	2000	2001	2002	2003
1. Return on assets	(2.64)	1.14	0.20	1.05
Operating profit/average total assets				
2. Adjusted return on assets	(4.70)	(1.77)	(1.50)	0.35
Adjusted operating profit /average total assets				
3. Adjusted return on equity	(149.39)	(43.55)	(25.46)	1.69
Adjusted operating profit/ average equity				
4. Operational self-sufficiency	65.62	114.69	102.08	110.59
Operating income/ total operating expenses				
5. Financial self-sufficiency	52	83	87	103
Operating income / adjusted operating expenses	(48%)	(16.5%)	(13.5%)	3.3%

Table E.1.4 Productivity Indicators, UNDP MFP, Chifeng

	2000	2001	2002	2003
Number of active loan clients per staff member (end of period)	107	148	136	121
Number loan officials as a % of total staff (end of period)	62.5	52.4	50.0	51.7
Number of active loan clients per loan officer (end of period)	172	283	272	234
Outstanding portfolio per loan officer (CNY, end of period)	91,515	174,603	245,798	229,885
Outstanding portfolio per loan officer (USD, end of period)	11,026	21,036	29,614	27,697

Table E.1.5. Outreach Indicators, UNDP MFP Chifeng

	2000	2001	2002	2003
All loan products				
1. Number of active loans at end of period	2,639	3,555	4,382	4,351
2. Percentage of clients who are women	100	100	100	100
3. Average balance per loan (CNY)	1,050	1,234	1,311	1,358
4. Average balance per loan as a percentage of per capita GDP in China	14.84	16.36	16.24	15.72

40. As one of the best donor supported MFPs in China, the MFP in Chifeng has achieved operational and financial sustainability with good outreach.[44] The MFI has provided loans solely to women, all loan officials are women and many management staff also women. The MFP has had a significant impact on the incomes and capacities of its women clients. The Women's Federation at the prefecture, country (banner) and township (Sumu) levels have also benefited from the program. By actively participating in the program, the Women's Federation has learned micro finance techniques, project management, client training and has applied those principles to their work.

41. The dependence of the MFI on external technical support has been reduced following implementation of the SMAP project. The MFI has established a set of loan disbursement and collection procedures, an accounting and financial management system and management rules of China Cadet Corps (CCC). Its accounting and financial management systems and operations are well developed, confirmed by a number of auditing reports. The MFI has a relatively strong management capacity and its management of CCCs is successful.

42. At county and township level the program is implemented by Women's Federation staff. Many staff of the Women's Federation work for the program on a part-time basis. The association needs to have more full time staff at the county and township level under the direct control of the association. In the longer term, the association needs to clarify its relationship with the Women's Federation at the Prefecture level.

43. Owing to the limited amount of micro finance revolving funds and relatively low productivity, the MFI is still dependent on implicit subsidies from the Women's Federation and other sources to a certain extent. Changing market conditions, with more unsecured micro-loans from RCCs, makes it difficult for the MFI to expand its client base and improve staff productivity.

44. Cash management, especially cash management with respect to collection of loans by the CCC needs to be strengthened. A system needs to be in place to make sure that loan officials accurately report cash received from clients, including loans repaid ahead of time and that cash received is deposited in a financial institution as soon as possible.

2. UNICEF Microfinance Program in Wushen Banner

45. SPPA is an UNICEF revolving fund program. SPPA was initiated in 1996 and has been implemented in 25 counties of 13 provinces in all poor areas of China. UNICEF regards Wushen

[44] It is based on the assumption that the data provided by the MFP are accurate.

as one of the best SPPA programs in China.[45] The major program objective is to support poor women and children in poor areas of China and build capacity for women by using micro-credit. Like Chifeng, the MFP in Wushen has also experienced two phases: Phase I from 1996-1999 and Phase II since 2000.

Table E.2.1 Project Progress Reports, UNICEF SPPA Wushen[1]

Item	2000	2001	2002	2003	2004
Program Officers at the Banner Office	7	7	7	6	5
Number of townships covered	12	12	9	9	9
Number of Small Groups	171	171	171	171	171
Active Borrowers	3,258	1,361	952	943	996
% Female Clients	100	100	100	100	100
Loan Portfolio (year end)	1,896,000	1,896,000	1,999,000	2,100,000	2,450,000
No. Loans Disbursed	3,258	1,361	952	943	996
Repayment rate for maturity loans	98%	96%	99.50%	100%	100%
Compulsory Savings	230,000	300,000	350,000	410,000	460,000

Note: 1. It is difficult to read the balance sheet, profit and loss statements and other reports from Wushen. They are not presented in the standard format and there are inconsistencies for the figures from different reports. The mission did not have enough time to check and compare the financial reports in Wushen.

Figure E.3. Loan Products, UNICEF SPPA, Wushen

<u>Regular Loans</u>

Target Market	Female farmers in the project area
Loan Conditions	No collateral and guarantee required except the group guarantee; no specific demand for borrower investment
Loan Size	Loan ceiling was CNY2,000 before the year of 2000 and CNY2,500 thereafter
Loan use	Income generation activities, both capital investment and working capital.
Loan Term	1 Year
Group Guarantee	Yes, five in a small group, and 5-6 small groups form a large group, usually a large group is a village or a Gatha.
2-2-1 Loan disbursement	No
Loan Repayment	Term loan repayment at the end of term
Centre Meetings	Monthly large group meetings, sometimes combined with training activities.
Compulsory Savings	CNY100 savings for joining the program, CNY10 each month put in at the time of the monthly large group meetings
Interest Rate	9.6 percent deducted at the time of loan disbursement (effective annual rate 10.5%)

46. The MFP in Wushen was not aimed at operational and financial sustainability by design. The program is heavily subsidized by local governments; including county and township governments. Low self sufficiency of the program in Wushen has been caused mainly by relatively low rates of interest on loans, use of interest income for social development, and the relatively small scale of the program and small size of loans. As shown in Figure E.1 and E.2, compared to the Chifeng MFP, the MFP in Wushen has a lower loan ceiling and a lower

[45] According to the UNICEF and the director of SPPA in Wushen, the other good SPPA is in Lijiang of Yunnan Province.

effective rate of interest. During Phase I of program implementation, one third of interest income was used as a risk fund and two thirds of interest income was earmarked as a social development fund; used for rural infrastructure projects, such as building bridges and toilets, child care centres, medical clinics. So the operational funds of SPPA were entirely dependent on subsidies from local governments. From 2000, the social development fund was basically suspended so the program office can use interest income to cover part of its operational costs. The capital fund of the MFP in Wushen is also smaller with a loan portfolio of CNY1.86 million by the end of 2004, as compared to CNY3.45 million in Chifeng. At the time of mission visits, local governments were still paying wages of most project staff as well as office expenses at banner and township levels.
Compared with Chifeng, SPPA in Wushen is more a government program in the sense that it depends on the local governments for financial supports and it is still a part of the banner government.

F. Success and Failure Factors for Micro Finance in China

47. MFPs/MFIs in China conducted experiments in new lending methodologies ahead of the formal financial institutions in China. The loans provided by traditional RFIs in China prior to the late 1990s were mainly term loans with low rates of interest of relatively large size. Other mechanisms for loan repayment, such as frequent loan repayment, dynamic incentives,[46] targeting women, and group guarantees were not in place. Loans provided by MFPs/MFIs in China (modified Grameen replicates) have been characterized by small loan size (from RMB 500-about 4,000 (maximum 5,000 RMB) per loan for rural loans, relatively high rates of interest, frequent loan repayments, dynamic incentives and targeting women. Some programs have adopted group guarantees with 5 per cent of loan principal as group fund deducted at the time of loan disbursement and compulsory savings programs. Compulsory savings and group funds could be regarded as collateral substitutes. Some new lending methodologies, such as dynamic incentives, targeting women and frequent loan repayment, have proven useful in raising loan repayment rates for small size loans to rural households. In general, the loan quality of the MFIs is better than that of the poverty loans disbursed by ABC, and the loan quality of well managed MFIs is better than those micro-loans disbursed by RCCs.

48. MFIs/MFPs in China have also tested higher lending rates for loans for poverty alleviation. Most donor-funded programs in China charge an effective rate of interest from 12 to 18 per cent per annum, which is much higher than the rate charged by RFIs in China (3-8.5 per cent per annum). The experiments with micro finance show that the current lending rates of interest for micro-loans on credit charged by RCCs are not able to cover the full costs for small scale RFIs that provide small size loans to the poor. The micro finance experiments indicate that MFIs in central China need to charge an effective nominal lending rate of about 15 per cent to achieve operational viability.[47] Moreover, MFIs in China have no historical burden, no tax obligations and loan repayment rates of well functioning NGO MFIs programs are higher than the average RCCs in China. This is an indicator that to meet their higher operating costs, RCCs should be charging interest rates even higher than those charged by MFIs in order to break even.

[46] Dynamic incentives also be referred to as positive incentives, which means that if a borrower successfully repays her loan, she will be granted another loan, usually a loan in a larger amount.
[47] See CGAP evaluation report, 2000. Operational sustainability here refers to the incomes of MFIs cover the operational costs, loan loss provisions and real fund costs (usually subsidized, not opportunity cost of capital).

49. MFIs/MFPs in China are primarily operated in China's poor counties and therefore have provided a significant proportion of their loans to poor households for poverty alleviation. Despite charging higher rates of interest than traditional RFIs and poverty alleviation programs, there is clearly a demand for MFP/MFI loans. The borrowers are able to use high interest rate loans profitably and in some cases the MFP is also able to extract a profit from the provision of micro-loans to the poor households.

50. A significant but less noticed contribution of the micro finance movement is the creation of new forms of institutions and new approaches for poverty alleviation, social welfare, and financial development in China. The conventional approach in China is that the provision of financial services, poverty reduction, and social welfare are the responsibilities of governments and their institutions. The development of micro finance movement in China demonstrates that semi official institutions and NGOs could be equally effective, and in some cases more effective and innovative, in delivering public goods.

51. A number of factors have been responsible for the success of NGO micro finance programs in China. First, unlike formal financial institutions such as RCCs that are subject to interest rate regulations, NGO micro finance programs in China have been able to charge higher rates of interest and test new lending methodologies. Second, as new institutions, the employment and remuneration packages of the MFIs are more flexible, as compared with formal financial institutions. MFIs are able to design their own incentive mechanism for their employees. Finally, many MFPs/MFIs have special funds for technical support and training, which is important for capacity building of the poor, and improves repayment rates.

52. The experiments in China's micro finance also show a number of constraints for financial development and poverty alleviation in rural China. Similar to what happened with the formal financial institutions, lack of a proper institutional form with good corporate governance and effective external monitoring/supervision are the two major obstacles for sustainable development of micro finance movement in China. China's micro finance movement has so far failed to test new form of institutions with clearly identified ownership structures and good corporate governance, committed to provide long-term sustainable financial services to the poor in rural China. Many MFIs are subject to influence from local governments. In some cases, local government employees manage the MFPs/MFIs. In other cases, MFPs/MFIs are subsidized to a large extent by the local governments and their agencies. There has not been effective external monitoring, supervision, and auditing for most MFIs/MFPs in China.

53. Most MFPs in China are Grameen replicates although Chinese MFPs are located mainly in rural areas and a considerable proportion of loans are used for agricultural production. With the increases in household incomes and widening income gaps, there has been a decline in the demand for Grameen model of micro-loans. It should be noted that the Grameen model has not been particularly effective in sparsely populated areas because the meeting requirement to conduct self monitoring is impractical and can be financially burdensome.

54. Finally, it is difficult for any micro-credit programs/institutions to be operationally and financially viable in the very poor and remote mountainous areas of China's southwest and northwest, with high transaction costs and lack of income generation opportunities in these areas. In addition to limited economic opportunity these areas face higher education costs and higher incidence of illness due to poor and expensive health care access. Remote areas of IMAR, especially in the sparsely populated western regions, can be expected to face similar obstacles.

55. A number of factors are responsible for the constraints discussed above. First and foremost, on an experimental basis, it is unlikely for any MFIs to attract funds from private investors and micro finance experiments in China therefore have to be dependent exclusively on the funds from donors. This has contributed to the unclear ownership structure and local government intervention in the operations of MFPs in China. Lack of clarity over ownership of MFPs/MFIs has resulted in the failure of donor supported MFPs/MFIs in many countries and donors are becoming reluctant to support MFPs/MFIs in such an environment. Moreover, with limited funds from donors, the scale of each MFP/MFI is generally small (CNY 2-5 million in each county), which makes it difficult for these programs to be financially viable in the long run. Next, for very poor areas, it is important for the government to invest more in public goods such as rural infrastructure, public health, and school education. The poverty in these areas can hardly be alleviated by micro finance alone. Finally, lack of a legal framework for the operation, monitoring and supervision of MFIs have also contributed to the ineffective external monitoring and auditing of MFIs in China.

Outreach and Financial Sustainability of MFPs/MFIs in IMAR of China

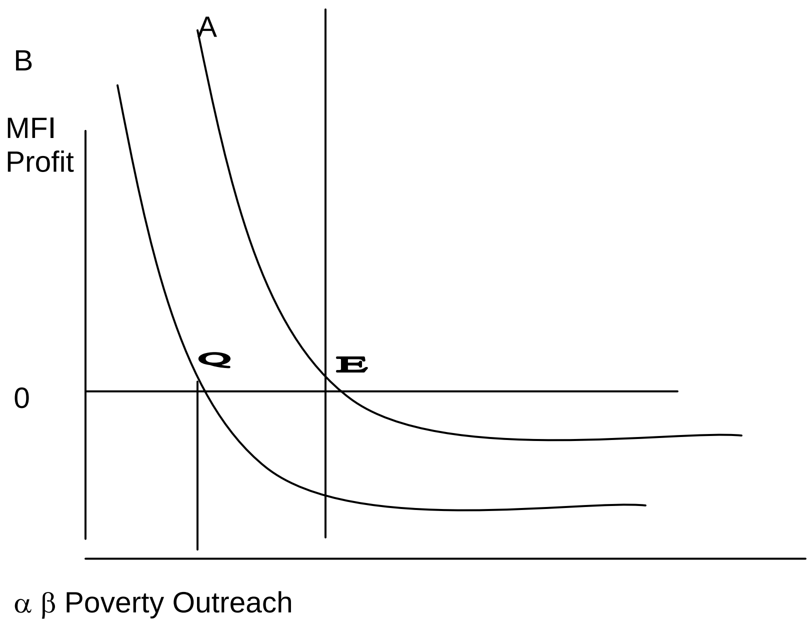

Chart 1. Trade-off between Outreach and Financial Sustainability

56. The trade offs between outreach and financial sustainability of MFIs are shown in Chart 1. As greater poverty outreach is achieved (reaching more poorer clients in the more remote areas), the profit of MFIs declines . A shift from Line B to A represents an increase in efficiency of a MFI. Here efficiency is defined as the profits achieved by a MFI given the poverty level of its clients and the impact of the micro finance services on the clients. For any given level of poverty reached, the profit of the MFI at line A is higher than line B.

57. In Chart 1, Line B represents the current level of trade off between outreach and financial sustainability achieved by well RCCs and NGO MFIs in IMAR (sustainable frontier

institutions). At the poverty level of α, a well-performing RCC/MFI is able to provide micro-loans to its clients up to Q without subsidies. With an improvement in efficiency, a well-performing institution will shift from B to A, achieving a deeper poverty outreach (up to point β) while maintaining its financial performance.

58. To promote micro finance for RCCs and NGO MFIs in IMAR, it is important to identify and quantify:

(i) The current levels of subsidies provided and depth of poverty (the level of income and welfare of rural households) reached for the provision of micro-loans by RCCs and MFIs in the following three categories of institutions in different regions of IMAR: the best performing institutions, the average institutions, and worst performing institutions;

(ii) The efficiency gains in moving the performance of all the other institutions to that of the best-performing institutions in different regions of IMAR.

(iii) The potential for efficiency gains for the best-performing institutions in different regions of IMAR by assuming that (a). There are no historical burdens for RCCs; (b). An increase in lending rates of interest for micro-loans without or with little impact on loan repayment; (c), A reduction in the operational costs and risks by innovations in financial products and institutions.

(iv) Point β in Chart 1, beyond that point, subsidies will be required for the MFIs to operate, even all the potential gains in efficiency has been achieved.

59. The analysis above has important policy implications. Actions (information assimilation, training, and technical support and institutional reforms) should be taken to improve the performance of all the other institutions (including RCcs and NGO MFIs) to the level of the best performing institutions to achieve the potential efficiency gains (to point α and Q). Next, further reforms should be undertaken to raise the lending rates of interest for micro-loans, to reduce operational costs and mitigate credit risks by conducting financial innovations (to point β and E).

60. For those regions and clients where a subsidy is required (beyond point β), policy makers need to decide whether micro finance should be supported through subsidies, if so, how to subsidize these institutions and who is going to pay for it? Even if subsidies are available, there is no guarantee that the subsidies will lead to greater outreach to the poor. Subsidies in themselves do not guarantee greater outreach to the poor. Subsidies must be accompanied by performance standards and monitoring. It is perhaps more important for the governments to provide more fiscal input to improve rural infrastructure, educational and health services in these poor and remote areas so as to reduce the subsidies for the provision of financial services.
Different institutional forms, such as real, member driven, credit cooperatives at the village level could be tested first in the remote sparsely populated areas of IMAR to provide sustainable micro finance in these regions where the competition for the services is very limited.

G. Micro Finance Options for IMAR

1. Immediate Actions

a. Clarify target groups for micro-loans and group guarantee loans.

61. It is important to note that group guarantee loans are loans with no collateral, and group guarantee is a collateral substitute. Risks for both micro-loans on credit and group guarantee loans are high, because both loans do not have physical collateral. Instead of granting

additional loan limits to households that already are offered micro-loans on credit, group guarantee loans shall aim at poorer sections of rural communities in remote areas where it is too costly for RCCs to screen loan applicants and monitor loan uses. Pooling a group loan and a micro-loan on credit to the same household simply increases vulnerability of households, credit risks for RCCs and reduces outreach. In general, the size of a group loan for one household should be smaller, rather than larger than an individual loan, as borrowers usually graduate from a group loan to an individual loan.

b. Improve RCC Unsecured Micro-loans

62. Unsecured micro-loans can be improved in terms of loan quality and outreach through:
Setting an overall standard in IMAR to link household credit rating to credit risk on two levels. RCCs with a higher proportion of non-performing loans may have a low credit limit for households in the area until loan performance improves. Household limits will be determined on the basis of repayment capacity rather than collateral or other considerations.

63. Replace credit rating with credit scoring, whenever possible. Under credit scoring, information on credit rating helps RCCs to assess loan applications, instead of replacing the process of loan application assessment, monitoring, and enforcement. Information on credit rating can help RCCs to determine the time and effort to be spent on threshold applicants, those with higher risks, and rewards and loan limits for rated households.

64. Enter data on rated households collected into a computer database, including the household incomes, family labour available, assets and past loan repayment records. This information is valuable for RCC credit scoring, loan assessment, and information sharing with other institutions.

65. Introduce a responsibility system for disbursement and collection of micro-loans with the RCC directors and RCC loan officials, following the experience from Tuzuo Banner. RCC directors and loan officials shall be made responsible, or at least partly responsible, when the loan collection rate falls below a certain percentage. The lessons from NGO micro finance pilots in China indicate that to link the remuneration package for loan officials to loan repayment rate is an important means for MFIs to improving loan quality. To avoid abuse of the responsibility system, RCCs need to segregate refinanced and rescheduled loans in their reporting.

66. Credit rating is only one mechanism for encouraging loan repayment. Other mechanisms, such as frequent repayment of loans,targeting women, progressive loans and other tools based on local conditions shall be introduced by RCCs.

67. Set more sustainable lending rates for RCC micro-loans, based on cost of funds, operation expenses, projected loan losses and profit for growth. At the same time to reduce other borrowing costs for borrowers, such as time spent on loan applications, small gifts and other considerations for loan officials, etc. With a relatively high lending rate, RCCs can rebate those who repay loans on time.

68. With improvement in loan quality, RCCs shall pay transportation costs and a small living allowance for loan officials going to villages for loan monitoring and collection.
Instead of targeting extensively household heads who are mainly men, RCC micro-loans shall target more women. In many NGO MFPs women have proven more reliable with a higher loan

repayment rate. Moreover, when a loan is granted to a woman, it tends to have a larger impact on the improvements of the welfare of the women and children in a family.

c. Improve RCC Group Loans

(i) Group guarantee loans should target poor rural households who have no physical collateral and other guarantee. The size of group loans shall be smaller than individual loans. Instead of pooling an individual loan with a group for a better off households, RCCs shall target poorer households with group loans and then graduate them into individual loans, as they demonstrate successful loan repayment over time.

(ii) Group sizes shall be restricted to less than 6-7 households, and limit to around five households if possible. No close relatives shall be allowed in a group.

(iii) Group funds and/or compulsory savings (as risk funds) could be introduced by RCCs to improve the loan repayment rate.[48]

d. Develop New Loan Products

69. A new loan product for agricultural enterprise shall be introduced by RCCs to finance farm production and investment with longer production and income generation cycles, such as cattle raising and production of some cash crops. Lack of appropriate agricultural loan products have increased loan defaults, as most of the micro-loans are short term, generally within 12 months and most from 7-9 months. Larger and longer term agricultural loans shall be based on repayment capacity and require more physical collateral, such as large farm machines and land use rights. There could be regulations as to the maximum proportion of large agricultural loans to ensure that the small farmers will be served as well.

2. Medium and Long Term Actions[49]

(i) It is important to clarify whether RCC micro loans are policy or commercial loans. RCCs shall be compensated for disbursement and management of policy driven micro finance loans. Compensation can be made in two installments to encourage prudent credit management, a portion up front to cover disbursement costs, and the remainder upon successful repayment of loans. Otherwise, market principles shall be applied.

(ii) Local government intervention on lending decisions, especially intervention from county level governments shall be removed. In the short term, direct local government intervention could be replaced by indirect interventions such as setting up guarantee funds to encourage RCCs to lend to specific sectors that are important to the local economy.

H. Experiment and Support NGO Micro Finance Institutions

70. As a successful MFP in China, the lessons from Chifeng MFP shall be summarized and learnt by RCCs and other NGO programs in Inner Mongolia. The pilot in Chifeng shows that; a) MFIs in most areas of Inner Mongolia can serve the rural households in a sustainable manner,

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[48] RCCs have compulsory savings for their group loan programs.

[49] Medium and long terms actions are actions upon the changes in central government policies and the ways in which the local governments are operating, which is often beyond the control of RCCs.

with a certain scale of fund input and sustainable lending rate of interest; b) Rural Mongolian women and other women in IMAR are bankable ;and 3). Non-financial institutions can play an important role in financing the poor.

71. The Chifeng Project can be strengthened by clarifying its relationship with the prefecture Women's Federation to an extent that changes in personnel and policies of the prefecture Women's Federation will not affect operations of the MFI. Productivity of the MFI needs to be improved. In the longer term, ownership of the MFI needs to be clarified with real owners. Corporate governance of the program needs to be improved as well.

72. The SPPA in Wushen is a government program, not a NGO MFI. The Program in Wushen cannot stand on its own and continuous subsidies are required if the program is to continue. In remote herding areas of Wushen and other areas of IMAR, pilot programs shall be undertaken to test real self funded rural savings and credit cooperatives organized by farmers based on compulsory savings program in Wushen SPPA.

73. In addition to experimenting with MFI's the IMAR government should experiment with subsidizing RCCs that deliver financial service in remote rural areas to marginal livestock producers and assisting the establishment of traditional savings and credit unions. Traditional savings and credit unions are owned by their members, the members provide lending to each other through their own savings, they establish their rules of operations and elect a board of directors and supervisory and credit committees to manage operations until they can afford to hire professional staff. Operating costs of traditional savings and credit unions tend to be very low as they rely on volunteers and repayment rates tend to be high because members are borrowing from their own savings, peer pressure for repayment is intense.

73. In general, MFIs in IMAR shall have a clear ownership and management structure, with real owners. Insider control (control by management) is a common problem for RCCs in China. With capital funds from donors and the government sector, NGO MFIs also have no real owners. Given the difficulties with ownership and institutional transformation of RCCs, in the short term we shall concentrate more on development of alternative institutional forms of micro-credit providers to promote competition in the provision of micro-finance services in the region in order to provide better micro finance services for the poor and micro-entrepreneurs.

I. Build up the Infrastructure and Environment for Micro-credit Development

74. To remove the distortion on rural financial markets, efforts shall be made to

(i) Experiment on possible collateral for loans, such as long-term land use right, especially for large size agricultural loans.

(ii) To increase government input in rural infrastructure, education and health and prevent rural households from over borrowing from RCCs and NGO MFIs for education, health and land development. The medical insurance program could be studied and experimented as well.

(iii) To take the environment and sustainable development into consideration when assessing household applications for credit. Large increases in the number of animals, supported by loans from formal and informal sources will contribute negatively to the sustainable development in IMAR.

(iv) Set up a credit bureau system to collect and exchange information on household borrowing. RCCs and NGO MFIs shall share and exchange client information. Some households have explored the system and borrowed from both sources

and the borrowing has not been necessarily backed by the loan repayment capacities. This not only increases risk to lending institutions it increases the vulnerability of households.

(v) Conduct training program for RCCs as soon as possible on RCC credit scoring, micro finance, etc to build the capacities for RCCs to conduct micro finance programs.

APPENDIX 11:FUTURE REFORM TO SUPPORT RCC SYSTEM

I. LEGAL REFORM

1. Some of the suggestions and recommendations made throughout this report are beyond the scope of the IMAR governments mandate particularly those that pertain to state institutions such as the CBRC. However the issues are raised to draw attention to the conflicts between the current legal and regulatory environment and practices and legislation, regulation and practices that are generally found to be conducive to healthy financial systems.

1. In the short term it is recommended that a more conservative approach be taken to prudential standards than is currently permitted under CBRC regulations. At the same time the IMAR government and the new ARRCCU raise legislative issues with the central government to work toward a stronger legal environment for rural finance.

2. Areas requiring particular attention are tax policy, prudential standards, roles and responsibilities of CBRC and legal standing for micro finance organizations.

3. Current tax policy places and onerous burden on RFIs by charging tax on gross revenues. This policy destabilizes RFIs by requiring payment of taxes even when the organization has a net loss. Thus when an RFI is already vulnerable, it is eroded further by having to pay taxes from its capital, provided that it has positive capital. The RFI is then less able to provide services to customers, which in turn limits economic opportunity for customers, which in turns places a burden on the state treasury to provide support to individuals who are denied the opportunity to help themselves.

4. Tax policy with respect to loan loss reserves does not encourage prudent management. Proper loan loss provisioning is essential to protect private investors and depositors in financial institutions. This is not just an issue for RFIs but for all deposit taking financial institutions with private investment, and will be a bigger issue as banks fully commercialize in advance of the WTO agreement.

5. The administrative and operational role of the CBRC is inappropriate as a regulatory body and its mandate should be changed. As a regulatory organization responsible for supervising prudential management of financial institutions the CBRC should maintain an arms length relationship with those institutions. CBRCs direct decisions in loan approvals, however limited, compromises its objectivity.

6. There is a need and great opportunity for micro finance organizations in China. At present there is no defined legal construction for micro finance suppliers. Most are projects funded by foreign NGOs and partnered with a government department. Projects, by their very nature, are not sustainable and not designed to be sustainable. In most cases it is expected that the project will be handed over to a local institution at its conclusion with the expectation that the successor organization will scale up the project or absorb it as a division of its existing organization to ensure continuity.

7. As most micro finance projects tend to be partnered with government departments staff are seconded on a part time basis, occasionally on a full time basis. This means that the first responsibility of staff is to their government department so when the donor organization withdraws, and particularly withdraws salary subsidies, there is a natural tendency to pay less attention to the project and focus more on departmental priorities. Micro finance projects partnered with government department are usually dependent on a departmental sponsor or

champion. When that sponsor is promoted, transferred or retires the micro finance project is very vulnerable, especially if the donor organization has already withdrawn. The new sponsor may be less interested in the project and fail to protect or promote is as they rarely understand the original motivation and vision of the project. The project is then vulnerable to diversion of purpose and sometimes diversion of earnings to support other departmental priorities.

8. Independent legal standing for micro finance suppliers would strengthen their capacity by allowing them to concentrate on the task at hand. It also makes it easier for them to implement policies and procedures to ensure sustainability. Finally it is easier to attract investment into independent micro finance institutions than to projects.

APPENDIX 12: SUPPORT OPTIONS FOR ADB IN IMAR

I. FINANCIAL SUPPORT FOR RESTRUCTURING RCCUS

1. Develop soft loan program to inject genuine liquidity into the system. Estimated capital shortfall between redeemable bills program and international standards for 9 RCCUs to be converted to banks is CNY644.4 million or USD 78.5 million
Loan program should at a minimum require:

- (i) Prior reclassification of NPL portfolio with loss provisioning based on international standards;
- (ii) Absolute targets for NPL reduction; and
- (iii) Prohibition of cash dividend payments until CAR is met

A. Develop One League as a Model

2. Financial and technical support to pilot extensive reform in one league including;

- (i) Conversion of one RCCU to a rural bank
- (ii) Restructuring one unified RCCU and one two person structure RCCU

B. Micro Finance Models

3. Support innovation in micro finance through experimentation with alternate delivery vehicles. Pilot improved micro-finance delivery through RFIs and establishing independent Micro Finance agent. Clear legal and ownership structure of Micro Finance agent should be established prior to funding

4. Establish of International Cooperative Alliance (ICA)style savings and credit union in remote rural area, support may include limited matching funds to kick start capital accumulation. (Recommend that funds matching of external funds to member investment be restricted to .75:1)

C. Support for ARRCCU and IMFO

5. Provide technical assistance to help develop strategic and operational plan to ensure cost effective, responsive and efficient organizational structure including:

- (i) Clarify relationships and develop MOUs with other agencies
- (ii) Needs assessment for support services required by RFIs
- (iii) Assessment of resources available outside RFI system
- (iv) Phased organizational development based on needs and financial capacity of RFIs
- (v) Determine staffing requirements in respect of numbers, qualifications, areas of expertise
- (vi) Establishing operating systems, work flows, reporting requirements
- (vii) Develop model policies for RFIs
- (viii) Explore data processing systems to support payments systems and network connectivity for RFIs throughout IMAR
- (ix) Establish treasury and payment systems

(x) Develop risk scoring for RFIs and develop risk based fees system to support ARRCCU and Risk fund

SUPPLEMENTARY APPENDIX 1: ANNOTATED SUMMARY OF THE STATE COUNCIL PILOT SCHEME TO DEEPEN REFORM OF RURAL CREDIT COOPERATIVES

This appendix presents the highlights of the reform program for the RCC system as prepared by the State Council. The text has been amended to incorporate the analyst's comments and recommendations regarding the viability of this reform and recapitalization program and its compliance with international best practices.

I. GUIDELINES AND GENERAL PRINCIPLES

1. The main requirements of the reform program 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 rural areas, agricultural production, farming households.

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

(i) Improve corporate governance and operations through ownership transformation, based on market principles, with the objective to enabling RCCs to become autonomous, disciplined market participants responsible for their own losses and developments;
(ii) Improve service functions and service quality to agricultural production and farming households in the rural area;
(iii) Explore all possible ownership structures and organizational forms, including shareholding, cooperative shareholding, as well as cooperatives, taking into consideration of local circumstances. The objective is to establish organizational forms and operating mechanisms that are compatible with local conditions;
(iv) 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.

3. While all of these principles represent admirable goals but are obviously lacking in the specific and practical action steps necessary for their sustainable implementation. Additionally, it was observed that there is a considerable lack of professional and technical experience and administrative capacity necessary to execute the difficult tasks in the reform process—among either RCCU management or their supervisory boards. The relative lack of success experienced in the eight pilot provinces where these reforms have begun can also be attributed to the high degree of political interference by various local government officials who have little experience in the financial sector.

A. Pilot Details

4. 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 to handing RCC management to local governments.

B. Ownership transformation in each RCC with legal person status

5. 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 shall first be distributed as dividends and fulfill obligations including unpaid interest payments and various insurance premiums.[50] The remainder shall be set-aside as loan loss provisions (100% for loss loans; 50% for doubtful loans; 20% for overdue loans, and 1% for normal loans), which shall be counted as subsidiary capital[51]. 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 the 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.[52]

6. Build up new ownership structure 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 shareholding[53] 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.

7. First, in advanced localities with a high degree of urbanization, shareholding banks shall be established based on 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%.[54]

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 person. Specific criteria are: (a) positive net worth on consolidated basis; (b) consent by grass-root level RCCs; (c) relatively strong management at the RCC union; (d) capital after ownership consolidation exceeds 10 million and capital adequacy reaches specified ratios.

9. Third, in other localities, the current two-tier system where RCCs and RCC unions are both legal persons 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 para-urban areas shall be closed according to the *Regulations on Withdrawal of Financial Institutions*.

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[50] This commitment to pay dividends to shareholders as soon as the capital account shoes a positive balance is the incorrect approach and practically guarantees that new investors will be attracted from the wrong reasons. No dividends should be allowed until all retained losses have been recovered and the NPLs are properly reserved for.

[51] This represents a significant increase in the loan loss reserve requirements for each category of NPL. However, the reform policies fail to take into consideration the cost of funding these reserves or their impact on earnings and capital.

[52] None of these actions are sound banking practice nor do they adequately address the issue of ownership structure.

[53] In this hybrid structure, decision-making in the RCC will be by one member one vote thereby preserving the cooperative nature. In 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.

[54] As these conditions must be met before conversion, most of the RCCUs in the IMAR province are not qualified. The level of NPLs far exceeds either the level of reserves or capital.

10. No matter what ownership structure is adopted, an in-depth due diligence will have to be conducted to verify the net value of the loan assets—i.e. classify the loans as to risk and nonperformance; 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.

11. A most unfortunate trend has been noted among the pilot projects in the implementation of their reform of ownership structure. Many of the RCCs and RCCUs involved have circumvented sound principles and regulations on their share capital increase through the following actions:

- *(i) Improper promises to prospective shareholders illegal loans and guaranteed dividend returns;*
- *(ii) Wrongfully counting certain term deposits placed by 'investors' as share capital;*
- *(iii) Violating CBRC regulations by advancing loans to investors and management for the purchase of new shares;*
- *(iv) Illegally disposing of selected non-performing loans and other unqualified assets;*
- *(v) Increasing the net capital amount on account without justification and in violation of proper accounting principles;*
- *(vi) Disseminating false advertisements to attract more shareholders without proper disclosure of actual investment risks.*

12. Coercing existing RCCs shareholders to increase their investment in the new rural banks and not allowing the timely withdrawal or sale of existing shares.

13. Due to these tactics and the lack of enforcement in existing regulation many people, particularly in the marginalized rural communities, have lost their confidence in the RCC reform and whether the capital support from the government can enable the RCCs to set up a sound regulation system

14. The management of RCCs shall be handed over to local governments. *One of the most controversial provisions in the announced reform program is the decision that the provincial governments are to assume the following responsibilities over RCC management:*

- (i) ensure the RCCs observe financial policies and guidelines set by the state, guide their operations in the direction of serving the rural sector. Local party committees shall step up their leadership over RCC party membership and ideological work;
- (ii) provide guidance to RCCs in accordance with laws and regulations to strengthen their self-discipline, supervise the election and appointment of RCC senior managers in accordance with laws and regulations;
- (iii) take leadership in preventing and resolving financial risks of RCCs in their jurisdiction. The central bank shall provide temporary support in failure resolution, and the fiscal authorities shall withhold future transfer payment to the provincial government should it fail to repay the central bank loans;
- (iv) assist the RCCs in collecting old loans and in fighting willful default, in investigation and punishment of fraudulence, and in creating a healthy credit culture and maintaining order and stability in rural finance.
- (v) in piloting areas where conditions are appropriate, a new RCC union shall be established at the provincial level, through which the provincial government can

exercise the necessary functions to manage, guide, coordinate and serve all other RCCs and their RCCUs.

(vi) the provincial government is to 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 RCCU or other forms of independent managerial units shall be established at the prefecture/municipality level.

15. It is the opinion of this analyst, as well as other members of the ADB technical assistance team, that the above actions to further delegate authorities and responsibilities for RCC management to local governments and to further create yet another layer of RCC administration in the form of a provincial RCCU will have a negative impact on the future corporate governance of the RCCUs and will prove detrimental to the sustainability of the reform process. Recommendations to amend these two components of the reform program are discussed in detail in section ___- of this report.

16. The reform program additionally decrees that the CBRC shall assume responsibility for the regulation and supervision of the RCCs, including:

(i) formulate regulations over RCCs in accordance with state laws and regulations;

(ii) authorize the establishment; change and suspension of (rural finance) institutions as well approve their business scope;

(iii) conduct on-site examinations and off-site surveillance, collect statistical information and conduct risk evaluation, as well as investigate and penalize violation of laws and regulations;

(iv) conduct fit-and-proper test of senior managers;

(v) provide regulatory data and relevant information to provincial governments, provide early-warning on risky institutions and assist provincial governments in dealing with risks;

(vi) provide training to specialized managerial staff designated by provincial governments and;

(vii) evaluate performance of provincial governments in managing RCCs and report findings to the State Council.

17. These administrative and regulatory responsibilities are all-encompassing and it remains to be seen whether the CBRC has the capacity to carry them out efficiently and independently. There is ample evidence that the local and provincial governments, in the form of their regional finance offices, will also mettle into these areas in their desire to maintain more direct control of the RCC operations[55].

18. 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 hazards, shall provide the following support: losses from indexed deposits during 1994-97. These are to be verified and reimbursed in stages by the fiscal authorities. From January 1, 2003 to December 31, 2005, income tax shall be exempted for all participating RCCs in the Western Region; and such taxes shall be halved for participating RCCs in other areas. A business tax shall be levied at 3% for all participating RCCs in all pilot areas;

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[55] At least part of their rationale for continued involvement in these areas is the desire to capture and benefit directly from the financial resources that the government (PBOC redeemable bills and direct payments for past deposit interest subsidies) will be providing through this reform program

19. Two variations and options for financial support are also to be made available to participating local governments and the RCCs. Participating localities shall be free to choose between the two options, details of which shall be specified by the PBOC:
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 to 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.[56] The formula for calculation negative net worth is: *cumulative losses + actual asset loss - owners equity - loan loss reserves*, of which actual asset loss is calculated by applying 40% to the sum of loss loans and doubtful loans, 10% to overdue loans, 10% to investments, and 50% to foreclosed assets.

20. The other financing that may be made available is for the central bank to issue special two-year notes in exchange of the non-performing loans of RCCs, at interest rate no lower than that on required reserves. The special notes shall not be tradable, endorsable or be 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 the performance criteria shall be conducted by local offices of the PBOC and CBRC as well as local governments.[57]

21. 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; micro loans to farmers shall not be floating upward and only in rare cases of high risk shall lending rates float upward but no more than 1.2 times of regulated rates; in areas plagued with natural disasters lending rates to farming households shall be floated downward as appropriate.
This is a more sophisticated approach to some of the funding and earnings problems experienced by certain RCCs but it will require considerable more research in the field to determine its true viability and impact on the reform process. It should be noted however, that the financial analysis conducted on the eight RCCUs in this study all show that they all have positive net interest spread margins and that their cost of funds on their deposit base are well below the interest rates charged for loans. The primary cause of their poor earnings is the non performing loans and high internal operating expenses.

C. Implementation

1. Organization and leadership

22. The pilot to deepen RCC reform shall be organized and implemented by the 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 programs 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 the CBRC and final approval by the State Council.

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[56] This special fund appears to be in addition to the redeemable bills which will be issued directly to the RCCU which are converting to RCB and RCOB operations. This appears to be funding for a provincial government guarantee which will have no direct or positive bearing on the CAR or operational viability of the new rural banks. The analyst does not agree with this aspect of the reform program and believes strongly that any government support for the RCCUs must be in the form of a direct recapitalization of the new banks.

[57] This option is be the same as the redeemable bill program for the converting RCCUs with the apparent difference that the bills can be issued directly to the local governments who would then 'recapitalize' the new banks with their own paper—a two-step approach. For obvious reasons the analyst disagrees with this concept as well.

2. Timing

23. 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 piloting 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 to the whole country.

3. Issues for Attention

24. The announced reform program concludes with the following three warnings, or 'issues for attention':

25. The RCCUs and the local governments should 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 pilot shall be reported promptly;

26. Appropriate balance shall be maintained between piloting and non-piloting areas. In the remaining areas not participating in the pilot, the CBRC and its local offices shall continue to regulate and supervise the RCCs vigilantly to make sure services to the rural sector are maintained;

27. Attention should be paid to avoiding payment risks. Local governments, PBOC and CBRC shall study mechanisms to deal with disruptive payment risks.

28. Once again these are commendable concepts which have yet to be proven achievable under the current conditions in IMAR.

SUPPLEMENTARY APPENDIX 2: STATE COUNCIL DOCUMENT 48 [2004], ADMINISTRATION AND SUPERVISION OF RURAL CREDIT COOPERATIVES

Unofficial Translation

China Banking Regulatory Commission & People's Bank of China

II. GUIDING PRINCIPLES

1. To implement the reform of RCCs (including the financial institutions converted from RCCs) ordered by the State Council, to clarify and regulate the responsibilities of 'certain subjects' on the supervision and risk resolution of RCCs, to enhance supervision and administration of RCCs and to ensure sustainable developments for RCCs, these guiding principles are framed in accordance with the laws and regulations in "The Supervisory and Administrative Regulations in PRC Banking System", "The Banking Laws of PRC", "The Laws on Commercial Banks in PRC", and "The Implementation Plan of Enhancing the Reform of Pilot RCCs" issued by the State Council (document [2003]15).

2. "Certain subjects" in the above item refer to the provincial government, CBRC and its sub-branches, People's Bank and its sub-branches, and the provincial administrative institutions of the RCCs.

3. The basic requirements for the supervision and administration of the RCCs are: the state exercises macro-control; the provincial government exercises the rights of supervision and administration according to the laws and regulations; the RCCs supervise themselves and be responsible for their own risks. The general principles for the supervision and administration of RCCs are: clear responsibilities and obligations; good cooperation, careful supervision and administration, and sustainable operation.

A. Responsibilities of the Provincial Government

4. The State Council requires that the administration of RCCs is the responsibility of the local government. Therefore the provincial government should be responsible for the administration and risk disposal of the RCCs.

5. The major administrative responsibilities of the provincial government for the RCCs:

(i) Under the requirements of the State Council, the provincial government exercises administration, direction, coordination and services for RCCs and through the provincial RCCU. It mainly makes the decision over the policies of development and reform, big issues such as the goals and plans of the RCCs, with respect to the local practicalities.

(ii) The provincial government supervises the implementation of national financial laws, administrative regulations and financial polices of RCCs, encourages RCCs to serve for the rural sectors (i.e. the rural economy, the rural communities and farmers), provides information for the local economic development, guides the RCCs to provide better financial services, and evaluate on daily operation and management on a regular basis with help from other departments.

(iii) The provincial government only administrates the RCCs, but does not intervene the daily business and operation activities of the RCCs.

(iv) According to relevant laws and regulations, the provincial government helps the provincial administrative division to formulate the regulations of self-management of the local RCCs and supervises the implementation of the regulations.

(v) The senior managers of the provincial administrative division are chosen through a series of procedures: they must be recommended by relevant departments, and their qualifications must be approved by the CBRC. The provincial government is responsible for the administration and evaluation of the senior managers of the provincial administrative division.

(vi) The provincial government investigates over the various cases of the RCCs with the help from the provincial administrative division and correspondent institutions. It decides the punishments of the principals of the provincial administrative division, and supervises on the implementation of punishments of the criminals exercised by the provincial administrative division.

(vii) The provincial government helps the RCCs with the collection of loans and the punishments of bad loans to make a stable rural financial market and a sound credit environment for the RCCs.

(viii) In the RCCs, the communist party members can be administrated by the provincial government or local government. The local party committee should be responsible for the guidance of the party leaders of the RCCs.

6. The responsibilities of risk management of the provincial government for the RCCs:

(i) Together with CBRC, People’s Bank, the Provincial administrative division of the RCCs, the provincial government formulates the risk management plan and ensures its implementation.

(ii) The provincial government is responsible for the organization and coordination of certain sectors to dispose the emergency payment risks.

(iii) The provincial government guides the RCCs with the restructure and the withdrawal from the market.

7. When the provincial government performs the function of helping the RCCs with the collection of loans and the punishments of bad loans, it should cooperate with the governments of the county and township levels to create a helpful environment for the developments of the RCCs.

8. The provincial government formulates the administrative rules for RCCs and prescribes the administrative responsibilities of the governments of county and township levels for the RCCs. The copies of the rules should be sent to the local branch of CBRC and police stations.

9. The provincial government will not transfer its administrative rights to the governments of the county and township level. The governments of the county and township level do not have the rights to intervene into the daily operation of the RCCs.

1. The responsibilities of the provincial administrative division of the RCCs

10. The provincial administrative division refers to the provincial institution that performs the function of administration to the RCCs. It may take the form of a provincial RCCU or other forms of institutions. Since up to now all the provincial administrative divisions take the form of a provincial RCCU, in the following part of this document, the provincial RCCU refers to the provincial administrative division. The provincial RCCU is mainly responsible for the guidance and supervision of the internal control and operational mechanism of the RCCs.

11. The major responsibilities of the provincial RCCU

- (i) The formulation of the regulations and supervision. The provincial RCCU is responsible for the formulation of the regulation rules in the following aspects: operation, auditing, staff employment, distribution system, and operational mechanism. It also takes the supervisory responsibility of the RCCs.
- (ii) The provincial government guides the RCCs to set up sound corporate governance structures and internal control system, which will eventually leads to the sound operational mechanism in which the decision-making, execution, and supervision are in a balance, with proper stimulation and incentive system.
- (iii) The provincial RCCU is responsible to provide trainings and supervisions for the business operations, financial activities, staff employment and social securities issues. The provincial RCCU should provide more training for the external shareholders, the representatives of the RCC members, members of the board of directors and management staff to enhance their ability in decision-making.
- (iv) The provincial RCCU is responsible to provide technical assistance to the capital clearance and capital settlements of the local RCCs to improve their efficiency in capital clearance and management. The provincial RCCU also transacts the capital clearance and capital settlements for the RCCs.
- (v) The provincial RCCU provides business guidance and information exchanges. It offers timely information for the capital demand, and encourages the floatation of loans between RCCs.
- (vi) The provincial RCCU is responsible for the protection of the legal rights of the RCCs.
- (vii) The provincial RCCU is responsible to perform other administrative functions authorized by the provincial government.

12. The provincial RCCU should carry out the administrative responsibilities on the RCCs in conformity with relevant laws and regulations. And it should respect the operational rights of the RCCs.

13. The provincial RCCU should observe relevant regulations when making capital adjustments between RCCs. The adjustments with no sound reasons are forbidden.

14. The provincial RCCU should supervise on the reform of the RCCs with high risks, and guides the RCCU of the county level on their risk control management. The county RCCU should be responsible for the prevention and disposal of financial risks of the local RCCs.

15. When the RCCs have to deal with emergency payment risks, the provincial government should start to implement its risk disposal plan and report to the provincial government, CBRC, and PBOC immediately. Under the leadership of the provincial government and with the help of CBRC and PBOC, the risk should be disposed through the capital arrangement organized by the provincial RCCU.
If the emergency payment risk is small, the county RCCU may ask for the deposit reserve from the branch of PBOC; if the risk is large and the deposit reserve is not sufficient in dealing with the risk, the provincial RCCU will apply for an urgent loan from the branch of PBOC on the premise that the provincial government will return the loan.

2. The responsibilities of CBRC

16. CBRC and its branches are responsible for the supervision of the RCCs.

17. The supervisory responsibilities of CBRC for the RCCs:

(i) CBRC and its branches formulate the supervisory regulations in accordance with relevant laws and regulations.
(ii) CBRC and its branches decide the setting up, conversion, extermination and the business scope of the RCCs.
(iii) CBRC and its branches organize the examinations on the spot and supervision off the spot; collect the information and evaluates the risks; check the unlawful financial behaviors inside the RCCs; set up the supervision and risk control system of the RCCs; determine the examination frequency, scope and other measures needed.
(iv) CBRC and its branches evaluate and supervise on the qualifications of the senior management staff.
(v) CBRC and its branches provide the supervisory information and data to the provincial government, warn the institutions of their potential risks and assist the provincial government to dispose the risks.
(vi) CBRC and its branches provide training for the senior management staff from both the provincial government and the provincial RCCU.
(vii) Entrusted by the State Council, CBRC and its branches supervise on the administration of RCCs done by the provincial government and report to the State Council.

18. The responsibilities of CBRC and its branches in the disposal of risks

(i) According to the requirements in “The China Banking Regulatory Regulations”, CBRC and its branches examine and evaluate on the risk status of RCCs periodically; divide the RCCs into different categories and supervise accordingly; and report the evaluation results to the provincial government and PBOC. With regard to the RCCs with higher risks, CBRC and its branches require reforms on them, and supervise the provincial RCCU on the reform and risk disposal measures.
(ii) With regard to the RCCs with a capital adequacy ratio lower than 2% and with higher risks, CBRC and its branches require them to reform within a certain deadline. For the RCCs that cannot meet the requirements even after the reform, CBRC and its branches will adopt the following measures: (1). Stop part of the businesses conducted by the RCCs and disallow new businesses. (2). Restrict the distribution of profits among their shareholders. (3). Restrict the transfer of their assets. (4). Order the controlling shareholders to transfer their warrants or restricts the warrants of relevant shareholders. (5). Rearrange the board of directors and senior managers or restrict their rights. (6) Stop the setting up of branches of such RCCs.
(iii) For the RCCs that still carry a high risk after the application of the above measures, the following measures may be adopted: close, taking over and restructure the RCCs. The specific measures will be formulated by CBRC and other relevant institutions.
(iv) CBRC and its branches will close the RCCs that cannot be remedied. CBRC and the provincial government will make a joint announcement of the closure of the

RCCs and the closure will be done by the provincial government in accordance with “The Regulations on the Closure of Financial Institutions”.

(v) If there are paroxysmal criminal financial cases in RCCs, CBRC and its branches will report to the provincial government and PBOC immediately, and assist with the disposal of the cases in accordance with the emergency disposal plan.

19. CBRC and its branches should clarify their supervisory rights and publicize their supervisory procedures.

3. The responsibilities of People’s Bank of China

20. According to item 32, “Law of People’s Bank of China”, PBOC should be responsible for the supervision and evaluation on the implementation of the regulations by the RCCs on deposit reserve, special loan allocation, RMB and foreign exchange, loaning between the banks, security market between the banks, clearance and money-laundry prevention, etc.

21. During the period of reform, PBOC will supervise and examine on those RCCs that applies for the redeemable bills and special loans.

22. Based on the reports from CBRC and its branches, PBOC will track down on the risk changes of the RCCs and keep an eye on their risk control and the implementation of the risk disposal plan done by the provincial government, provincial RCCU and CBRC.

23. When a partial payment risk takes place in a RCC, PBOC should provide immediate capital support in accordance with certain regulations. The procedure of the capital support is: the county RCCU applies for the application of the deposit reserve; the provincial RCCU applies to PBOC for the emergency loan, for the payment of which the provincial government should be responsible.

24. When the RCC encounters an emergency payment risk, PBOC should cooperate with the provincial government to formulate the emergency plan, examine the application for the deposit reserve and emergency loan and gives timely approval.

25. When a RCC is closed, the provincial government is responsible for the assets realization of the RCC and pays for the lawful debt. If the assets are insufficient in paying off the debt, the provincial government will apply for a temporary loan from PBOC.

The appended drawings

26. This document applies to the pilot areas in the reform of RCCs.

27. This document will be implemented by CBRC and PBOC under the approval of the State Council.

SUPPLEMENTARY APPENDIX 3: STATE COUNCIL DOCUMENT 66 [2004], OPINIONS ON THE DEEPENING OF RCC REFORM IN PILOT AREAS FROM THE OFFICE DEPARTMENT OF THE STATE COUNCIL

Unofficial Translation

1. People's Government of provinces, autonomous regions and municipal cities, departments and divisions of the State Council:

2. According to State Council Document [2003] 15 (abbreviated as the Pilot Scheme in the following text), and approved by the State Council, Pilot Reform has been carried out in 8 provinces (municipal cities), namely, Jilin, Shangdong, Jiangxi, Zhejiang, Jiangsu, Shanxi, Guizhou and Chongqing. In the past year, the reform has gone smoothly and made significant progress. To boost the RCC reform, to deepen the reform in 8 pilot provinces (municipal cities), and to extend the pilot areas, the following opinions are presented under the approval of the State Council:

3. The pilot experience in 8 provinces (municipal cities) should be carefully reviewed and the guiding principles of the Deepening of RCC reform should be clarified.

4. According to the Pilot Scheme and the requirements of the State Council, under the arrangements of the people's government of the provinces (municipal cities) and the supervisions by the relevant departments, the pilot reform has achieved a preliminary success:

   1. A new supervisory administrative system is framed. The supervisory responsibilities for the RCCs are further clarified.
   2. The historical debts of the RCCs are partly resolved and the operations of the RCCs are bettered.
   3. The RCCs are more competitive which results in their increased support and financial services to the rural sectors.
   4. The reform of ownership structures in the RCCs has been started and operational mechanism is beginning to be transformed and the internal control system is being strengthened.
   5. The RCCs are enjoying a better reputation and their staffs are more conscientious, which will facilitate the future reform.

The useful experiences in the pilot reform:

1. The local government paid great attention to the pilot reform.
2. The relevant departments have made great cooperation to implement the supportive policies.
3. The provincial administrative institutions have been set up within a short time.
4. The regulations were set up first to guarantee the regulated and ordered reform.
5. The detailed work was carried out in accordance with the schedule.
6. The pilot reform has been carried out as well as the supervisory admistration, risk prevention and support to the rural sectors.

There are also new situations and problems emerged during the reform:

1. Who should be responsible for the supervision of the RCCs after the provincial government takes over the regulatory responsibilities of the RCCS?
2. How to set up a perfect legal person management system under the different ownership structures to guarantee a better service to the rural sectors?

3. How to transform the operational mechanism of the RCCs effectively and how to strengthen the credit risk management?

5. These problems will be solved gradually with the deepening of the reform.

The guiding principles for the Deepening of RCC Reform in pilot areas are:

6. The management system and the ownership structure of the RCCs should be bettered to improve their internal control and to transform their operational mechanism, which will enable the RCCs to become a self-operated, self-disciplined, self-developing and risk-taking local community financial institutions serving for the farmers, agriculture and rural economy, directed by Deng Xiaoping Theory and "Three Representatives", guided by the sixteenth party meeting and the third session of the sixteenth congress, oriented by the market economy, centered on the service for agriculture, rural communities and farmers, and under the general requirements of "The ownership structure should be clarified, the internal control system should strengthened, the service should be bettered with the support from the national government and the local government should take the responsibility", and with the chief purpose of "better the rural financial services and increase support to the rural sectors".

7. The deepening of RCC reform in the 8 provinces (municipal cities) should be carried on.

8. The supervisory responsibilities should be clarified.

9. According to State Council Document [2004] 48, the people's government of the 8 provinces (municipal cities) should formulate regulations on the RCC administration and risk control regulations in detail and point out the one that should be responsible for the risks and how to dispose the risks. The provincial government should regulate the RCCs but does not intervene their daily operations with respect to the RCCs' legal person status and rights of independence. The provincial government encourages the governments of city and county levels to play a positive role in the development of rural finance but does not pass the administrative rights to them. The provincial government plays the following functions to the RCCs: administration, guidance, cooperation and service. Meanwhile it helps the RCCs to develop the ability of self-management. CBRC and PBOC should help the provincial government to supervise the RCCs. The provincial government, CBRC and PBOC should supervise and evaluate on the risks of RCCs and take measure (warning, termination, take-over and restructuring) to prevent and resolve the risks.

10. The ownership structure reform should be deepened to form an RCC legal person management system.

11. After the pilot reform, the basic ownership structures of RCCs have been framed. The key work for the next stage is to set up a reasonable, scientific and effective legal person management system.

12. To perfect the ownership structure. The RCCs should set up a reasonable minimum starting amount for shares with considerations to local practicalities to attract more investors who are interested in the RCCs, including big cultivators, private enterprise owners and enterprises with legal person status and to improve the RCCs' decision-making and management. There are two things to be watched: on one hand, the RCCs should not be controlled by some big shareholders due to the concentration of shares; on the other hand, the shares should not be too decentralized so that the RCCs are controlled by staff members.

13. A sound legal person management system should be set up in the RCCs in accordance with the requirements for modern enterprises. The legal person management system should have decision-making, execution and supervision in a balance with responsibilities and rights clarified. To build an effective legal person management system for RCCs in rural China, we should be innovative and decisive.

14. The regulations should be bettered. The working procedures and regulations should be formulated scientifically to increase the transparency of decision-making and to improve the operational efficiency.

15. The operational mechanism should be transformed to improve the management efficiency.

16. The internal control system should be perfected along with the ownership structure reform. For all the RCCs with different ownership structures and different organizational modes (including financial institutions converted from RCCs), a set of internal control regulations with appropriate incentives, strict control, clear responsibilities, rewards and punishment system should be set up. The employment system should be reformed to make it more effective in that all the staff members should be evaluated and the competent staffs will be employed. The salary system should be reformed to make it an incentive for the employees. The risk control system should be bettered and the crediting should be observed with great care. There should be more training provided to improve the competency of the staff. New staff of talents should be hired into the RCCs and senior executive staff should be hired publicly to guarantee the quality of management.

17. The rural finance service should be bettered to increase support to the rural sectors.
RCCs should improve their rural financial services and increase their support to the rural sectors. No matter what kinds of ownership structures and organizational forms they have, they should be serving for the rural sectors. The credit capital of the RCCs should mainly serve for the needs of the local agriculture and farmers. Even those RCCs that have been converted into joint stock regulations should allocate a certain percentage of capital to be used in the rural sectors. The rural microfinancial credit should be enforced and the guaranteed loans should be further developed. The settlement system of the RCCs should be improved by: the development of modern payment instruments such as bankcards and the exploration of new financial services for the farmers, including insurance agent, securities, private financial management and information consultations. The relevant divisions in the State Council and the local government will abolish unreasonable restrictions and regulations on RCCs to enlarge the capital source of the RCCs, to improve their services to the rural areas and to create a beneficial environment for the development of RCCs.

18. The supportive policies should be implemented.

19. All the relevant departments should cooperate and implement the supportive policies in accordance with the Pilot Scheme and other regulations. All the policies that were raised by the 8 provinces (municipal cities) should also be implemented as soon as possible. CBRC should study the approaches to return the postal savings to the rural areas and choose pilot areas to test these approaches. PBOC and other relevant departments should offer solutions for the providing of financial services to poor and remote areas. All these will serve for the rural financial reform.

20. The pilot areas of RCC reform should be extended.

21. Arranged by the State Council, volunteered by themselves, and evaluated in accordance with strict principles, 21 provinces (regions or municipal cities) are included in the pilot areas for the deepening of RCC reform, namely, Beijing, Tianjin, Hebei, Shanxi, Inner Mongolia, Liaoning, Heilongjiang, Shanghai, Anhui, Fujian, Henan, Hubei, Hunan, Guangdong, Guangxi, Sichuan, Yunnan, Gansu, Ningxia, Qinghai and Xinjiang.

22. All the provinces (regions or municipal cities) that are included in the pilot areas should carry out the following tasks in accordance with the Pilot Scheme:

1. The ownership structure should be reformed to set up a legal person management system. In terms of ownership structures, the RCCs can adopt shareholding system, shareholding-cooperative system or cooperative system. In terms of organizational forms, some of the RCCs can be converted into commercial banks. The Rural Cooperative Banks and other financial institutions in the same county or city can have a unified legal person or they can still adopt the system in which the RCCU at the county or township levels is the legal person. Those insolvent RCCs or RCCs that locate in urban or suburban areas and offer little support to the rural sectors can be terminated in accordance with "The Regulations on the Termination of the Financial Institutions".
2. The reform of the administrative system of the RCCs. The provincial government should be responsible for the administration of the RCCs. The administration of the RCCs should follow the following guiding principles: the national government exercises massive control and supervision; the provincial government takes the responsibility of supervision; the RCCs exercise self-discipline on themselves and take risks by themselves.
3. The transform of the operational mechanism of RCCs and the betterment of support to the rural sectors. The reform should be aimed at the betterment of support to the rural sectors. Therefore the internal control system should be strengthened and the operational mechanism should be transformed.

23. The supportive policies by the central government should be carried out in accordance with the *Pilot Scheme*. There are some small adjustments made. The central government subsidies the RCCs that suffered losses during 1994-1997 due to the inflation-proof interests provided. From January 1, 2004 to the end of 2006, all the pilot RCCs in the middle and west area will be free of income tax. The income tax of other RCCs will be half reduced. From January 1, 2004, the sales tax of the pilot RCCs will be collected at the rate of 3%.

24. The pilot RCCs will still have the access to the special bills issued by PBOC or central bank special loans. The special bills will be used solely for the displacement of non performing loans of the RCCs and the coverage of the accumulated losses.

25. The deepening of RCC reform will be led by the State Council and implemented by CBRC. In accordance with the *Pilot Scheme* and this document, the people's governments of the 21 pilot provinces (regions and municipal cities) should set up RCC reform leading groups and formulate implementation plans of the pilot scheme as soon as possible, which will be appraised by CBRC, PBOC, the Financial Ministry, and the Taxation Ministry and implemented under the approval of the State Council. The reform of the administrative system should be done by the end of the year. The reform on ownership structures and the transformation of operational mechanism will be progressed in accordance with the local practicalities.
Meanwhile, the relations between reform, development and stability should be dealt with properly to guarantee the normal business and administrative operations of the RCCs. Proper propaganda measures should be taken to encourage the participations and support to RCC

reform. Payment risks should be prevented and disposed properly to maintain the stability of the reform. These things should be kept an eye on and prevented: the employment of the extra staff and the unreasonable promotion of administrative staff by using the reform as an excuse, the careless money squandering and other moral delinquencies. The capital and assets should be checked strictly; the debts should be recollected while the responsibilities should be clarified and the crimes should be punished severely. Special attention should be paid on the support to the rural sectors during the reform period to maintain the sustainable development of agriculture and rural economy.

SUPPLEMENTARY APPENDIX 4: THE GUIDING PRINCIPLES AND MAIN OBJECTIVES OF REFORM FOR THE RCC SYSTEM IN INNER MONGOLIA AUTONOMOUS REGION
Unofficial Annotated Translation

1. The guiding principles established for the reform of the RCC system are: (i) The operation of RCC should be in accordance with the codes of the market economy; the ownership should be clarified; the governing agent should be A legal person; the RCC should be a market *(market-driven)* subject with the capacity of operation, discipline, development and the management of risks. (ii) The RCC is dedicated to assist farmers, herdsmen and small and medium enterprises in rural districts. Therefore it should offer financial support to the rural area. (iii) The organization and operation of RCC should be in accordance with the local condition; the possible composition of ownership may include joint stock, cooperation, and joint stock and cooperation. (iv) The RCC should have a sound supervision system with the support from the local government, the supervision division of the bank, the national bank and RCC for a better management of risks. (v) The endowment insurance of RCC should be guaranteed; the operation and the staff should be stable.

2. The main objectives to be achieved within three years include: (i) the establishment of a sound management system. The development of a sound supervision system to be set up by the end of August in 2005 and composed of: (a) The Supervision Division of the National Bank (now the CBRC), (b) The Inner Mongolia Government and, (c) the RCC itself. (ii) The reform of the rights of ownership. The first attempt will include 2 rural commercial banks and 6 rural cooperative banks. Then all the banks will be reformed into rural commercial banks or cooperative banks if possible. (iii) The enlargement of rural financial services.

3. By the end of 2006, the balance of deposit will be more than CNY 50 billion and the total amount of loans will be CNY 30 billion, 2.5 times of the two items compared with 2002. The annual loan to agriculture and animal husbandry will take 70% of the total loan, 10% more than that in 2002. 4. the improvement of efficiency. By the end of 2006, the non performing loan rate will be lower than 15%; the capital adequacy ratio higher than 8%; the accumulated loss within 2% of total capital.

A. The main aspects of the RCC reform

The reform of the management system of RCC under the responsibility of the IMAR Government.

4. The IMAR Government is to be responsible for the guiding principles and major plans of RCC reform. It is to supervise RCC operations through its observation of the respective financial and administrative laws, guide the RCC for better customer service, and evaluate its operation. The IMAR Government will not intervene with the daily operations or performance of RCC. The senior management is to be recommended by specific organizations, evaluated by the supervision division of the national bank (the CBRC) and approved through regular procedures. The evaluation of the senior management will be conducted by the IMAR Government. The IMAR Government helps with the investigation of any crimes in RCC, the recover of bad debt, and the maintenance of the stability of the rural financial market. It will assist in risk management and the restructure of non-performing assets of RCC; the rights of management over RCC solely belong to the IMAR Government, not the government of the leagues, cities, banners or counties. The management of RCC is not to be intervened by the government of the leagues, cities, banners or counties.

B. The setup of the new RCCU of IMAR (ARRCCU)

5. The yet to be established RCCU of the IMAR province (herein labeled as the IMRRCU) is to be the financial institute composed of the existing 88 RCCUs with the qualification of independent legal person. The IMRCCU will have the following functions: (i) the forging and supervision of the following management regulations: basic rules, operational rules, rules of

appraisal, employment rules, rules of distribution, and risk management; (ii) the forging and supervision of the following operational rules: the legal person managing structure, the checks and balance of decision-making, execution and supervision, and the combination of motivation and discipline; (iii) the selection of the management; the training and checking of the managing tasks, including the operation, financial activities, employment, social securities and the internal welfare; the training of the stockholders and the representatives of RCCs and RCCUs to improve their ability of decision-making; the improvement of the technical system to improve efficiency; the providing of the financial information to enhance the circulation of the capital.

C. The reform of the rights of ownership of RCC

6. For the program to set up rural commercial banks (also known as RCBs); it is proposed that two rural commercial banks will be set up in Keqin, Tongliao and Dongshen, Erdos. Different measures will be adopted such as the increase of stocks and the decrease of the non performing loans.

7. For the program to set up rural cooperative banks (also know as RCOBs); it is proposed that 6 rural cooperative banks will be set up in suburban Hohhot, suburban Baotou, Manzhouli, Hailer, (Hunl Bir), Yuanbaoshan(Chifeng), and Naiman(Tongliao). These banks are appropriate to be selected in that they are sufficient in assets and equity capital.

8. In the setup of unified legal persons, there will be 30 rural commercial banks and rural cooperative banks with the unified legal person by the end of 2005, and all the banks will achieve this goal by the year 2006. The guiding principles are: the banks will have the unified legal person and the right to manage. The evaluation of the banks will be conducted respectively.

D. The increase of shares and the decrease of non performing loans

9. To increase the shares, there are several approaches: regulate the management of the shares; ensure the appropriateness of the standard and ratio of qualification shares and the investment shares; check the original shares; encourage the input of the natural person, the legal person of enterprises and other organizational forms.

10. To decrease the non performing loans, there are several approaches: use the notes issued by the central bank to replace the non performing loans; set the appropriate loan cycle according to the cycle of the local agriculture and animal husbandry; decrease the ratio of non performing loans by enlarging the total amount of loans.

E. Improvement of the legal person management system and management practices

11. In the program for the improvement of the legal person management the following steps will be taken: Firstly, the RCC staff should not only be composed of farmers and herdsmen, but also the owners of SMEs who have a better understanding about the management of the system. Secondly, the shares should not only be composed of the qualified shares from farmers and herdsmen, but also the investment shares from owners of enterprises to guarantee a better supervision on the bank. Thirdly, the RCCU should have a director general, a manager and a supervisor, who are in charge of three different branches. Fourthly, there should be a sound supervision system.

12. In the program for the improvement of the management mechanism the following steps will be taken: Firstly, the staff should be employed for their excellence instead of special relationships with a certain leader. Secondly, every staff member should be very clear about their own rights and responsibilities. Thirdly, there should be a sound evaluation system.

F. The Improvement of service for the peasants, rural areas and the agriculture.

13. The ultimate purpose of RCC is to provide services to the peasants and to be helpful to the development of agriculture. RCC will continue to offer its microfinance credit and mutually guaranteed loans to the peasants, and to keep a control over the growth of informal (and illegal) credits in the rural financial sector. Theoretically, 80% of the total loans granted by an RCC should be provided to the rural area.

G. The supporting policies issued by the government

14. The implementation plan for the reform of the RCC system calls for the state and local governments to provide the following support:

15. A financial subsidy provided by the national government for the rural credit cooperatives that suffered losses for inflation proof savings deposits. From 1994 to 1997, the rural credit cooperative suffered a loss of CNY 58.4 billion due to the special policy. This loss will be recovered by the Ministry of Finance of PRC within three years.

16. Tax deductions and exemptions. There will be no income taxes for RCCs from January 1, 2004 to the end of 2006. From January 1st, 2004, there will be sales tax for the RCCs. The normal tax rate is 3%.

17. By the end of 2002, there were 1,087 RCCs suffering from insolvency. The amount of insolvency is calculated at CNY 2.73 billion. According to the national policy, these RCCs can get a capital support for 50% of this amount or CNY1.37 billion. In IMAR, CNY 930 million of the non-performing loans and CNT 440 million of the open account operational losses over the years can be 'replaced' (i.e. paid off through this support).

18. A flexible (floating) interest rate policy has been initiated. In some areas, except for microfinance credit and areas afflicted by natural disasters, the interest rate can be floating in accordance with the national regulations.

19. Supportive policies by the government of the IMAR and other official agencies

20. A total of CNY 10,000,000 is to be provided to the reform of the rural credit cooperatives for liquidation of non-performing loans, asset evaluation, financial checking, staff training and advertisement. Reportedly this sum of money is not to be used for the direct compensation of losses. A *'risk control fund'* is to be created and allocated for the RCCs in IMAR. The sales tax income received from RCCs in IMAR in 2004 will be a base line. In the 10 years after 2005, all the exceeding sales tax compared with the base year of 2004, will be consolidated into this fund controlled by the IMAR government. This fund will be mainly used for the future risk control of RCCs in IMAR. The policy follows the example of the pilot program of Jiangsu Province and is seen as a way for the local government to raise money for the purpose of risk control. The fund is set up on the basis of total income tax of 2004. From 2005 on, the exceeding sum of income tax will be used consolidated to control the possible risk.

21. Help with the resolution of non performing loans. For the non performing loans which are owed by the governments and officials of various levels, the local government will help to resolve through various administrative and legal procedures.

22. Regulation of the evaluation and due diligence of the RCCs. All the evaluation and due diligence should be approved by the IMAR government except for the evaluation done by the China Banking Regulatory Commission and the Central Bank.

23. Support to the service expansion of RCCs. All the limitative and discriminative regulations against RCCs will be cancelled. The endowment insurance and rural fund will be encouraged to open an account in the RCCs. The RCCs will be agencies for the sanction loans, poverty reduction loans, and fiscal supporting fund. Some postal savings accounts will be transferred to the RCCs according to a certain ratio.

H. The leading agent and the general framework

1. the leading agent

24. The implementation of the reform of the pilot RCCs in IMAR will be under the direct leadership of the IMAR government. There will be 5 leading agents, composed of specialists from Inner Mongolia Banking Regulatory Commission, People's Bank of China, Hohhot Branch, IMAR Government Financial Office, Financial Administrative Bureau, Taxation Bureau, Land Tax Bureau, Construction Bureau, Propaganda Bureau, and the Development Bank Inner Mongolia Branch, chaired by the vice chairman of the standing committee of Inner Mongolia

Government. There will also be the leading teams from the various league, township and county level.

2. The arrangement

25. Before the end of December 2004, a report will be submitted to the State Council the implementation framework of the pilot RCCs. In January 2005, there will be an allocation meeting for the reform of RCCs.

26. The asset evaluation of the RCCs. From December 2004 to January 2005, the asset evaluation of all the RCCs in IMAR will be finished. The RCCs of the township and county level will perform an internal asset evaluation before the end of December 2004; the leading group for the reform of RCCs will choose several RCCs in IMAR and perform the final check.

27. The setup of the RCCU of IMAR. The application of RCCU of IMAR will be sent to the State Council. It is expected that the RCCU of IMAR will start its operation in March 2005. The government is not allowed to intervene with the management of RCCUs. This super RCCU does not provide loans or doing any kinds of services, instead it plays a role of government management, including policy implementation, allocation of Risk Control Fund, etc

28. A review over the pilot areas will be done before June 2005.

29. Set-up pilot RCCs for the reform of ownership structure. Make sure the implementation of the supporting policies.

30. Review over the reform of all the RCCs in IMAR during the latter 6 months of 2006.

31. Keep the integrity between reform, development and stability of the RCCs. Corruption and crime should be watched over in the course of reform and development of RCCs.

SUPPLEMENTARY APPENDIX 5: PROVISIONAL REGULATIONS ON THE ADMINISTRATION OF RURAL COMMERCIAL BANKS

Unofficial Translation

China Banking Regulatory Commission

- **GUIDING PRINCIPLES**

Article 1 Rural Commercial Bank is defined as a share-issuing local financial institute, initiated by farmers, enterprises, legal entities and local financial institutes. It functions in providing financial services to farmers and promoting harmonious development of local economy.

Article 2 Rural Commercial Bank is established on the basis of RCCs and the RCCU on county level..

Article 3 Rural Commercial Bank is legally independent, who possesses all rights that an independent legal person holds. Entire capital is divided into shares of equal value, where the shareholders bear responsibilities to the bank to the extent of the number of the shares they hold and the bank bears responsibilities for its debts with all its assets.

Article 4 Shareholders of Rural Commercial Bank are entitled by law the rights of participating important decisions and selecting managers.

Article 5 The management principles of Rural Commercial Bank are profitability, security and liquidity through independent management, risk-control and self-restriction.

Article 6 Rural Commercial Bank shall be responsible to guarantee the legal rights of depositors not to be intruded by others.

Article 7 Rural Commercial Bank is obliged to observe laws and regulations, implement central governmental policies and accept supervision from PBRC.

- **INSTITUTIONAL SETUP**

Article 8 To establish a rural commercial bank, following requirements have to be satisfied:

a. The number of initiators shall be no less than 500.
b. The registered share capital shall be no less than RMB 50,000,000 Yuan and a minimum capital adequacy rate of 8%
c. Total assets of all RCCs in the region shall be over RMB 1,000,000,000 Yuan and non-performing loan rate shall be under 15%.
d. Senior management personnel shall have sufficient professional knowledge and relevant working experience.
e. A sound organizational structure, management and risk control system.
f. Proper business premises, safety measures and other facilities for business operation.
g. Other requirements set out by the China Banking Regulatory Commission.

Article 9 The Rural Commercial Bank is established by means of promotion. Promoters or initiators buy all the shares issued by the Rural Commercial Bank. The RCCU shareholders remain to hold shares in the transformed RCB and new shareholders, such as farmers, small private-owned businesses, enterprises and other financial institutes, are allowed to invest.

Article 10 To prepare establishing of a rural commercial bank, the RCCU shall subject to the approval of the local branch of CBRC, and when the application is approved by both county and provincial (or autonomous region) branches of CBRC. The China Banking Regulatory Commission, upon receiving a complete set of application documents for the preparation of a Rural Commercial Bank, shall provide its decision of approval or denial in writing within three months.

Article 11 The application document for a rural commercial bank shall include:

a. Application Letter.(including name of the bank, location of the Bank, registered capital, business scope, etc.)
b. Practicability Analysis Report
c. Establishment Scheme
d. Name-list and resumes of personnel in charge of establishment preparation.
e. Balance Sheet and Profit & Loss Statement in the recent three years.
f. Other documents required by China Banking Regulatory Commission.

If the applicant fails to apply for business commencement upon the completion of the preparation stage in six months from the date that the approval is issued, the original approval document for the preparation shall become void automatically, and the applicant is not allowed to re-apply in 3 months.

Article 12 When the preparation is finished, the RCCU shall apply for business commencement to the China Banking Regulatory Commission with the following attachments:

a. An application letter for business commencement.
b. A report on completion of the preparation.
c. Proposed business rules and procedures and internal controls
d. A certification of paid-in capital issued by a qualified Chinese certifying agency.
e. Names and detailed resumes of proposed senior managerial personnel
f. Other documents required by the China Banking Regulatory Commission.

The approval procedures are the same with Article 10.

Article 13 If the application is approved, the applicant shall receive a license to conduct financial business with the prescribed business scope issued by CBRC provincial branch (or autonomous region). The applicant shall, before commencing operations, register with the State Administration of Industry and Commerce with the presentation of the license to conduct financial business, and receive a corporate legal entity business License.

Article 14 On demands of business expansion, the Rural Commercial Bank can set up sub-branches, agents and operational institutes. The Bank shall appropriate proper amount of operational funds to all subsidiaries of the Bank concerning their respective size of business. The total operational funds appropriated shall not exceed 60% of the total capital of the Bank.

Article 15 To set up a subsidiary, the Bank shall submit to audit by CBRC local branches (on county level) and be approved by CBRC provincial branch.

- **EQUITY STRUCTURE**

Article 16 Share capital of Rural Commercial Bank is composed of natural person shares and legal person shares.

Article 17 All shares issued by Rural Commercial Bank have the same face value. One share equals to RMB 1 Yuan.

Article 18 Among all the shareholders, one nature person shall not own over 5‰ of the total, one independent legal person and its associated enterprises shall not own over 10% and the maximum percent of shares held by bank's personnel is 25%.

The associated enterprises refer to one or several enterprises that are under direct / indirect control or under decisive influence of the same legal person.

The board of directors of Rural Commercial Bank shall submit a name-list of top 10 shareholders to local supervisional institute in time.

Article 19 Apart from the original RCCU shareholders, who remain to be shareholders of the Bank by reappraising the capital and assets and reevaluating the value of total share capital owned, initiators of the Bank shall buy shares by cash without installment.

Article 20 Initiators are not entitled to sell the shares they hold in three years from the date a rural commercial bank is established.

Article 21 Before using bank shares as security for oneself or other person, Shareholders is obliged to apply to Board of Directors in advance for permission. The directors, supervisors, manager, and deputy manager are not prohibited to transfer or pledge their shares during the period when they are in the post.

- **ORGANIZATIONAL STRUCTURE**

Article 22 Representative Assembly of Shareholders owns the highest authority in the rural commercial bank.

Article 23 Representative Assembly of Shareholders assumes following functions:

a. Constitute and revise Articles of Association.
b. Discuss and approve Rules of Procedure for Representative Assembly of Shareholders.
c. Elect or change board members of directors and supervisors. Both director and supervisor candidates shall be shareholders. Decide affairs such as salary for board members, etc.
d. Discuss and approve working reports of Board of Directors and Board of Supervisors.
e. Discuss and approve bank development program, operation and investment schemes.
f. Discuss and approve annual financial budget and actual budget of the rural commercial bank; decide schemes of profit distribution and loss recovery.
g. Make decisions on increase or decrease registered capital.
h. Make decisions on affairs of bank separate, incorporation, closure, liquidation, etc.
i. Decide other important affairs.

Article 24 Board of Directors is responsible for summoning annual Representative Assembly of Shareholders within six months after each financial year. If any of the cases appear, as specified in *Article 104* of *The Company Law of the People's Republic of China,* a provisional assembly shall be held.

Article 25 Shareholders of the Assembly vote in accordance with number of shares they hold. One share, one vote. An attorney entrusted by a shareholder is permitted to present the assembly and vote, on condition that a written letter of attorney is submitted to Board of directors.

Article 26 Any decision made by the Assembly shall be approved by over half of votes held by the representatives. Any decision concerning changes of Articles of Association, bank incorporation, seperate, closure, or liquidation shall win at lease 2/3 of the total votes held by the representatives present.

Article 27 A complete copy of documents and records of the Assembly shall be submitted to CBRC local branch.

Article 28 A rural commercial bank shall have seven to nineteen directors in the board, elected by the Representative Assembly of Shareholders. At lease 1/4 of the board

members shall be bank personnel but not exceeding 1/3 of the total number of directors. At lease 1/4 of the board members shall be elected from natural person shareholders outside of the bank personnel. A single term lasts three years and directors can be re-elected and re-appointed.

Article 29 Board of Directors in a rural commercial bank shall have independent directors. Independent directors make decisions and judgment free from any extent of influence from major shareholders. An independent director shall perform his function on behalf of depositors and shareholders with relatively small amount of shares.

Article 30 Board of Directors has one chairman and one or two deputy chairmen. The chairman is the legal representative of the bank. Both chairman and deputy chairman can be re-elected and re-appointed. Before leaving the post, there shall be internal auditing.

Article 31 Board of Directors holds responsibility for Representative Assembly of Shareholders and performs following functions:

a. Summon Representative Assembly of Shareholders and report to the Assembly
b. Implement decisions of the Assembly
c. Discuss and approve operation and investment scheme of the Bank
d. Constitute annual financial budget, actual budget, profit distribution and loss recovery.
e. Propose scheme for increasing or decreasing registered capital.
f. Appoint or dismiss bank manager and based on the manager's proposal, appoint or dismiss deputy manager, head of financial officer, head of loan officer and decide salaries of these personnel.
g. Propose schemes of bank separate, incorporation and closure.
h. Other functions regulated in the Articles of Association.

Article 32 Board of Directors shall hold at lease four regular meeting per year. The chairman summons and presides the meeting, and inform Board of Supervisors to attend the meeting as non-voting representatives.

Directors of rural commercial bank (including independent director) shall attend meeting at lease two times per year. On the approval of shareholders' assembly, if any director violates this article, his qualification as being a director can be void.

Article 33 The election of directors shall be open and strict. Every shareholder shall be fully informed about the resume of candidates one month before the Assembly is held.

Article 34 Any decision made by Board of Directors shall be signed by directors in person and a copy of relative documents shall be submitted to CBRC local branches 10 days after the meeting.

If the decision violates relevant laws and regulations so that the rural commercial bank subjects to severe losses, the decision makers shall be responsible to compensate the losses.

Article 35 A written report is required to the CBRC when Board of Directors dismisses a manager within his term. Without manager's nomination, Board is not allowed to appoint or dismiss deputy manager, head of financial officer and loan officer.

Article 36 The rural commercial bank has one manager and one or two deputy managers, appointed or dismissed by Board of Directors. The manager holds responsibility for Board of Directors and performs following functions:

a. Nominate or propose dismiss candidate of deputy manager, head of financial officer, head of loan officer and other senior managerial personnel.
b. Appoint or dismiss other personnel apart from the ones specified in Article 36-a and senior managerial personnel in sub-branches.
c. Represent senior managerial level to propose operation and investment scheme to Board of Directors, and implement the scheme on approval.

d. Entitle authority to senior managerial level, internal functional divisions and managers of sub-branches to operate business.
e. Take immediate measures when urgency occurs and report to Board of Directors and Board of Supervisors instantly.

Article 37 One single term for a manager and a deputy manager is three years and both manager and deputy manger can be re-appointed and re-elected. The chairman of Board of Directors shall not be appointed as manager of the bank.

Article 38 The manager of rural commercial bank is submit to annual audit from carried out by Board of Supervisors, which result shall be open to Board of Directors and Representative Assembly of Shareholders. Before leaving the post, both manager and deputy manager are submit to special audit.

Article 39 The rural commercial bank shall have five to nine supervisors in the board, which is elected among staff representatives and shareholder representatives. No more than 1/3 of the supervisors is from bank staff, elected by General Assembly of Bank Staff. Other supervisors are elected by Representative Assembly of Shareholders. One single term of a supervisor is three years and supervisors can be re-elected.

Directors, bank manager, deputy mangers, head of financial officer and head of loan officer shall not be elected as supervisors.

Article 40 Board of Supervisors performs following functions:

a. Supervise the performance of Board of Directors and senior managerial personnel.
b. Urge directors, chairman and senior managerial personnel to regulate their behavior that brings losses to the Bank.
c. Carry out annual audit and special audit for directors and senior managerial personnel
d. Inspect financial operation of the rural commercial bank.
e. Inspect the operation of managerial decisions and measures of risk-control
f. Inquire upon managerial activities of directors and other senior managerial personnel
g. Propose provisional shareholders' assembly.

Article 41 If any suggestion or proposal concerning problem solution to directors and senior managerial personnel is refused or delayed, the Board of Supervisors shall report to local CBRC branch and shareholders' assembly.

Article 42 Qualifications for senior managerial personnel of rural commercial bank shall be approved by China Banking Regulatory Commission.

- **MANAGEMENT AND OPERATION**

Article 43 Business scope of rural commercial bank shall be approved by China Banking Regulatory Commission and be in accordance with *The Law of Commercial Banks for People's Republic of China.*

Article 44 The ratio of liabilities for rural commercial bank shall be decided in accordance with *The Law of Commercial Banks for People's Republic of China.*

Article 45 Rural commercial bank shall establish a complete and sound system of all types of businesses, and constitute relevant rules that staff income shall be based on their working achievement.

Article 46 Rural commercial bank shall set aside a certain proportion of loans given to farmers or support rural economy. The specific proportion shall be decided by Representative Assembly of Shareholders according to the actual situation of local economy, and report the decision to local CBRC branch.

Article 47 Rural commercial bank is not permitted to give credit loans to shareholders, and shareholders shall not have any priority in obtaining collateral loans over other customers.

Article 48 Rural commercial bank applies unified national financial standard.

Article 49 According to relevant laws and regulations, the Bank shall keep a truthful record of its business operations and pay tax in compliance with relevant laws.

Article 50 Rural commercial bank shall send financial statements, statistical documents and other information to China Banking Regulatory Commission. The Bank shall be responsible with the truthfulness, promptness and completion of any document it provides to the CBRC.

Rural commercial bank is supposed to public its financial reports, risk-control measures, operational situation, etc.

Article 51 Rural Commercial bank shall public loans given to shareholders.

Article 52 An annual financial report shall be submitted by the end of each financial year to Board of Supervisors and Representative Assembly of Shareholders. Board of Supervisors shall appoint certified accounting services with CBRC recognition to audit the report, and on the approval of audit result by the Assembly, copies of the report shall be submitted to local CBRC branch and other local banking supervision authorities.

Article 53 The annual financial report shall be submitted to shareholders twenty days before Representative Assembly of Shareholders.

- **INCORPORATION, CHANGE AND TERMINATION**

Article 54 Any change concerning the following items shall subject to the approval of the China Banking Regulatory Commission:

a. Change of name
b. Change of registered capital
c. Change of business premises
d. Change of business scope
e. Change of senior managerial personnel
f. Change of Articles of Association
g. Other changes specified by China Banking Regulatory Commission.

Article 55 Rural commercial bank subjects to operational termination because of dissolution, closure of bankruptcy shall operate in compliance of *The Law of Commercial Banks for People's Republic of China* and other relevant laws and regulations.

Article 56If a rural commercial bank operation terminated because of dissolution and closure of bankruptcy, the license shall be cancelled, which gives certified permission to conduct financial business with the prescribed business scope issued by CBRC provincial branch (or autonomous region). The bank shall also report to the State Administration of Industry and Commerce to cancel the license to conduct financial business. Canceling licenses in both cases shall be informed to the public.

- **LEGAL LIABILITIES**

Article 57 Any establishment of a rural commercial bank without the approval of the China Banking Regulatory Commission shall be banned. If the case constitutes a crime, criminal liabilities shall be investigated. If the case dose not constitute a crime, the China Banking Regulatory Commission shall close the bank and confiscate the illegal earnings.

Any establishment of sub-branches of rural commercial bank without the approval of the China Banking Regulatory Commission shall be banned. The China Banking Regulatory Commission shall issue a warning and impose a fine no less than RMB 50,000 Yuan and no more than RMB 300,000 Yuan. The senior managerial personnel with direct responsibility shall be dismissed.

Article 58 In case of any change specified in Article 54 without the approval of the China Banking Regulatory Commission, the China Banking Regulatory Commission shall issue a warning and impose a fine no less than RMB 10,000 Yuan and no more than RMB 100,000 Yuan. In case of any change of senior managerial personnel without approval, the senior managerial personnel with direct responsibility shall be dismissed.

Article 59 In case of a rural commercial bank being found to engage in business activities beyond its prescribed business scope, the China Banking Regulatory Commission shall issue a warning against the bank, confiscate the illegal earnings and impose a fine in a range of one to five times the illegal earnings. If no illegal earnings are involved, the China Banking Regulatory Commission imposes a fine of no less than RMB 100,000 Yuan and no more than RMB 500,000 Yuan. The senior managerial personnel with direct responsibility shall be dismissed. In a extremely serious case, the license issued by China Banking Regulatory Commission shall be cancelled. If the case constitutes a crime, the criminal liabilities shall be investigated.

Article 60 In case of a rural commercial bank being found in violation of relevant laws and regulations in business like deposit, loan, and clearance, the Bank shall be subject to enforcement actions by relevant regulatory authorities.

Article 61 A rural commercial bank, in case of being found in violation of Article 21, Article 44, Article 47, Article 48, shall be punished in accordance with *The Law of Commercial Banks for People's Republic of China*. If the case constitutes a crime, the criminal liabilities shall be investigated.

Article 62 Staff in a rural commercial bank, in case of being found in violation of relevant laws and regulations to accept bribes or embezzle funds or loans, shall be subject to enforcement actions by relevant regulatory authorities. If the case constitutes crime, the criminal liabilities shall be investigated.

- **SUPPLEMENTARY PROVISIONS**

Article 63 The power of the interpretation for this Provisional Regulations rests with the China Banking Regulatory Commission.

Article 64 The Provisional Regulations takes effect the issuing date.

SUPPLEMENTARY APPENDIX 6: PROVISIONAL REGULATIONS ON THE ADMINISTRATION OF RURAL COOPERATIVE BANKS

Unofficial Translation

China Banking Regulatory Commission

I. GUIDING PRINCIPLES

Article 1 Rural Cooperative Bank is defined as a share-holding local cooperative financial institute, invested by farmers, enterprises, legal entities and local financial institutes. It functions in providing financial services to farmers, promoting economic development of local rural areas.

Article 2 Share-holding local cooperative financial institute refers to the financial institute established on a cooperative basis but applies operating mechanism similar to a share-issuing financial institute.

Article 3 Rural Cooperative Bank is established on the basis of RCCs and the RCCU on county level..

Article 4 Rural Cooperative Bank is legally independent, who possesses all rights that an independent legal person holds. Entire capital is divided into shares of equal value, where the shareholders bear responsibilities to the bank to the extent of the number of the shares they hold and the bank bears responsibilities for its debts with all its assets.

Article 5 Shareholders of Rural Cooperative Bank are entitled by law the rights of participating important decisions and selecting managers.

Article 6 The management principles of Rural Cooperative Bank are profitability, security and liquidity through independent management, risk-control and self-restriction.

Article 7 Rural Cooperative Bank shall be responsible to guarantee the legal rights of depositors not to be intruded by others.

Article 8 Rural Cooperative Bank is obliged to observe laws and regulations, implement central governmental policies and accept supervision from PBRC.

II. INSTITUTIONAL SETUP

Article 9 To establish a rural cooperative bank, following requirements have to be satisfied:

- h. Owns Articles of Association in compliance with the Provisional Regulations.
- i. The number of initiators shall be no less than 1000.
- j. The registered share capital shall be no less than RMB 20,000,000 Yuan and a minimum tier-1 capital adequacy rate of 4%
- k. Non-performing loan rate shall be under 15%.
- l. Senior management personnel shall have sufficient professional knowledge and relevant working experience.
- m. A sound organizational structure, management and risk control system.
- n. Proper business premises, safety measures and other facilities for business operation.
- o. Other requirements set out by the China Banking Regulatory Commission.

Article 10 To prepare establishing of a rural cooperative bank, the RCCU shall subject to the approval of the local branch of CBRC, and when the application is approved by both

county and provincial (or autonomous region) branches of CBRC. The China Banking Regulatory Commission, upon receiving a complete set of application documents for the preparation of a Rural Cooperative Bank, shall provide its decision of approval or denial in writing within three months.

Article 11 The application document for a rural cooperative bank shall include:

g. Application Letter.(including name of the bank, location of the Bank, registered capital, business scope, etc.)
h. Practicability Analysis Report
i. Establishment Scheme
j. Name-list and resumes of personnel in charge of establishment preparation.
k. Balance Sheet and Profit & Loss Statement in the recent three years.
l. Other documents required by China Banking Regulatory Commission.

If the applicant fails to apply for business commencement upon the completion of the preparation stage in six months from the date that the approval is issued, the original approval document for the preparation shall become void automatically, and the applicant is not allowed to re-apply in 3 months.

Article 12 When the preparation is finished, the RCCU shall apply for business commencement to the China Banking Regulatory Commission with the following attachments:

g. An application letter for business commencement.
h. A report on completion of the preparation.
i. Proposed business rules and procedures and internal controls
j. A certification of paid-in capital issued by a qualified Chinese certifying agency.
k. Names and detailed resumes of proposed senior managerial personnel
l. Other documents required by the China Banking Regulatory Commission.

The approval procedures are the same with Article 10.

Article 13 If the application is approved, the applicant shall receive a license to conduct financial business with the prescribed business scope issued by CBRC provincial branch (or autonomous region). The applicant shall, before commencing operations, register with the State Administration of Industry and Commerce with the presentation of the license to conduct financial business, and receive a corporate legal entity business License.

Article 14 On demands of business expansion, the Rural Cooperative Bank can set up sub-branches, agents and operational institutes. The Bank shall appropriate proper amount of operational funds to all subsidiaries of the Bank concerning their respective size of business. The total operational funds appropriated shall not exceed 60% of the total capital of the Bank.

Article 15 To set up a sub-branches, the Bank shall submit to audit by CBRC local branches (on county level) and be approved by CBRC provincial branch.

On the approval of setting up a sub-branch, the Bank shall receive a license to conduct financial business with the prescribed business scope issued by CBRC provincial branch (or autonomous region). The Bank shall, before commencing operations, register with the State Administration of Industry and Commerce with the presentation of the license to conduct financial business, and receive a corporate legal entity business License.

III. EQUITY STRUCTURE

Article 16 Share capital of Rural Cooperative Bank is composed of natural person shares and legal person shares. Both natural person shares and legal person shares have two share options: qualification shares and investment shares. Qualification shares

shall be obtained by paying a fixed amount of cash, while investment shares shall be obtained by additional cash investment.

Article 17 Shareholders shall obtain financial services from a rural cooperative bank with priority. Investment shareholders shall obtain dividends to according to the value of shares they hold.

Article 18 One qualification share equals to one vote. For every natural person shareholders, every 2000 Yuan investment shares adds to one vote; for every legal person shareholders, every 20,000 Yuan investment shares adds to one vote.

Article 19 All shares issued by Rural Cooperative Bank have the same face value. One share equals to RMB 1 Yuan. The minimum qualification shares for a natural person shareholder is 1000; the minimum qualification shares for a legal person shareholder is 10,000.

There is no minimum limit for investment shares.

Article 20 Among all the shareholders, one natural person shall not own over 5‰ of the total, the maximum percentage of shares held by bank staff is 25% and the minimum percentage of natural person shares except bank staff is 30%

Shares held by one legal person and its associated enterprises shall not exceed 10%. Any legal person holding over 5% of the total shares shall submit to the approval of local branch of China Banking Regulatory Commission.

The associated enterprises refer to one or several enterprises that are under direct / indirect control or under decisive influence of the same legal person.

The board of directors of Rural Cooperative Bank shall submit a name-list of top 10 shareholders to local supervisional institute in time.

Article 21 Apart from the original RCCU shareholders, who remain to be shareholders of the Bank by reappraising the capital and assets and reevaluating the value of total share capital owned, initiators of the Bank shall buy shares by cash without installment.

Article 22 Rural cooperative bank shall issue shareholder warrant to each shareholder.

Article 23 Investment shareholders shall transfer or sell their shares but not withdraw unless they hold their qualification shares for three years. Any shareholders who intent to sell or withdraw shares they hold should submit to the approval of Board of Directors.

Rural cooperative bank shall not accept shares of its own as collaterals.

Article 24 Before using bank shares as security for oneself or other person, Shareholders is obliged to apply to Board of Directors in advance for permission. The directors, supervisors, manager, and deputy manager are not prohibited to transfer or pledge their shares during the period when they are in the post.

IV. ORGANIZATIONAL STRUCTURE

Article 25 Representative Assembly of Shareholders owns the highest authority in the rural cooperative bank.

Representative Assembly of Shareholders assumes following functions:

j. Constitute and revise Articles of Association.
k. Discuss and approve Rules of Procedure for Representative Assembly of Shareholders.
l. Elect or change board members of directors and supervisors. Both director and supervisor candidates shall be shareholders. Decide affairs such as salary for board members, etc.
m. Discuss and approve working reports of Board of Directors and Board of Supervisors.
n. Discuss and approve bank development program, operation and investment schemes.
o. Discuss and approve annual financial budget and actual budget of the rural cooperative bank; decide schemes of profit distribution and loss recovery.

p. Make decisions on increase or decrease registered capital.
q. Make decisions on affairs of bank separation, incorporation, closure, liquidation, etc.
r. Decide other important affairs.

Article 26 Board of Directors is responsible for summoning annual Representative Assembly of Shareholders within six months after each financial year. A provisional assembly shall be held in cases of proposal of Board of Directors, 1/2 of the shareholders or 2/3 of Board of Supervisors.

Article 27 Shareholders of the Assembly vote in accordance with number of shares they hold. One share equals to one vote. On cases of bank separation, incorporation, closure, liquidation, or advising Articles of Association, an approval shall be obtained by 2/3 of the votes from the present shareholders.

Article 28 An attorney shall be required presenting the Representative Assembly of Shareholders and shall prepare a written legal evidence letter.

Article 29 A complete copy of documents and records of the Assembly shall be submitted to CBRC local branch or local banking supervisional authority..

Article 30 A rural cooperative bank shall have seven to nineteen directors in the board, elected by the Representative Assembly of Shareholders. At most 1/3 of the board members shall be bank personnel. At lease 1/3 of the board members shall be elected from farmers and small-scale rural business owners outside of the bank personnel. A single term lasts three years and directors can be re-elected and re-appointed.

Article 31 Board of Directors in a rural cooperative bank shall have independent directors. Independent directors make decisions and judgment free from any extent of influence from major shareholders. An independent director shall perform his function on behalf of depositors and shareholders with relatively small amount of shares.

Article 32 Board of Directors has one chairman and one or two deputy chairmen. The chairman is the legal representative of the bank. Both chairman and deputy chairman can be re-elected and re-appointed. Before leaving the post, there shall be special internal auditing.

Article 33 Board of Directors holds responsibility for Representative Assembly of Shareholders and performs following functions:

i. Summon Representative Assembly of Shareholders and report to the Assembly
j. Implement decisions of the Assembly
k. Discuss and approve operation and investment scheme of the Bank
l. Constitute annual financial budget, actual budget, profit distribution and loss recovery.
m. Propose scheme for increasing or decreasing registered capital.
n. Appoint or dismiss bank manager and based on the manager's proposal, appoint or dismiss deputy manager, head of financial officer, head of loan officer and decide salaries of these personnel.
o. Propose schemes of bank separate, incorporation and closure.
p. Other functions regulated in the Articles of Association.

Article 34 Board of Directors shall hold at lease four regular meetings per year. The chairman summons and presides the meeting, and informs Board of Supervisors to attend the meeting as non-voting representatives.

Article 35 Directors of rural cooperative bank (including independent director) shall attend meeting at lease two times per year. On the approval of shareholders' assembly, if any director violates this article, his qualification as being a director can be void.

Article 36 The election of directors shall be open and strict. Every shareholder shall be fully informed about the resume of candidates one month before the Assembly is held.

Article 37 Any decision made by Board of Directors shall be signed by directors in person and a copy of relative documents shall be submitted to CBRC local branches 10 days after the meeting.

If the decision violates relevant laws and regulations so that the rural cooperative bank subjects to severe losses, the decision makers shall be responsible to compensate the losses.

Article 38 A written report is required to the CBRC when Board of Directors dismisses a manager within his term. Without manager's nomination, Board is not allowed to appoint or dismiss deputy manager, head of financial officer and loan officer.

Article 39 The rural cooperative bank has one manager and one or two deputy managers, appointed or dismissed by Board of Directors. The manager holds responsibility for Board of Directors and performs following functions:

f. Nominate or propose dismiss candidate of deputy manager, head of financial officer, head of loan officer and other senior managerial personnel.
g. Appoint or dismiss other personnel apart from the ones specified in Article 36-a and senior managerial personnel in sub-branches.
h. Represent senior managerial level to propose operation and investment scheme to Board of Directors, and implement the scheme on approval.
i. Entitle authority to senior managerial level, internal functional divisions and managers of sub-branches to operate business.
j. Take immediate measures when urgency occurs and report to Board of Directors and Board of Supervisors instantly.

Article 40 One single term for a manager and a deputy manager is three years and both manager and deputy manger can be re-appointed and re-elected. The chairman of Board of Directors shall not be appointed as manager of the bank.

Article 41 The manager of rural cooperative bank is submitted to annual audit from carried out by Board of Supervisors, which result shall be open to Board of Directors and Representative Assembly of Shareholders. Before leaving the post, both manager and deputy manager are submitted to special audit.

Article 42 The rural cooperative bank shall have five to nine supervisors in the board, which is elected among staff representatives and shareholder representatives. No more than 1/3 of the supervisors is from bank staff, elected by General Assembly of Bank Staff. Other supervisors are elected by Representative Assembly of Shareholders. One single term of a supervisor is three years and supervisors can be re-elected.

Directors, bank manager, deputy mangers, head of financial officer and head of loan officer shall not be elected as supervisors.

Article 43 Board of Supervisors performs following functions:

h. Supervise the performance of Board of Directors and senior managerial personnel.
i. Urge directors, chairman and senior managerial personnel to regulate their behavior that brings losses to the Bank.
j. Carry out annual audit and special audit for directors and senior managerial personnel
k. Inspect financial operation of the rural cooperative bank.
l. Inspect the operation of managerial decisions and measures of risk-control
m. Inquire upon managerial activities of directors and other senior managerial personnel
n. Propose provisional shareholders' assembly.

Article 44 If any suggestion or proposal concerning problem solution to directors and senior managerial personnel is refused or delayed, the Board of Supervisors shall report to local CBRC branch and shareholders' assembly.

Article 45 Qualifications for senior managerial personnel of rural cooperative bank shall be approved by China Banking Regulatory Commission.

V. MANAGEMENT AND OPERATION

Article 46 Business scope of rural cooperative bank shall be approved by China Banking Regulatory Commission and be in accordance with *The Law of Cooperative Banks for People's Republic of China.*

Article 47 The ratio of liabilities for rural cooperative bank shall be decided in accordance with *The Law of Cooperative Banks for People's Republic of China.*

a. Total value of loans divides total value of deposits shall be equal to or less than 80%
b. Total value of current assets divides total value of current liabilities shall be equal to or greater than 25%.
c. Total value of loans of one person shall not exceed 20% of the total value of capital of the rural cooperative bank.

Article 48 Rural cooperative bank shall carry out its business mainly with farmers and provide financial support to local rural economy. A certain proportion of loans should be allotted to support rural economy. The specific proportion shall be decided by CBRC local branch according to the actual situation of local economy.

CBRC local branch shall evaluate the actual loan business allotted to support rural economy and use the evaluation result as considerations on cases of an approval of sub-branch of the bank is made.

Article 49 Rural cooperative bank shall establish a sound managerial system and take profit of the bank and staff achievement as important considerations for staff salaries.

Article 50 Rural cooperative bank is not permitted to give credit loans to shareholders (except farmer shareholders) and their acquaintances, and shareholders shall not have any priority in obtaining collateral loans over other customers.

The acquaintances of shareholders refer to directors, supervisors, and managerial personnel of the bank and their relatives. Besides, the enterprises or financial institutes that these personnel invest or take charge of shall also be defined as acquaintances.

Article 51 According to relevant laws and regulations, rural cooperative bank shall keep a truthful record of its business operations and pay tax in compliance with relevant laws.

Article 52 Rural cooperative bank shall send financial statements, statistical documents and other information to China Banking Regulatory Commission. The Bank shall be responsible with the truthfulness, promptness and completion of any document it provides to the CBRC.

Rural cooperative bank is supposed to public its financial reports, risk-control measures, operational situation, etc.

Article 53 Rural Cooperative bank shall public loans given to shareholders and their acquaintances in accordance with relevant regulations issued by CBRC.

Article 54 An annual financial report shall be submitted by the end of each financial year to Board of Supervisors and Representative Assembly of Shareholders. Board of Supervisors shall appoint certified accounting services with CBRC recognition to audit the report, and on the approval of audit result by the Assembly, copies of the report shall be submitted to local CBRC branch and other local banking supervision authorities.

Article 55 The annual financial report shall be submitted to shareholders twenty days before Representative Assembly of Shareholders.

VI. INCORPORATION, CHANGE AND TERMINATION

Article 56 Any change concerning the following items shall subject to the approval of the China Banking Regulatory Commission:

a. Change of name
b. Change of registered capital
c. Change of business premises
d. Change of business scope
e. Change of senior managerial personnel
f. Change of Articles of Association
g. Other changes specified by China Banking Regulatory Commission.

Article 57 Rural cooperative bank subjects to operational termination because of dissolution, closure of bankruptcy shall operate in compliance of *The Law of Cooperative Banks for People's Republic of China* and other relevant laws and regulations.

Article 58 If a rural cooperative bank operation terminated because of dissolution and closure of bankruptcy, the license shall be cancelled, which gives certified permission to conduct financial business with the prescribed business scope issued by CBRC provincial branch (or autonomous region). The bank shall also report to the State Administration of Industry and Commerce to cancel the license to conduct financial business. Canceling licenses in both cases shall be informed to the public.

VII. LEGAL LIABILITIES

Article 59 Any establishment of a rural cooperative bank without the approval of the China Banking Regulatory Commission shall be banned. If the case constitutes a crime, criminal liabilities shall be investigated. If the case dose not constitute a crime, the China Banking Regulatory Commission shall close the bank and confiscate the illegal earnings.

Any establishment of sub-branches of rural cooperative bank without the approval of the China Banking Regulatory Commission shall be banned. The China Banking Regulatory Commission shall issue a warning and impose a fine no less than RMB 50,000 Yuan and no more than RMB 300,000 Yuan. The senior managerial personnel with direct responsibility shall be dismissed.

Article 60 In case of any change specified in Article 56 without the approval of the China Banking Regulatory Commission, the China Banking Regulatory Commission shall issue a warning and impose a fine no less than RMB 10,000 Yuan and no more than RMB 100,000 Yuan. In case of any change of senior managerial personnel without approval, the senior managerial personnel with direct responsibility shall be dismissed.

Article 61 In case of a rural cooperative bank being found to engage in business activities beyond its prescribed business scope, the China Banking Regulatory Commission shall issue a warning against the bank, confiscate the illegal earnings and impose a fine in a range of one to five times the illegal earnings. If no illegal earnings are involved, the China Banking Regulatory Commission imposes a fine of no less than RMB 100,000 Yuan and no more than RMB 500,000 Yuan. The senior managerial personnel with direct responsibility shall be dismissed. In a extremely serious case, the license issued by China Banking Regulatory Commission shall be cancelled. If the case constitutes a crime, the criminal liabilities shall be investigated.

Article 62 In case of a rural cooperative bank being found in violation of relevant laws and regulations in business like deposit, loan, and clearance, the Bank shall be subject to enforcement actions by relevant regulatory authorities.

Article 63 A rural cooperative bank, in case of being found in violation of Article 47, Article 50, shall be punished in accordance with *The Law of Cooperative Banks for People's Republic of China*. If the case constitutes a crime, the criminal liabilities shall be investigated.

Article 64 Staff in a rural cooperative bank, in case of being found in violation of relevant laws and regulations to accept bribes or embezzle funds or loans, shall be subject to enforcement actions by relevant regulatory authorities. If the case constitutes crime, the criminal liabilities shall be investigated.

VIII. SUPPLEMENTARY PROVISIONS

Article 65 The power of the interpretation for this Provisional Regulations rests with the China Banking Regulatory Commission.

Article 66 The Provisional Regulations takes effect the issuing date.

SUPPLEMENTARY APPENDIX 7: GUIDELINES ON UNIFIED LEGAL PERSON REFORM OF COUNTY LEVEL RCCUS

Unofficial Translation

China Banking Regulatory Commission

I. AIM AND GUIDING PRINCIPLES

The aim that RCCUs in county level shall carry out reform on their legal and equity structure and implement unified legal person is:

a. clarify ownership structure and improve management system
b. specify administrative responsibility
c. form a sound internal administrative mechanism
d. promote transformation of operational mechanism
e. establish a new management system, reduce managerial cost and enhance efficiency
f. add new shares and attract new investment
g. strengthen the overall capability of risk resistance
h. improve service

The following principle shall be observed in the process of transformation:

a. all transforming activities and procedures shall not violate the relative laws and regulations
b. all transforming activities and procedures shall be carried out with the consideration of local situation; an active explore of feasible transforming mechanism and ownership structure is required.
c. Focus on practice and actual effect. Combine structure reform closely with improve internal management system
d. Stick to better service and strengthen support to rural areas.

II. TRANSFORMING STANDARDS

At major farming areas or relatively heavy populated areas, the county level RCCUs shall transform to implement unified legal person. The specific standards are:

i. the total solvency of all RCCs under the RCCU shall be above zero
j. the RCCs hold no objection to the transformation
k. the county level RCCU has relatively high administrative ability
l. the share capital upon transformation of the RCCU shall be no less than RMB10,000,000 Yuan (the number of share capital requirement can be adjusted on the approval of local bank administrative unit.). The CAR for core capital shall maintain a minimum 2%.

III. FOCUS OF THE TRANSFORMING WORK

The focus of the transforming work is to clarify ownership structure, establish a feasible ownership and administration mode, improve management system, transform internal administrative mechanism and promote the overall operation of the RCCU. Therefore, following aspects have to be emphasized:

1. Careful clarification of ownership structure. Clarifying the ownership structure is the fundamental base of the reform. Through substantial investigation, work out the actual figures of assets, liabilities and equity as well as uncover the actual operational status. Figure out the actual assets' losses and clarify actual creditor and debtor.
2. Proper disposal of current assets. For equity apart from the share capital (including reserves and accumulated losses), the RCCUs may propose their own tranformative principles according to their actual condition. The reserves, according to the general principle, should be included in the supplementary capital. These

reserves shall first be used in paying off dividends, interest payables, all sorts of insurance funds and risk reserves (100% for bad loans, 50% for idle loans, 20% for past-due loans and 1% for normal loans); and only when the above requirements are met, can the RCCU use a certain percentage of the reserves to increase the share capital.

3. Establish a new ownership structure. The share and investor composition shall be diversified. In the process of ownership structure reform, local conditions shall be taken into consideration and gradually prefect joint stock cooperative system as well as establish a new feasible and efficient legal structure.
   a. Set a higher minimum figure of investment. A reasonable minimum figure of investment shall be set up with regards to the actual local condition.
   b. Expand the range of qualified investors. The RCCU shall attract investment from farmers, small family business owners, enterprises and other financial organizations in the region on the basis of their original member RCCs. The RCCU shall also fully inform the investors about the relative rules and regulations that forbid associated enterprises to invest into the same RCCU.
   c. Active explore a new and feasible ownership structure. The RCCU, which is going to transform to the unified legal person structure, may issue qualification shares or adopt qualification plus investment shares pattern on the basis of their actual conditions. Qualification shares refer to the compulsory amount of investment in order to invest into the RCCU, and it is also the preliminary condition on which RCCU investors are entitled with special favorable services. Investment shares refer to the investment from financial institutes and individuals with strong economic strength. Qualification shareholders own one vote per person while investment shareholders owns their votes according to the amount of their investment. According to the general principle, one qualification share for natural person equals to RMB 1000 Yuan, and the minimum amount of investment for one legal person qualification share is RMB10,000 Yuan. RCCUs are entitled to adjust the minimum amount of investment for one qualification share and decide the minimum amount of investment shares according to their local condition. The total shares held by one natural person (including qualification shares and investment shares) shall be no more than 5‰ of the total amount of shares; shares held by RCCU staff shall not exceed 25% of the total amount; shares held by one legal person shall not exceed 5%.
4. Improve managerial system. A unified legal person RCCU shall establish General Assembly of Shareholders, Board of Directors and Board of Supervisors. Regulate their respective function and performance; establish a mutual restrict and assistance system with balanced power of decision making, implementing and supervising. The chairman of the board of directors, as the legal representative of the RCCU shall not be the same with the manager. The manger shall be appointed by the board and shall carry out business under the scope specified by the board. Investors and the board shall be responsible for the risk. As the representative of investors, the board of directors is entitled to make important decisions and commit to the responsibility of any losses brought by false decisions. The RCCU shall also prevent internal monopoly; natural person shall take at lease half of the positions in the board. RCCU staff shall not take greater than 1/3 of the total positions in the board. If condition permitting, RCCU can appoint independent director. At least 2/3 of the board of supervisors shall not be RCCU staff.
5. Establish a sound internal control system. Allot work and share responsibilities scientifically; set up an integrated system of internal audit, loan issuing, financial management, staff training, etc.

6. Strengthen the self-administration mechanism. According to the principle of "self-management, self-administration, self-development and self-risk control", the RCCU shall establish a complete and sound self-administration mechanism to enhance working efficiency, reduce operating cost and non-performing loan portfolio.
7. Improve services. The RCCU shall expand their business scope with regard to the economic development of the local region, provide services in new areas and improve the quality of services.

IV. TRANSFORMING PROCEDURES

Based on the National Council [2003] 45 document, the pilot reforming program on the transformation of RCCUs shall be carried out under the leadership of the working group for deepening pilot RCCU reform. The working group shall be responsible to devise specific implementation principles as well as issuing and implementing principles for asset clarification. The sub-branches of CBRC in local areas shall be responsible to regulate and assist the reforming program.

1. Preparing stage
   a. the working group shall first investigate and line up the RCCUs based on the transforming requirement and choose the qualified RCCUs as candidates.
   b. Sep up preparation-leading group for unified legal person. The CBRC local branch shall assist the local government to establish the leading group. County level sun-branch of PBRC, county level RCCU and Industrial & Commercial Administrating Bureau, etc. shall participate in the leading group.
   c. The qualified RCCUs shall reach a written agreement on the transformation by shareholders and be approved by shareholders under normal legal procedure.
2. Establishing Stage
   a. The asset evaluation shall be carried out by the preparation-leading group, and the working result shall only attain its legal status when it is signed personally by the group members.
   b. After the asset evaluation, the leading group shall submit a establishing plan to CBRC for approval.
   c. Increase capital and add shares. On the basis of asset evaluation, the original shareholders of RCCU shall voluntarily keep their shares according to a certain proportion. Apart from the original capital, the RCCU shall attract new investment under the frame of relevant laws and regulations.
   d. Hold general assembly of shareholders, constitute Articles of Association, establish boards of directors and boards of supervisors through voting. Vote for chairman of directors and supervisors. Appoint manager and deputy manager.
3. Open for business. When the preparation is finished, the leading group shall apply for business commencement to the local branch of China Banking Regulatory Commission and the application shall be approved by both county and provincial level CBRC. On receiving the application, CBRC shall consult the provincial government before it reaches any decision. If the application is approved, the applicant shall receive a license to conduct financial business with the prescribed business scope issued by CBRC provincial branch (or autonomous region). The applicant shall, before commencing operations, register with the State Administration of Industry and Commerce with the presentation of the license to conduct financial business, and receive a corporate legal entity business License. Meantime, the RCCU shall observe legal procedures to make necessary changes on the liability relationship.
4. The qualification inspection about the appointment of senior managerial personnel shall observe relative regulations on RCCUs.

SUPPLEMENTARY APPENDIX 8: PROVISIONAL REGULATIONS ON THE ADMINISTRATION OF PROVINCIAL (AUTONOMOUS REGIONAL OR AUTONOMOUS CITY) RURAL COOPERATIVE CREDIT UNION

Unofficial Translation

China Banking Regulatory Commission

I. GUIDING PROVISIONS

Article 1 To achieve effective administration on the Provincial RCCU, this Provisional Regulations is established in compliance with *The Law of Commercial Banks of People's Republic of China, The Company Law of People's Republic of China* and other relevant laws and regulations.

Article 2 Provincial RCCU is defined as an independent legal person local financial institute, voluntarily invested in shares by rural cooperative credit unions and rural cooperative banks. Its primary functions are administrating and providing services to RCCUs and RCOBs.

A rural commercial bank, if willingly, shall obtain same services as provided to RCCUs and RCOBs if investing in shares.

Article 3 Provincial RCCU is legally independent, who possesses civil rights entitled by relevant laws and assure civil responsibilities. The shareholders, RCCUs and RCOBs bear responsibilities to the bank to the extent of the number of the shares they hold and the provincial RCCU bears responsibilities for its debts with all its assets.

Article 4 On the accredit of provincial government, the provincial RCCU shall perform functions of administration, guidance, coordination and service.

Article 5 The management principles of Provincial RCCU are independent management, self risk-control and self-restriction. Its primary function is implementation of national financial policies and shall not carry out loan or deposit businesses.

Article 6 Provincial RCCU is obliged to observe laws and regulations, implement central governmental policies and accept supervision from PBRC.

II. INSTITUTIONAL SETUP

Article 7 The title for a provincial RCCU is " (Name of the Province or autonomous region) RCCU"

Article 8 To establish a provincial RCCU, following requirements have to be satisfied:

i. A proper Articles of Association in accordance with this Regulations.
ii. The registered share capital shall be no less than RMB 5,000,000 Yuan.
iii. Senior management personnel shall have sufficient professional knowledge and relevant working experience.
iv. A sound organizational structure, management and risk control system.
v. Other requirements set out by the China Banking Regulatory Commission.

Article 9 The Provincial RCCU is established by means of promotion. Promoters or initiators buy all the shares issued by the Provincial RCCU.

Article 10 To prepare establishing of a provincial RCCU, the RCCU shall subject to the approval of China Banking Regulatory Commission after the application is approved by provincial (or autonomous region) branch of CBRC..

Article 11 The application document for a provincial RCCU shall include:

m. Application Letter.(including name of the RCCU, registered capital, business scope, share composition, number & names of initiators, etc.)
n. Establishment Scheme
o. Name-list and resumes of personnel in charge of establishment preparation.
p. Contract and signed documents of initiators.
q. The written approval of provincial branch of CBRC.
r. Investing approval from Board of Directors of initators.
s. Other documents required by China Banking Regulatory Commission.

Article 12 When the preparation is finished, the RCCU shall apply for business commencement to the China Banking Regulatory Commission with the following attachments:

m. An application letter for business commencement.
n. A report on completion of the preparation.
o. Draft of Articles of Association.
p. Names, detailed resumes and certificates of proposed senior managerial personnel
q. Assets verification certificate issued by authorized verification institute, a copy of capital composition, names of initiators and respective proportion of shares they hold.
r. Resumes and certificates of directors
s. Basic data of staff and RCCU organization.
t. Relevant documents on establishment meeting and decisions approved by Board of directors.
u. General managerial regulations
v. Other documents required by the China Banking Regulatory Commission.

The approval procedures are the same with Article 10.

Article 13 If the application is approved, the applicant shall receive a license to conduct financial business with the prescribed business scope issued by CBRC provincial branch (or autonomous region). The applicant shall, before commencing operations, register with the State Administration of Industry and Commerce with the presentation of the license to conduct financial business, and receive a corporate legal entity business License.

Article 14 On the approval of provincial branch of CBRC, the Provincial RCCU shall set up agents. These agents shall not have legal person qualification and license of to conduct financial business. Any civil responsibility occurred shall be assumed by the provincial RCCU.

Article 15 Any change specified in the following items shall subject to the approval of China Banking Regulatory Commission:

a. Change of Name
b. Change of Articles of Association
c. Change of senior managerial personnel
d. Change of registered capital
e. Change of business scope
f. Other changes specified by China Banking Regulatory Commission

Article 16 Provincial RCCU subjects to operational termination because of dissolution, closure of bankruptcy shall operate in compliance of *The Law of Commercial Banks for People's Republic of China* and other relevant laws and regulations.

III. EQUITY STRUCTURE

Article 17 Shareholders of provincial RCCU are RCCUs in county level, RCOBs and RCBs. No natural person or legal person shares are issued.

Article 18 One share equals to RMB 100,000 Yuan. One single shareholder shall hold no more than 10% of the total value of shares. The total amount of the investment made by the shareholders shall not exceed 30% of the pain-in capital of their own.

Article 19 All investment share be paid in monetary fund. No installment shall be allowed.

Article 20 The provincial RCCU shall issue registered warrants to shareholders printed with value of shares in RMB. The registered warrant is also a warrant for ownership and dividends.

Article 21 The registered warrant shall be succeeded or transferred. In case of transfer, relevant transferring procedures shall be finished by the end of each financial year before the Representative Assembly of Shareholders.

IV. ORGANIZATIONAL STRUCTURE

Article 22 Representative Assembly of Shareholders owns the highest authority in the provincial RCCU. Each shareholding RCCU or RCOB has the same member of representatives. One single term for a representative is three-year.

Representative Assembly of Shareholders assumes following functions:

s. Constitute and revise Articles of Association.
t. Discuss and approve Rules of Procedure for Representative Assembly of Shareholders.
u. Discuss and approve working reports of Board of Directors.
v. Discuss and approve RCCU development program, operation and investment schemes.
w. Elect or change board members of directors. Decide affairs such as salary for board members, etc.
x. Discuss and approve annual financial budget and actual budget of the provincial RCCU; decide schemes of profit distribution and loss recovery.
y. Make decisions on increase or decrease registered capital.
z. Make decisions on affairs of bank separate, incorporation, closure, liquidation, etc.
aa. Appoint or dismiss certified accountants offices performing audit.
bb. According to the suggestion of administrative authority, constitute improvement schemes.
cc. Discuss the report on the performance of directors.
dd. Decide other important affairs.

Article 23 Representative Assembly of Shareholders shall be held annually. In case of necessity, a provisional assembly shall be summoned.

Board of Directors is responsible for summoning annual Representative Assembly of Shareholders. Each shareholder shall receive a written notice for the assembly ten days before. No decision or approval shall be made beyond the scope specified in the written notice in case of a provisional assembly.

An assembly shall not be held without 1/2 of the shareholders present at the meeting. One representative holds one vote. Any decision made by the Assembly shall be approved by over half of votes held by the representatives. Any decision concerning changes of Articles of Association, incorporation, separate, closure, or liquidation shall win at lease 2/3 of the total votes held by the representatives present at the meeting.

Article 24 Candidates of directors shall be proposed to the Assembly of shareholders and elected anonymously. The total number of candidates shall be 20% more than the actual number of directors.

Article 25 A provincial RCCU shall have nine to fifteen (in odd number) directors in the board. Each shareholding RCCU or RCOB shall have no more than one director in the board. No more than 20% of the total number of directors shall be elected from RCCU personnel. A single term lasts three years and directors can be re-elected and re-appointed.

The Board of Directors shall hold responsibility for the Representative Assembly of shareholders and perform following functions:

q. Summon Representative Assembly of Shareholders and report to the Assembly
r. Implement decisions of the Assembly
s. Discuss and approve operation and investment scheme of the RCCU
t. Constitute annual financial budget, actual budget, profit distribution and loss recovery.
u. Propose scheme for increasing or decreasing registered capital.
v. Decide the setup of both internal and agent structure.
w. Appoint or dismiss bank director and based on the director's proposal, appoint or dismiss deputy director, head of financial officer, head of loan officer and decide salaries of these personnel.
x. Supervise the performance of senior managerial personnel
y. Propose plan for appointing certified accountants office
z. Propose schemes of RCCU separate, incorporation and closure.
aa. Evaluate director's working report.
bb. Other functions regulated in the Articles of Association.

Article 26 The Board of directors shall have one chairman and one or two deputy chairman. The Chairman is the legal representative of the RCCU. Both chairman and deputy chairman shall be elected on the approval of 2/3 of the total directors. Board of Directors shall hold at lease four regular meeting per year. The chairman summons and presides the meeting. On the proposal of chairman, 1/3 of directors or the director, a provisional meeting shall be held.

The meeting shall be held with at lease 1/2 of directors present. One director has one vote. Any decision made by the board shall subject to the approval 1/2 of the directors. In case of vital matters, only with the approval of 2/3 of the directors shall a decision be made.

Directors of provincial RCCU (including independent director) shall attend meeting at lease two times per year. On the approval of shareholders' assembly, if any director violates this article, his qualification as being a director can be void.

Article 27 Chairman of the Board of Directors shall perform following functions:

a. Preside the Representative Assembly of Shareholders; summon and preside the meetings of the Board.
b. Inspect the actual implementation of decisions by the Board, and report the result of inspection to the Board.
c. Sign registered warrant of each shareholder; sign and issue decisions made by the Board.
d. Other functions specified in the Articles of Association

Article 28 The senior managerial level has one RCCU chief and two to four chief assistants. The appointment of both the chief and chief assistants shall subject to the approval of 2/3 of directors. One single term for the chief and assistants is three years and both

the chief and his assistants can be re-appointed and re-elected. The chairman of Board of Directors shall not be appointed as the chief of RCCU.

RCCU chief holds responsibility for Board of Directors and performs following functions:

k. Implement decisions of the Board and make working report to the Board
l. Implement annual operational scheme of the RCCU
m. Draft institutional setup
n. Draft administrational rules and regulations
o. Nominate or propose dismiss candidate of assistants, head of financial officer, head of loan officer and other senior managerial personnel.
p. Appoint or dismiss other personnel apart from the ones specified in Article 28-e and senior managerial personnel in sub-branches.
q. Attend meetings of the Board as non-voting member.

Article 29 Apart from the qualifications specified in Article 57 and Article 61 of *The Company Law of People's Republic of China*, directors of provincial RCCU shall have following qualifications:

a. No records of violating laws and regulations
b. A college educational background
c. At lease five years' working experience in economic and financial administration or management
d. Familiarity with laws and regulations concerning banking management

Article 30 Five days before the Shareholders' Assembly and the meeting of the Board, the provincial RCCU shall inform local banking supervisional authority. The authority assumes the right to attend any of the above meeting as non-voting member. Any decision made by these meetings shall be reported to the supervisional authority in 10 days.

Article 31 Qualifications for following personnel shall apply relevant regulations concerning the qualification of senior managerial personnel in financial institutes: chairman and deputy chairman of the board of directors, RCCU chief and chief assistants. The qualifications are: 1. B.S. Degree; 2. more than eight years' working experience in financial field, or more than ten years' working experience in economic field and five years' experience in financial field.

Article 32 All senior managerial personnel and directors of the RCCU shall be approved by China Banking Regulatory Commission.

Article 33 All senior managerial personnel and directors of the RCCU shall not hold any post in governmental or communist party institutions. Any business activities irrelevant to RCCU management shall be banned.

V. BASIC ROLES AND FUNCTIONS

Article 34 The provincial RCCU shall play following roles and functions:

a. Supervise the implementation of national financial policy in RCCs
b. Establish regulations for vocational management
c. Provide guidance to RCCs concerning the improvement of institutional structure and management strategies.
d. Assist RCC management and audit businesses carried out by RCCs
e. Supervise the election and appointment of RCC senior management personnel and directors.
f. Guide and resolve financial risk of RCCs
g. Direct internet system construction
h. Protect the legal rights of RCCs entitled by law
i. Assist interbank borrowings and lendings
j. Join in the capital market and liquidize RCC funds
k. Open clearance business for RCCs
l. Provide information consulting service

m. Other functions specified in the Articles of Association

Article 35 The provincial RCCU shall establish auditing regulations, appoint professional auditing officers and carry out regular auditing to RCCs. The result of audit shall be reported to local banking supervisional authority.

Article 36 Provincial RCCU shall send financial statements, statistical documents and other information of the RCCU and its member RCCUs and RCOBs to China Banking Regulatory Commission. The provincial RCCU shall be responsible with the truthfulness, promptness and completion of any document it provides to the CBRC.

Provincial RCCU is supposed to public its financial reports, risk-control measures, operational situation, etc.

Article 37 The provincial RCCU shall respect the lawful rights and independent managerial right of its member RCCUs and RCOBs, protect legal rights of its members. No funds or cash of its members shall be used or transferred free of charge by the provincial RCCU.

VI. SUPPLEMENTARY PROVISIONS

Article 38 The power of the interpretation for this Provisional Regulations rests with the China Banking Regulatory Commission.

Article 39 The Provisional Regulations takes effect on the issuing date.

SUPPLEMENTARY APPENDIX 9: BEST PRACTICE APPROACH FOR ANALYSIS OF FINANCIAL INSTITUTIONS

APPLYING INTERNATIONAL STANDARDS TO THE TRANSFORMATION PROCESS OF RCCUS IN IMAR

'GOOD DECISIONS IN BANK MANAGEMENT BEGIN WITH GOOD FINANCIAL INFORMATION'

1. It is essential to understand the financial structure and the earnings performance a financial institution, be it a large commercial bank or a rural credit cooperative (RCC)[58], before any restructuring or reform measures can be designed or effectively implemented. The restructuring of any financial institution generally requires that non-performing assets be identified and stripped out and that the bank or RCC be recapitalized. The balance sheet and entire financial operation must be analyzed and reconfigured, including downsizing, before the restructured institution be restored to a commercially viable position.

2. With increasing frequency, this objective is being met by swapping non-earning assets on the balance sheet with interest bearing government bonds, which have usually been created and provided either directly by the government, in the case of a government owned bank, or through the national deposit insurance (or equivalent) institution where deposits are formally or implicitly guaranteed by the government.

3. While this methodology indirectly recapitalizes the bank (on an accounting basis only) and provides some level of earnings (depending on the interest rate paid on the bonds and their marketability for resale); this course of action has proven to be virtually unworkable in the case of system-wide restructurings or reforms. With their very high levels of non-performing loans (NPL), weak capitalization, and inefficient operations; the RCC system in the IMAR province do not appear to be viable candidates for this approach.

4. A number of alternative approaches have been implemented as a result of banking failures around the world. A common alternative is to remove seriously impaired assets and then to remove all liabilities in excess of the amount of assets removed, thereby effectively downsizing and recapitalizing the institution. This option is most relevant when a significant portion of the bank's liabilities constitute either direct loans from state agencies, loans guaranteed by the state, or the various forms of state-owned deposit schemes that have been developed over time. As the rural finance system of China has a long history of such government subsidy and intervention programs, it is recommended that the various restructuring options available through the conversion of these liabilities and debt instruments to equity be fully explored.

5. Some other programs that have been developed for bank restructuring, such as purchase and assumption agreements (common in the United States) or the write down of individual shareholdings are not immediately adaptable to the RCC situation and are therefore outside the scope of this paper. However, a fundamental element which has been included in all successful recapitalization and restructuring programs; the increased accountability and possible replacement of senior bank management and directors, is a concept that authorities must be accept and be prepared to carry out—even if parties may lose their positions of influence.

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[58] For sake of clarity, this paper will use the generic term **BANK** is its broadest context. In most cases the term will be interchangeable with and can be considered to include the specific titles of Rural Credit Cooperative (RCC), Rural Credit Cooperative Union (RCCU) as well as the planned new financial institutions of Agricultural Commercial Bank (ACB) and Agricultural Cooperative Bank (ACOB)

6. In the case of China, with its commitment to conduct a sweeping reform program for the entire rural finance system, there is a strong need to closely study and incorporate international best practices to the problem. It is clear that the extremely high levels of non-performing loans and weak capitalization levels of the RCCs, are simply too severe to employ many of the recapitalization measures proposed to date. Many of the proposed policies, particularly the structure of the redeemable bills program, do not begin to truly solve the fundamental problems intrinsic to the rural finance sector nor create viable or sustainable financial institutions for the future.

7. At this stage it is important that those responsible for the conversion of selected RCCUs into a more formal banking operation, understand the following fundamental issues:

- (i) The full extent (*the number of loans, level of past-due principal, and past due interest)* of the outstanding non-performing loans as well as the impact of funding for the level of loss reserves which must be formed against them at the levels required by international accounting standards and the Basel Guidelines;
- (ii) The need to conduct an in-depth audit of the outstanding loans in the RCCUs to include a proper classification of the loan portfolio with a realistic assessment of the level of losses that have already occurred;
- (iii) The actual level of new capital that is required by these institutions to meet international capital adequacy ratios;
- (iv) An understanding and acceptance that the best form of any capital increase is through new cash-based equity investments, and;
- (v) The realization that the extensive use of or over-reliance upon an extensive program for the use of redeemable bills (effectively the traditional government recapitalization bonds) is not a viable solution in this case.

8. This paper presents an international best practices guide to the steps necessary in analyzing the financial condition of the eight RCCU operations which are scheduled to be transformed into either an ACB or ACOB operation. The paper will discuss the variety of issues which must be considered in this process and offer recommendations for changes in the current practices and proposed actions for the proposed restructuring of these institutions. The expected benefit of this paper is that the agencies responsible for these conversions will be better able to understand the nature and severity of the losses that have already incurred and develop a comprehensive, feasible and practical recapitalization program for the RCCUs.

A. Portfolio Analysis

9. A bank's capital and overall profitability are critically dependent on the quality of its loan portfolio, and the financial analysis exercise is literally meaningless without a good understanding of the value of the bank's assets. An important first step in any bank restructuring program is to conduct a complete and impartial analysis and realistic classification of the loan portfolio. The risk assets of the institution must be reviewed by an objective third-party, preferably though an audit conducted under international standards, with the purpose of estimating the true extent of risk of loss on each loan and the level of reserves which should be established against the loan portfolio.

10. In practice, an analyst outside of the country's banking supervision area is unlikely to obtain the necessary detailed information necessary to conduct such an analysis since this information is usually considered to be confidential. Additionally, there is often a fear (not totally unfounded) that inappropriate disclosure could result in impairment of public confidence in the bank, possibly leading to a run on the deposit base.

Recommendation:

11. Since none of the RCCUs which have been selected, nor their underlying member RCC institutions, have ever undergone a formal portfolio review, it is recommended that the CBRC contract with an independent auditing firm to conduct a complete full due diligence of their financial structure and operations. The goal of this exercise would be to determine the portfolio quality, risk profile and loan loss reserve requirements of each of the RCCUs scheduled for transformation into an ACB or ACOB operation. From this analysis a more realistic assessment of the capital account can also be achieved. Even if the decision is then made to proceed with the conversion under less rigorous financial standards or with an acceptance of a higher than standard level of NPLs; the authorities will nonetheless be aware of the shortfalls present and the weaknesses that will be built into the reform program.

B. Past-Due Aging Analysis

12. A widespread and fairly effective form of analytical quantification of loan portfolio quality is based on the extent by which a principal or interest payment is past due. This is a time-bound approach which closely follows the common practices of companies that are managing their accounts receivable. In the case of a financial institution such as a bank or RCC, the initial first days after a payment is due are critical, and the probability of ultimate repayment is generally inversely proportional to the amount of time the payment is past due. The process of measuring this timeline and the risk of ultimate repayment is called aging. Therefore any change in a bank's past due aging profile can be provide a clear signal of a change in the quality and risk of loss from the bank’s loan portfolio.

13. In the case of the majority of the RCCs operating in the rural sector of IMAR, care must be taken in using monthly data of this type, due to seasonality of a significant portion of the RCC’s portfolio being extended to agriculture-based lending. Unfortunately, while this approach is useful and represents a simple and consistent method, it should be understood that past-due aging is a lagging indicator. This approach can only identify a loan as troubled once payment is formally recognized as past due, as opposed to when future payments becomes questionable, as is the case with a proper loan classification system.

14. A simple past due analysis often understates the full extent of problems in the credit portfolio. However, a great deal of information and assistance in the credit risk management process can be obtained if the aging schedule is designed properly and is updated on a regular basis. To accurately track the level of past due credits as well as loan recoveries over time, the amounts due each period should be fixed, and recoveries of all amounts received tracked against the original period. This will produce a recovery curve for each accounting period, with the net recoveries forming the comparison base between periods.

15. A common practice among the RCCs has been to purposefully structure loans on inappropriate terms so that will soon become past due and extra fees and penalty interest can be charged. Alternatively, the RCCs often renegotiate past due loans through extension of repayment terms or even through new loans to fund interest and principal payments. This can remove a bad credit from the past due list, even though the chances of recovery may not have improved. Under these practices even a properly constructed past-due aging analysis could therefore represent an imperfect measure of the extent of the true loss risk in the loan portfolio, unless a clear listing of restructured credits is also maintained and cross-referenced with the aging schedule.

16. The key to the usefulness of a past-due aging analysis lies in the follow-up actions of bank management and the supervisory authorities. While this approach remains a fundamental

and necessary step in the transformation process of the selected RCCUs, If properly used this process can also stimulate corrective actions to limit future financial loss as well.

Recommendation:

17. As over 90% of all non-performing loans outstanding in the selected RCCUs have been classified in vague category of 'idle loans' with little or no specific loss reserves taken against them, it is recommended that the CBRC require each RCCU to prepare a complete and comprehensive aging schedule for these credits. With a better understanding of the loss risk on this significant portion of the institutions' loans, the authorities can initiate necessary corrective actions and will be in a better position to properly classify the loan portfolio and determine the level of recapitalization necessary. This exercise, and the corrective actions that such an aging analysis should initiate, is considered critical for the successful transformation of these RCCUs as they currently do not meet any of the local standards or criteria regarding the acceptable maximum NPL ratios, as required for transformation to a bank.

The aging analysis should also include a schedule which identifies those credits which are considered to be credits that have been extended under official government directives and are not the direct responsibity of the individual RCCU lending policies. These particular credits can then be reclassified and any losses recognized as the sole responsibility of the government. There are a number of alternative measures available for the assumption of these debt obligations and removing them from the books of the new bank.

C. Portfolio Classification Analysis

18. International practices provide a more sophisticated approach to classifying the risk and quality of the loan portfolio than is being currently used within the rural finance system of China. While the current simple three-tier approach which broadly classifies loans as past due, idle or bad, could have been sufficient for the RCC system in the past, this is no longer an adequate or appropriate system given the high level of NPLs that have been allowed to accumulate.

Under the current system, which is inflexibly fixed to time boundaries, the classification criteria are not clearly defined and, more importantly, neither the actual classifications nor the related reserve requirements are universally applied. The PBOC and the CBRC currently require that all loans 1-90 days in arrears on their principal and/or interest payments be classified as 'past due'. Interest accruals and accumulated interest not received, are supposed to be suspended at 90 days. The next level of non-performance, 'idle loans', is burdened with a number of loopholes which have allowed the RCCs to avoid normal risk management practices and proper reserve requirements. The final category of 'bad loans' has a long list of formal exceptions which only delay the financial impact of the required loss write-off.

19. To compound these problems, actual practices in the classification of loan assets has become overly subjective and vague, leading to RCC and RCCU management to assume such negative decisions as:

(i) Delaying the classification of a loan as past due until well beyond its scheduled payment date;
(ii) Not classifying loans at all when minimal interest payments are kept current;
(iii) Considering *idle* loans as low risk because the original loan terms were too short or because "the borrower has the capacity to fully repay, eventually;"[59]

[59] Discussions with RCCU management has revealed that many of the loans to rural farmers have been purposefully extended on terms much shorter than repayment abilities and kept in a non-performing status in order to charge penalty interest rates above the maximum interest rates allowed under government sponsored credit programs.

(iv) Delaying the re-classification or movement of loans into the next category (particularly from the classification of 'idle' to 'bad') as the delinquency becomes greater;
(v) Failure to maintain the proper level of loss reserves under the mistaken belief that recovery will come once the borrower is of a mind to make a payment, and;
(vi) Failure to conduct past due aging schedules or initiate proper and organized collection efforts on major past due accounts.

Recommendation:

20. The current system for classifying non-performing credits has proven itself to be totally inadequate under current circumstances. It is strongly recommended that the CBRC accelerate it program for requiring the RCC system to adopt the five level loan classification commonly applied under international best practices. This approach provides a view of the risk asset portfolio sorted by degree of future risk of nonpayment, and usually includes an analysis of the adequacy of loan loss reserves. It is most important that a complete in-depth diagnostic of the quality and classification of the loan portfolios of each RCCU be conducted by independent audit team in coordination with the CBRC, before they be allowed to convert to rural banks. This diagnostic study and reclassification of accounts will require that the CBRC hire an independent audit firm but it is believed that this cost will is justified in order to ensure that the reform program is implemented properly and the recapitalization costs be fully recognized.

21. As pointed out in the financial analysis section of this report, the failure of RCC management to implement proper risk management procedures at the time of initially granting a loan as well as the failure of the CBRC in enforcing its rules on loan loss provisions, has led to an almost total bankruptcy of the system. The value of the loan portfolio and consequently of the bank's equity is only stated fairly if the loan loss provisions correctly adjust the face value of loans to the true recoverable value. Fairly setting the size of this adjustment requires a consistent approach to analyzing loans and determining the probable extent of any impairment in value
The control of credit risk is generally recognized as one of the key elements of sound bank management, and a broadly accepted set off international standards have been designed to tightly monitor the quality of credit portfolios. A financial environment, such as that now found within the RCC system, which does not require proper loan classification will rapidly deteriorate in both profitability and operational sustainability. There is also culpability among the bank supervisory authorities who fail to either introduce or more commonly enforce effective loan classification systems. Often the explanation lies in the existence of the major government-owned banks which have large quantities of loans to ailing or technically bankrupt parastatal enterprises. These loans would most certainly be adversely classified if the loan classification process were to be followed objectively. Such adverse classifications would then force recognition of the problem, precipitating expensive restructuring of the bank and possibly restructuring or closure of the parastatals.

22. In China it appears the lack of an effective loan classification system within the RCC system is also impacted by the government's unwillingness to accept the underlying causes of the NPL problems and the immense losses they represent. This issue can no longer be considered as a lack of technical expertise, which is readily available to the bank supervisory authorities, but a matter of political will. The historical evidence shows that while the authorities have in fact addressed the losses in the large commercial banks, they have followed a program of deferment in the case of the rural financial sector[60].

[60] Past actions on the part of the PBOC and CBRC in dealing with the RCCs, their NPL problems and the rural financial sector in general have been described by several researchers as a pattern of 'differ, delay and deny'

Recommendation:

23. It is strongly recommended that the CBRC reassert its singular position of authority over compliance to a set standard for credit risk management, loan classifications and required loan loss provisions. It must be well understood and accepted by the regulatory authorities that requiring that all credits be allocated a specific rating at least annually to partially reduce the likelihood of a troubled credit escaping notice or for the RCC accumulating the levels of loss overhang or historical burden that is now prevalent within the RCC system. In order to implement a forward looking classification system which addresses credit risk management issues dynamically, the CBRC will have to embark on a major training program for RCCU management.

24. One set of forward looking classification guidelines, originally developed by the US Federal Reserve Bank as part of their policies and procedures manual for bank examiners, has been adopted by the Basle Committee and is now generally accepted as a standard in many jurisdictions. The following provides brief descriptions of each classification category:

25. **Pass Assets:** All loans, advances and discounts approved within the normal credit policy and procedure guidelines of the bank (assuming these are satisfactory), are properly protected by the cash flow or pledged assets of the borrower, are properly documented and are performing. Performing is defined as meaning that all principle and interest payment are being made as agreed, and that all financial and other data is being routinely provided in form and substance satisfactory to the bank.

26. **Special Mentioned Assets (SM) or Watch. Assets**: Loans in this category are performing according to the original agreement between bank and its client, comply with the bank's credit policy and procedures, are properly documented, and appear sound. However, some changes appear to be occurring in the market or in the condition of the borrower that indicate that some difficulties could occur if the changes are not reversed. Assets in this category should be more closely monitored than pass assets, and the bank should make doubly sure that all agreements and documentation are rechecked and that it understands the client's approaches to dealing with the potential difficulties.

27. **Substandard:** While the credit is still performing as agreed, some discrepancy exists between the type or structure of the loan and the bank's normal credit policy, such as inappropriate, improperly executed, mutilated or missing documentation, or some change in the borrower's condition that appears to have increased the risk above the level normally accepted by the bank.

28. **Doubtful:** A significant deviation of the borrower's performance has occurred from that required to service the loan properly. Any non-payment of interest or principle when due would qualify as such a deviation, as would any impairment in the basic cash generation capacity of the borrower or of the value to the bank of any collateral. However, while some loss is probable, the exact extent of the loss has not yet been determined.

29. **Loss:** The chance of recovering any significant portion of the loan is so small that the asset is no longer worth maintaining on the balance sheet, and should be recognized as a loss.

30. **Split Classification:** If a non-performing loan is partially secured and that security is realizable, that portion of the loan that is properly secured could be classified Substandard while

the remaining unsecured portion would be classified Loss. Real estate and any other collateral should be valued at the lower of cost or net realizable value. Therefore the amount that the bank would expect to receive from the seizure and sale of the collateral, after deduction of legal and administrative expenses and taxes will invariably be well below the initial valuation level of the collateral.. The amount of a non-performing asset-based loan that exceeds the net recoverable value would be classified as loss and should immediately be charged off, while that portion adequately covered by the realizable value of collateral could be treated as a lesser risk.

D. Provisioning Issues

31. In many countries, the rules for loan loss provisioning are not structure to solely capture losses at an early stage, but rather to consider the “objective” factors that could be taken into account by the fiscal authority. Some countries provide such principle-based rules, with only general guidance on how to determine adequate provisioning to be able to anticipate future provisioning requirements. This approach is now common for the more developed countries which follow the Basle Guidelines.

32. In contrast, countries that issue detailed regulations on loan classification often define quantitative minimum provisioning requirements. Most emerging markets take this approach. The rationale behind issuing detailed regulatory parameters could be to level the playing field or make bank regulations more easily enforceable in a difficult environment. Among non-G-10 economies, provisioning requirements are usually defined in four or five categories, although some have created more.

33. Worldwide, provisioning requirements may differ significantly for several reasons. One initial factor is, of course, the conceptual basis for provisioning requirements: Do they aim at addressing only losses that follow from visible and identifiable events, or do they aim at establishing provisions for probable or future losses? A related aspect is if only specific provisions are used or if general provisions are also permitted or required. Furthermore, the approaches differ as to whether the impairment is measured on the basis of discounted cash flows or undiscounted cash flows.

34. One important aspect is if and how banks are expected to factor in the value of collateral. In many countries, the value of collateral is subtracted from the required provisions to determine the level of the actual provisions to be established. Under a second approach, collateral is taken into account when classifying a loan, allocating it, for example, to a more favorable category than that reflecting its own risk? and determining the level of provisions accordingly. No evident convergence toward one of the two approaches has emerged from the many surveys conducted on the subject.

35. The importance of loan loss classification and loan loss provisioning was heightened with the introduction of the 1988 Basel Capital Accord. The Basel Capital Accord accepts, under certain conditions, that general provisions be included in Tier II capital. However, most countries, particularly those with emerging financial sectors, have adopted a more restrictive approach than that specified in the Capital Accord. In any case where general provisions are permitted in Tier II capital, the limit is generally set at 1.25 percent of risk-weighted assets, as defined by the Capital Accord. It is important to note that under the Basle Accord, specific loss provisions which are charged against classified loans can not counted as Tier I capital as is currently practiced by the RCCs and RCCUs in China.

E. Monitoring and Enforcement

36. The enforcement of rules and regulations is a sensitive issue that bank supervisors confront daily. Effective supervision requires considerable competence and judgment and is not just the implementation of inflexible and preset administrative rules. Efficient supervision

depends on the right combination of supervisory powers, including sanctions and penalties, and moral suasion. However, when supervisors have too flexibility in enforcing prudential rules, particularly in difficult and inefficient financial systems such as found in rural China, it can result in excessive supervisory forbearance—with negative effects on their credibility and on market discipline.

37. In most countries loan classification and provisioning involve substantial subjective judgment, requiring difficult assessments under considerable uncertainty. The room for subjective judgment is directly proportional to the sophistication of the financial institutions being supervised and the degree of competence they exhibit in credit risk management. Experience has shown that if banks are allowed to use their own classification and provisioning criteria or if they are given several regulatory options, the less sophisticated operations soon exhibit much greater percentages of actual loan losses. Given the NPL problems currently documented in the RCC system of rural China, it is strongly recommended that further enforcement of existing regulations and the execution of specific penalties and sanctions to enforce classification and provisioning regulations be applied. The lack of proper loan loss provisions is an endemic problem in the RCC system and must be addressed promptly if the planned reform program is to succeed.

F. Loan Loss Provisions

This is the most obvious weakness in the balance sheet structure and financial condition of the RCCUs under consideration for transformation to RCB or RCOB institutions. It is also the principal basis for the high levels of new capital which will be required. As the financial analysis of each RCCU presented in Appendix 2 of this report clearly demonstrate; in each case the institution has failed to properly fund sufficient loss reserves to cover their NPLs. Recognition of the impairment of value of the loan portfolio through loan loss provisions must correspond to the actual condition of the loan portfolio and continued denial of the gravity of the situation runs counter to the goals of the stated reforms.

Recommendation:

38. It is strongly recommended that the CBRC immediately clarify past conflicting directives and compel all RCCUs which are being considered for conversion to conduct a through reclassification of their loan assets and establish the following loss reserve regulations:

(i) General Reserves to be established corresponding to a minimum of 2% against all currently normal and watch loans. Normally the percentage of general reserves is dependent on the long-term effectiveness of the bank's risk management process, with more efficient and proven systems requiring a lesser amount of general provisions. However, in the case of the RCC system a 2% general reserve would be justified for at least the next 5 years. The Basle Committee has established recommendations which is some cases, depending on the overall soundness of the institution, allow for such general reserves to be included in equity for the determination of capital adequacy. It is the analyst's opinion that such a credit to capital should not be allowed until such time as the new rural bank has shown a positive track record in their new loan underwritings and has achieved profitability;

(ii) Specific loss reserves should be immediately calculated and established on all loans which have been reclassified in the Substandard, Doubtful and Loss categories. Under normal circumstances the regulatory authorities would determine a percentage (based on historical experience) of Substandard loans to determine the level of provisions required with case by case analysis and

historical experience determining the amount to be allocated against Doubtful loans. In all cases full reserves (100%) are required on all loans classified as Loss. The analyst recommends increasing the loss reserves in each category to the international norms of 20% against Substandard credits, and 50% on Doubtful loans. Additionally all loans should be placed on a non-accrual basis after 90 days with all accrued but unpaid interest reversed from the income statement.

G. Risk Concentration Analysis

39. Excessive exposure to a few clients, either through loans or deposits, can easily cause instability in the bank. This exposure can be either in assets or liabilities, as follows:

H. Sources of Funds

40. Reliance on a few large depositors may appear attractive to a bank's management, since it simplifies the deposit generation effort and minimizes accounting requirements. However, withdrawal of a large block of deposits from a bank can precipitate a liquidity crisis if the bank cannot immediately replace those deposits. In the case of the large urban-based RCCUs there are indications that though their head office operations that they have taken in a disproportionate amount of deposits, usually paying higher rates than deposits from rural households, from local enterprises and government authorities. Along with such concentrations of sources of funding comes the pressure to extend favorable loans to these overly influential customers. This practice has allowed already weak institutions to expand their lending imprudently, with the result that the risk of failure of the bank is increased. However, because of the centralized control and influence exerted by these persons, the RCCUs continue in business and they are in danger of finding themselves unable to recover their deposits without causing the collapse of the bank.

I. Uses of Funds

41. Similarly, the inability (or unwillingness) of a few very large borrowers to repay their loans when due can result in the very rapid depletion of a banks capital. Prudent banking regulations normally set limits on the amount of loans to any one borrower or group of related borrowers of between 10% and 25% of unimpaired capital. Loans in this context includes all loans, advances and overdrafts, plus outstanding loan commitments (balance of loans not yet disbursed) and contingent liabilities. Such policies ensure that the bank properly applies an actuarial dispersion of risk to ensure that defaults by one or a few major clients do not bring down the bank. The CBRC has legal loan limits in place for the RCCUs as well as the new rural banks that are to be formed; however, the lack of data provided by the eight RCCUs under study has prevented the analyst from verifying any degree of compliance with these regulations.
Sound banks generally also have similar risk diversification policies on exposure to particular economic sectors, to ensure that difficulties in one sector of the economy do not cause excessive losses through the simultaneous failure of many smaller clients. These policies are not in place in the RCC system despite the fact that specialized banks, which are mandated to concentrate in specific areas such as agricultural or small and medium enterprises in the rural sector are particularly vulnerable to risk concentrations in both the assets and liabilities.

J. Affiliated Companies

42. Currently it does not appear that the main RCCUs in IMAR which plan to convert rural commercial banks are heavily involved in any investments in other businesses than could be considered as affiliate companies. However, this situation could rapidly change due to some of the methods being discussed for attracting new investors. The new rural banks could become effective affiliates or even subsidiaries of companies owned by their new majority shareholders.
A conservative but often justified analytical approach is to assume that loans to an affiliate have not been made on normal commercial terms, and that the amount outstanding effectively

represents a transfer of capital from the bank to the affiliate. A conservative analyst will reduce his evaluation of the bank's capital for capital adequacy purposes, although an ownership threshold of maybe 10% may be appropriate, up to which no capital adjustment is made, but above which ownership control is assumed, and the entire amount outstanding, plus the amount of the equity investment, should be deducted from the bank's capital.

Recommendation:

43. It will be important for the PBOC and CBRC to fully analyze and determine the true shareholding percentages in the new banks in order to assure that new large credits are not extended to affiliated parties beyond the limits established in the prudential regulations. This applies even if the majority stakeholder is in fact the local government either directly or through one of its other controlled companies.

K. Shareholders—Insider / Related Party Credits

44. A major cause of bank failures worldwide has been unrecoverable loans that were made to related companies or individuals. Loans to affiliated companies, shareholders, or directors and policy level managers are rarely made on a strictly commercial basis, and represent a potential source of impairment of capital. In the case of the IMAR rural finance sector, these risks are quite apparent and there have been several reported abuses of insider lending in recent months.

45. Significant shareholders invariably have direct influence over management through the Board of Directors or other forms of political control exhibited in the Chinese system. It is simply not reasonable to expect that loans to significant shareholders will be made on a fully commercial basis unless very careful regulatory monitoring is present and swift enforcement measures are applied. Even where such loans may be commercially justifiable, the terms may well be at other than normal market rates. Any significant lending to shareholders should be a cause for concern and reason for additional inquiry with management.

L. Bank Management and Directors (when to replace)

46. Likewise, the managers who set the bank's policies are unlikely to get completely objective consideration from lending officers who depend on these managers' good will. Properly managed banks have a formal policy of not lending any amount to any officer above a certain level in management. In many state-owned banks the exact opposite is the rule, since low interest loans represent a convenient way around unrealistic government imposed pay scales. However, the efficient reallocation of national resources requires competence, motivation and integrity, and it would seem that governments ought to be interested in encouraging the best candidates to enter their banks, and in motivating them through competitive pay scales based on performance.

Recommendation*:*

47. It is recommended that a through review of the management and directors of the RCCUs which are to convert to rural banks be conducted by the CBRC to determine any outstanding lending relationships which exist. Corrective measures should be taken before permission to convert is granted or any government support is provided.

SUPPLEMENTARY APPENDIX 10: PRECONDITION FOR EFFECTIVE BANKING SUPERVISION[61]

1. Banking supervision is only part of wider set of economic, regulatory and risk management arrangements that are needed to promote stability in financial markets.
These arrangements include:

1. sound and sustainable macro-economic policies;
2. a well developed public infrastructure;
3. effective market discipline;
4. procedures for efficient resolution of problems in banks; and
5. mechanisms for providing an appropriate level of systemic protection (or public safety net).

2. Providing sound and sustainable macro-economic policies are not within the competence of banking supervisors. Supervisors, however, will need to react if they perceive that existing policies are undermining the safety and soundness of the banking system. In the absence of sound macro-economic policies, banking supervisors will be faced with a virtually impossible task. Therefore, sound macro-economic policies must be the foundation of a stable financial system.

3. A well developed public infrastructure is necessary to cover the following facilities, which, if not adequately provided, can significantly contribute to the destabilization of financial systems:

1. a system of business laws including corporate, bankruptcy, contract, consumer protection and private property laws, that is consistently enforced and provides a mechanism for fair resolution of disputes;
2. comprehensive and well-defined accounting principles and rules that command wide international acceptance;
3. a system of independent audits for companies of significant size so that users of financial statements, including banks, have independent assurance that the accounts provide a true and fair view of the financial position of the company and are prepared according to established accounting principles, with auditors held accountable for their work;
4. effective banking supervision (as outlined in this document);
5. well-defined rules governing, and adequate supervision of, other financial markets and, where appropriate, their participants; and,
6. a secure and efficient payment and clearing system for the settlement of financial transactions where counterparty risks are controlled.

4. The maintenance of effective market discipline depends on an adequate flow of information to market participants, appropriate financial incentives to reward well managed institutions and arrangements that ensure that investors are not insulated from the consequences of their decisions. Among the issues to be addressed are corporate governance and ensuring that accurate, meaningful, transparent and timely information is provided by borrowers to investors and creditors.

5. Market signals can be distorted and discipline undermined if governments seek to influence or override commercial decisions, particularly lending decisions, to achieve public policy objectives. In these circumstances, it is important that if guarantees are provided for such

[61] Bank of International Settlements, Basle September 1997

lending, they are disclosed and arrangements are made to compensate financial institutions when policy loans cease to perform.

6. Sufficiently flexible powers are necessary in order to implement efficient resolutions of problems *before* they become endemic. Where problems are remediable, supervisors will normally seek to identify and implement solutions that fully address their concerns; where they are not, the prompt and orderly exit of institutions that are no longer able to meet supervisory requirements is a necessary part of an efficient financial system. Forbearance, whether or not the result of political pressure, normally leads to a worsening of problems and higher resolution costs. The supervisory agency should be responsible for, or assist in, the orderly exit of problem banks in order to ensure that depositors are repaid to the fullest extent possible from the resources of the bank (supplemented by any applicable deposit insurance) and ahead of shareholders, subordinated debt holders and other connected parties.

7. In some cases, the best interests of depositors may be served by some form of restructuring, possibly takeover by a stronger institution or injection of new capital or shareholders. Supervisors may be able to facilitate such outcomes. It is essential that the end result fully meets all supervisory requirements that it is realistically achievable in a short and determinate time frame, and that, in the interim, depositors are protected.

8. Deciding on the appropriate level of systemic protection is by and large a policy question to be taken by the relevant authorities (including the central bank), particularly where it may result in a commitment of public funds. Supervisors will also normally have a role to play because of their in-depth knowledge of the institutions involved. In order to preserve the operational independence of supervisors, it is important to draw a clear distinction between this systemic protection (or safety net) role and day-to-day supervision of solvent institutions. In handling systemic issues, it will be necessary to address, on the one hand, risks to confidence in the financial system and contagion to otherwise sound institutions, and, on the other hand, the need to minimize the distortion to market signals and discipline. Deposit insurance arrangements, where they exist, may also be triggered.

9. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organizations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking organizations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

10. This standard requires the following components to be in place:
   (i) a clear, achievable and consistent framework of responsibilities and objectives set by legislation for (each of) the supervisor(s) involved, but with operational independence to pursue them free from political pressure and with accountability for achieving them;
   (ii) adequate resources (including staffing, funding and technology) to meet the objectives set, provided on terms that do not undermine the autonomy, integrity and independence of the supervisory agency;
   (iii) a framework of banking law that sets out minimum standards that banks must meet; allows supervisors sufficient flexibility to set prudential rules administratively, where necessary, to achieve the objectives set as well as to

utilize qualitative judgment; provides powers to gather and independently verify information; and, gives supervisors power to enforce a range of penalties that may be applied when prudential requirements are not being met (including powers to remove individuals, invoke sanctions and revoke licenses);

(iv) protection (normally in law) from personal and institutional liability for supervisory actions taken in good faith in the course of performing supervisory duties; and,

(v) a system of interagency cooperation and sharing of relevant information among the various official agencies, both domestic and foreign, responsible for the safety and soundness of the financial system; this cooperation should be supported by arrangements for protecting the confidentiality of supervisory information and ensuring that it is used only for purposes related to the effective supervision of the institutions concerned

A. Current Trends in Regulation and Supervision: A Cursory Note

11. Globalization and liberalization have benefited the world through open markets and capital flows, but at the same time, has created a widening of global inequality and rising poverty in the world's poorest countries. The financial turmoil and economic meltdown caused by the general mismanagement of economic and financial fundamentals has contributed to the high level of non-performing loans and in some cases rising unemployment.

12. Financial deregulation and reform has the following dimensions:

- abolishing credit controls,
- deregulating interest rates,
- allowing free entry into the financial services industry,
- making banks autonomous,
- privatizing bank ownership and,
- freeing international capital flows.

13. In order to achieve these goals weaknesses in banking supervision and governance must be corrected. Particular emphasis is needed in the development of standards and codes to bring transparency, order and corporate governance.

14. Banking regulation and supervision has two main objectives; reducing the risks of failure and promoting stability of the banking and financial system as a whole. There is now a shift from rule-based external regulation to risk-based supervision. The latter type, which is interactive, aligns a supervisory approach with how banks are managed, focuses on prevention, integrates systemic analysis, emphasizes risk management, promotes transparency and uses risk-rating methodology.

15. Trends in regulation and supervision include the maintenance of soundness by setting minimum levels of capital or investments, the establishment of capital adequacy requirements appropriate fort local market risks, the creation of new lines of bank business and the enhancement of internal controls and audit procedures. Operational independence and necessary resources should be provided for supervisors; a proper licensing regime for setting up banks and sound prudential regulation installed to address various risks.

16. There is a need to enforce supervisory requirements and gather information through on-site examination and off-site review. The ability to conduct consolidated supervision and to exchange information must be improved. There is a need to continue working on human resource development, modernizing both hardware equipment and the mindset of the bank managers.

B. Guidelines for monitoring and supervision to reduce loan default may include the following:

- lending should be demand-oriented, taking into account the borrowers' actual demand for credit;
- borrowers should be well screened and carefully selected;
- size of loan to be provided must be carefully evaluated considering the debt-carrying capacity and repayment performance;
- terms of loan must be flexible and be convenient in relation to its repayment plan;
- the interest rate must be rational both to the borrowers and rural money market;
- the loaning procedures should be clear and transparent, especially to the borrowers;
- paper work for the loan should be simple and explicit;
- loan performance must be monitored daily with help of a well-organized information management system;
- alternative forms of mortgage and collateral substitutes, such as group guarantee and joint liability, should be accepted;
- borrowers, whose repayment performance is excellent, can be rewarded with incentives, such as interest rate rebate, confirmation of future loans and larger amount of subsequent loans.

SUPPLEMENTARY APPENDIX 11: BANK RESTRUCTURING AND CAPITALIZATION

A. Introduction

1. A large number of countries have experienced banking system crises and it is likely to continue to be one of the more important areas that require intervention by international organizations to provide both technical and financial support. Banking crises are often associated with macroeconomic problems and can result from weaknesses in executing financial liberalization and reform programs.

2. The costs for addressing banking system crises can be high (estimated to total over US$250 billion since 1980), ranging from 10-15 per cent. of GDP in many of the recent instances, to as much as 30 per cent., as was in the case for Chile in 1981 to Various approaches have been taken to resolving banking system problems around the world, with mixed results. Experience suggests that there does not exist a single best strategy for resolving banking crises, but rather that a ‘tool kit’ approach needs to be taken, albeit including some instruments that appear to be needed in all crises.

3. The purpose of this Section is to highlight some of the key principles for approaching bank restructurings. An overview of some of the principal instruments and techniques is provided. Perhaps the key lesson from this Section is that bank recapitalizations, by themselves, are unlikely to be effective. They inevitably need to be accompanied by appropriate restructuring action to address the causes that gave rise to the need for recapitalizations in the first place.

B. Diagnosing the problem

4. The most important initial step in a bank restructuring exercise is developing a good understanding of the underlying problems that have contributed to a the problem. This diagnosis phase needs to focus on the nature and extent of the banks’ financial problems and operational weaknesses.

5. The former requires, in particular, an in-depth analysis of the banks’ accounting and reporting policies on classifying assets, provisioning and accruing for unearned interest. Banks experiencing problems often tend to overstate their assets and earnings by adjusting these policies. Poor disclosure practices and weak supervision tends to exacerbate the problems. Also, ailing banks tend to suffer from higher than average operational costs. On the operational side, focus on the banks’ credit and internal control procedures and practices is important. As is highlighted later in this Section, weakness in management tends to be associated in most bank problems, which also manifests itself in weak corporate culture.

C. Bank restructuring modalities

6. Restructuring does not have fixed rules. The right strategy may depend on several factors, including the importance of the banking system for the economy and the extent and depth of insolvency, the maturity of the society and the political system, ownership of the banking system – whether private or State, the ownership and management alternatives available, and, particularly, the political will to address the problem.

The modalities of restructurings may vary. Restructuring may be addressed case-by-case, as problems are uncovered or across-the-board when insolvency is deep and generalized. Restructuring operations may be run from the supervisory institution, a specialized institution or specialist units within the banks themselves. It can be financed by the government, by the depositors and creditors, by the banking system, or a combination of the above (in reality, the government generally bears the largest share of costs). Restructuring may be simultaneous with change of ownership and management, through mergers or acquisitions, or otherwise. In some cases it may require interim management by a specialized institution.

7. There are different ways in which bank restructuring strategies can be categorized. In a recent seminar, the World Bank categorized them into four broad groupings:

(i) *Lifeline:* The government, usually through the central bank, arranges funding for banks, which then work out their problems on their own. This can work if the losses are not very high, for example, after making provisions, capital adequacy ratios are between zero and two per cent. However, such situations are rare, so the lifeline approach is not widely applicable. It has worked with some of the smaller banks in the UK and was tried in the early phase of bank restructuring in Argentina.

(ii) *Operating room:* The regulator surgically removes the bad loans, restructures banks and then sells them. Spain – 'bank hospital', Ghana, the Philippines, and a number of other countries have tried this. The approach was successful in Spain because the economic outlook was good, the institutional infrastructure was put in place fairly rapidly, foreign banks were very interested in purchasing the restructured banks, and there were very large, strong Spanish banks to which the restructured banks could be sold. In Ghana, where such circumstances are lacking, the process is considerably slower. It has taken longer to establish the necessary institutional framework, to restructure the institutions, to build skills and to find buyers.

(iii) *Fugue:* A number of actors move forward, picking up a theme and reinforcing it, just like different instruments in a musical composition. First, the banks take provisions against their bad loans. The government injects capital into the banks to recapitalize them. The banks then handle the workout, sometimes through debt-for-equity conversions and in many cases through some debt forgiveness. This approach is appropriate to systems undergoing systemic transformation. It was first used in Poland, and has since been tried in Slovenia.

(iv) *Face-lift:* cosmetic surgery. Only the balance sheet is fixed, often by revaluing the fixed assets, or by giving guarantees on some loans. No fundamental changes take place in the banks or their business environments. However, in the absence of fundamental change, relapses usually occur. According to the World Bank, there were relapses in all the countries that used this method (including Mauritania, Guinea and Hungary).

8. The relative level of development of financial sectors and the macroeconomic environment can have an important influence on the success of and options available for bank restructurings. For instance, the availability of buyers for failing banks can considerably facilitate a restructuring exercise. Conversely, seeking to restructure financial institutions in a highly unstable macroeconomic environment is likely to be problematic. In a comprehensive overview of the experience of bank restructurings in the 1980s around the world, the World Bank has grouped countries into four broad categories (namely, developed, developing countries with relatively stable macro-economic environments, centrally planned and transition economies and highly indebted and high inflation countries), and finds they all had similar experiences.

D. Key steps in bank restructurings

9. Irrespective of the underlying conditions and the particular modalities followed, a typical bank restructuring and recapitalization program requires a series of steps to be taken. There are generally five key stages in bank restructurings:

- (i) Diagnosis of losses, quality of the portfolio, management, policies, etc.
- (ii) Improvement in governance/management
- (iii) Improvement in debt recovery/reduction in lending to non-performing borrowers
- (iv) Allocation of losses among depositors/lenders/equity holders/banking system/State
- (v) Rebuilding profitability through recapitalization, strengthening of credit culture, and reduction in staff and branches.

10. In addition, the importance of contemporaneously addressing the banks' business environment, including improving legal and accounting infrastructure, strengthening regulation and supervision and the need for a sound macroeconomic environment to support a turnaround are highlighted by a number of authors.

E. Recapitalization

11. An insolvent bank has, by definition, lost all or a sizeable part of its capital. When equity capital is lost only partly, reconstruction of capital may be possible through conventional procedures: the bank will top up its reserves through retained earnings or raise capital by issuing securities to the market. When equity capital is lost (often three to ten times book capital) original or new shareholders are unlikely to be willing to inject new funds. Capital reconstructions through external mechanisms would then be necessary. Two comprehensive approaches have developed from past experiences to structure a sustainable program for recapitalization:

12. New capital is required to replenish losses after lost and doubtful assets have been written-off or provided for respectively, and to ensure that the bank has adequate net capital to carry on its business. Such capital is generally provided by way of a mixture of performing assets (for example, government bonds) and cash. Too high a proportion of the former creates illiquidity in the system and risks making future returns on investments low. Cash is always the best form of new capital investment but there is a danger in allowing management of the failed institution too much freedom as to where to invest excess liquidity or to invest it too rapidly. Management practices must be changed to avoid a continuation of past poor loan decisions.

13. The purchasing the bad assets of a failed bank by a government institution is an excellent alternative to supplement capital increases by new investors. The key is to replace bad assets with good performing assets, ideally, once again, a combination of cash and government securities. Gradual conversion of the latter into cash helps minimize monetary distortions. Such purchases can be made through the central bank or a specialized institution. It is important to stress that the financial reconstruction of banks' capital needs to be integrally linked with wider operational and environmental reforms. By itself, a recapitalization exercise simply enables poor practices to continue, creates moral hazard, and buys time for the next round of recapitalizations.

14. Under perfect market conditions, the cost of bank failures would fall primarily on their shareholders and, to the extent that they are not protected by deposit protection arrangements, on the depositors and other creditors. In systemic banking crises, or in the case of large banking institutions that can have contagion effects, rescues often entail fiscal costs. This is particularly the case in developing countries, where political pressure to rescue failing banks can be greater. In addition, to the extent that banks are State-owned, the government shares in the losses suffered as a shareholder. Irrespective of the circumstances, however, the principle of

cost sharing needs to be adhered to. Bailing out shareholders and depositors entirely risks creating moral hazard problems.

15. The following table shows the cost sharing options that are commonly used during bank restructurings:

COSTS AND COST SHARING OPTIONS IN BANK RESTRUCTURINGS

Costs to bank stakeholders	**Costs to the State** (Fiscal/Quasi-fiscal)
• Collateral commitments • Future liabilities to the State • Fresh equity capital • Owners can lose their stakes • Managers and staff may lose jobs • Creditors and depositors may take losses • Higher deposit insurance premia for banks • Fees for twinning/management services • Central bank budget remittance falls • Contingent liabilities (guarantees) rise	• Government debt increases • Deficit increases • Costs of liquidation (Courts, etc.) • Unemployment compensations • Severance pay to SOCB employees • Budget transfer to deposit insurance • Fee to acquiring bank (for mergers) • Investment banking services for merger or privatization • Budget allocation for asset management • Fees for twinning/management services • Collateral commitments • Future liabilities for further 'bail outs'

16. Various techniques have been used to share costs. For instance, adjusting the basis of valuation on which the State takes over a bank's bad debts in exchange for cash or bonds can vary the share of the losses that the State ultimately bears. Similarly, the terms on which the State issues any financial instrument for recapitalization purposes can be adjusted. Also, in many countries, banks' premia for deposit insurance have been raised during bank restructuring operations as part of the loss-sharing arrangements.

17. A World Bank survey of 24 developed, developing and transition countries' systemic bank restructurings shows that the countries were divided into those that made substantial, moderate and slow progress in addressing their problems respectively, as well as those whose experience is too recent for results to be discerned. World Bank statistics indicate that the total costs of bank restructurings since the 1980s has been estimated at around US$250 billion. The cost to governments has generally ranged between 10 and 15 per cent. of GDP, although it can be as high as 30 per cent.. The conclusions from that survey and other experiences are outlined below.

18. The need to take quick and decisive action is apparent. Timing also needs to be coordinated with wider economic reform, to the extent it is necessary.
An in-depth and wide-ranging diagnostic phase is essential for problems to be identified so that a robust restructuring package can be designed.

19. Change of management is a key necessity for successful restructurings. Even if the banking problems are contributed to by wider environmental factors, leaving management in place impedes effective operational restructuring and is associated with a high failure rate.

20. Market-based solutions appear to be the most efficient and least costly to the taxpayers. If private sector purchasers cannot be found for failed banks, in general, liquidations are cheaper than keeping insolvent banks open.

21. The experience of whether bad assets should be carved out of banks into asset recovery agencies, or retained in the books is mixed. Much depends on the ability of new asset owners to take effective action compared with sufficient changes having been made in host banks to be able to take objective decisions and effective action.

22. The nature of assets also needs to be taken into account – the *modus operandi* and relatively short exit time horizon of asset recovery agencies often means that they cannot assist in the full turnaround of weak enterprises and therefore optimize value. Central banks' direct involvement in banking system restructuring appears to be linked with a general lack of success.

23. As a general principle, government programs which subsidize the recapitalization of a financial institution in such a manner as to bail out private shareholders should be avoided. In an open economy with market-driven investment principles, the risk of loss exists for all investors equally. In addition to change of management, successful restructuring usually requires improving banking skills of staff, changes in working practices and corporate culture to prevent recurrence of problems.

24. Coordinating the restructuring of banks with that of SOEs is particularly important for transition economies and those countries with weak public sector enterprises. The need to take a pragmatic and flexible approach is also critical. Although careful planning and strategizing is important, in fluid situations, often with various competing interests seeking to influence the exercise, seizing opportunities when they appear is the key to effective implementation.

SUPPLEMENTARY APPENDIX 12: OUTLINE TERMS OF REFERENCE FOR CONSULTANTS TAR: 4430 PRC

A. Component A: Inner Mongolia Autonomous Region

1. International Consultants (8 person-months)

a. Team Leader and Rural Finance Restructuring Specialist (4 person-months)[62]

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;[63] (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,[64] (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)[65] and identify inconsistencies with the existing RCC reform process.[66]

(iv) Improve the policy environment for rural finance by covering key areas such as interest rate liberalization,[67] payment and settlement system, risk management, new and diversified financial products, credit guarantees, agriculture insurance, credit rating, and credit information bureaus.

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[62] 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.

[63] Deliberation for applicability of restructuring modalities prescribed by the central Government.

[64] 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.

[65] 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.

[66] 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.

[67] 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).[68]

(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.[69]

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 diligence[70] 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;[71] 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.[72]

(iii) Recommend non performing 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,[73] (b) calculating the financial internal rate of return (FIRR),[74] and (c) calculating the economic internal rate of return for external funding.[75]

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[68] Aimed at strengthening corporate governance standard and financial, institutional, and operational capacities through (i) identifying restructuring options and a suitable non performing 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.

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

[70] 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.

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

[72] 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.

[73] Advising application of conditions, or covenants that should be required as conditions.

[74] 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.

[75] 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.[76]

2. **Domestic Consultants** (15 person-months)[77]

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 leader[78] 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.

(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

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

[77] 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.

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

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;[79] (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.

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[i] Establishing a Framework for Sustainable Rural Finance, ADB, February 2005
ii. Inner Mongolia Financial Office, March 2005.

[iii] Establishing a Framework for Sustainable Rural Finance, ADB, February 2005
[iv] Establishing a Framework for Sustainable Rural Finance, ADB, February 2005

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