



Stanford

Center for International
Development

Working Paper No. 292

Developments and Prospects for Rural Finance in China

by

David Scott

Wang Jun*

September 2006



Stanford University
579 Serra Mall @ Galvez, Landau Economics Building, Room 153
Stanford, CA 94305-6015

* World Bank

Developments and Prospects for Rural Finance in China

David Scott and Wang Jun
The World Bank

May 19, 2006

Abstract

A central theme of China's 11th Five Year Plan (2006-2010) is the building of a "new socialist countryside." Over recent years, reforming rural finance and improving access to credit by small businesses and farmers has figured increasingly prominently in the leadership's proclamations of support to rural economic development. While hundreds of pilot innovations in small-scale finance have been pursued by local and international donors, very few have proven financially self-sustaining and none have proven scalable. A key challenge in promoting rural financial sector development is having sustainable, systemic impact. Internationally, the policy approach and business practices necessary to meet the credit and financial services needs of formal and informal smaller businesses on a commercially sustainable basis are increasingly well understood. This paper assesses the extent to which such approaches and practices are being adopted in China generally, and their prospects for adoption in rural China. It examines several recent central government financial sector initiatives, most of which have the potential to have systemic impact. It makes recommendations regarding one important challenge not yet initiated in earnest, the restructuring of the Agricultural Bank of China.

JEL Codes: G21, O16, O18

Keywords: rural finance, bank restructuring, China

List of Abbreviations

ABC	Agricultural Bank of China
BOC	Bank of China
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
CDB	China Development Bank
MFIs	Microfinance institutions
MSME	Micro and Small and Medium Enterprise
NGOs	Non-governmental Organizations
NPL	Non-performing Loans
PBC	People's Bank of China
PSRB	Postal Savings and Remittance Bureau
RCB	Rural Commercial Banks and Rural Cooperative Banks
RCC	Rural Credit Cooperative
RCCU	Rural Credit Cooperative Unions
SME	Small and Medium Enterprise
UCC	Urban Credit Cooperative

DEVELOPMENTS AND PROSPECTS FOR RURAL FINANCE IN CHINA

David Scott and Wang Jun¹

Recent Developments Relevant to Rural Finance

Introduction

Since the early days of Chinese economic reform and the surprising growth of township and village enterprises, China's rural economy has become increasingly diversified. Promoting financial sector development in rural China must have as its goal substantially increasing convenient access by businesses, households, and even local governments, to a wide range of efficiently priced financial services. The focus in this paper is business lending, and particularly lending to small and micro businesses, as many farming households in China might be characterized, with the ultimate objective of stimulating rural economic growth and job creation. Small businesses have traditionally been ignored by most of China's commercial banks, in urban and rural areas alike. Yet, at the same time, in the international sphere, the policy approach and business practices necessary to serve this market are increasingly well understood. This paper examines the extent to which such practices are being adopted in China, and the prospects for their adoption in rural China, in the context of current central government initiatives to improve the quality and availability of financial services generally.

International success in serving the small and micro business market is grounded on two basic facts. The first is that many viable small businesses are creditworthy and willing and able to pay for reliable access to credit. The second is that reliable long-run access to credit requires stable and efficient financial institutions. The nexus of these two facts is a mutually agreed and advantageous commercial business relationship between financial institutions and borrowers that creates positive incentives for both. When financial institutions are managed to achieve sustainable profitability -- the prerequisite for stability and efficiency -- they have strong incentives to price loans adequately, to control the risk of loan defaults, and to continue to expand their client base of borrowing customers. Since borrowers value reliable, flexible and timely access to credit and are willing to pay for it, they have incentives to repay previous loans and otherwise to maintain a good business relationship with a reliable financial institution.

¹ David Scott is Advisor in the Financial Sector Development Department at World Bank headquarters in Washington. Wang Jun is the Bank's Senior Financial Sector Specialist in its Beijing office. This paper was prepared specifically for the Pan Asia Conference: Focus on Economic Challenges, Stanford Center for International Development, May 31 – June 3, 2006. The views and opinions expressed here are the authors', and not necessarily those of the World Bank.

The implications of these two facts for governments are increasingly understood. Most importantly, governments should remove policies that either unnecessarily impede the ability of financial institutions to design, price and offer loans and other financial service products, or that undermine the commercial incentive structure for financial institutions or borrowers. Governments should promote competition among financial institutions in order to increase the supply of credit and other financial services, while seeking to ensure that competition is rational, especially in terms of pricing credit risk in a manner consistent with sustainable profitability. Governments also can take steps to reduce risks and costs and improve incentives, for example by strengthening the utility of collateral to financial institutions and borrowers and by promoting the development of credit information registries.

While not to be addressed comprehensively in this paper, in the past few years the Chinese leadership clearly has come to accept much of this. There is increasing acceptance of the importance of the commercial sustainability of financial institutions, and the need to charge interest rates that cover the costs and risks of lending. Steps are being taken to build credit information registries,² and to improve the collateral regime.³ Recognition of the importance of competition in the provision of financial services in rural markets underlies some of the initiatives that will be discussed in this paper.

There is equally clear recognition internationally of what has failed to increase access to credit by small and micro businesses. Government subsidized credit programs mostly have proven costly failures because they undermine the commercial incentives for both financial institutions and borrowers, and introduce other distortions. Most government credit guarantee schemes have failed for similar reasons. Many financial institutions attempting to penetrate the small business finance market also have failed, usually because they employed poor credit policies or procedures, lacked sufficiently skilled staff, or expanded too rapidly and lost control of the business, all of which undermined the profitability of small business lending.

What is less clear is whether the Chinese leadership has accepted these particular lessons of international experience. There appears to be ambiguity about the role of subsidized lending as a means to deliver income support. Credit guarantee schemes still figure prominently in the pronouncements of objectives for rural financial sector development. And while there is increasing recognition of the positive experiences of financial institutions in other countries in successfully penetrating small business and rural markets, there remains the tendency to discount the relevance of these experiences to the perceived special circumstances of China.

² For example, the central bank is building a consumer credit information reporting system, while continuing to improve the corporate debt registries. For detailed information see www.pbc.gov.cn.

³ Studies have been conducted by the central bank with assistance from the World Bank Group to improve the secured transactions framework. If implemented, movable assets, among other assets, will qualify as acceptable collateral for banks, which should improve access to bank lending by numerous micro and small borrowers which, in general, have difficulty in meeting existing collateral requirements.

We believe it is compelling that the lessons of successful small business lending practices internationally are relevant in China. The successes have several features in common. Loans typically are granted on the basis of judgments regarding the cash flow, debt service capacity and character of borrowers. Since confidence regarding these judgments naturally increases as borrowers repay loans, default risk often is controlled in part by policies that graduate borrowers to larger, longer-term and sometimes less expensive loans as their repayment performance is established. Policies requiring frequent payments (monthly for example) serve to monitor cash flow and repayment performance and to minimize default risk. The timing of loan disbursement and loan repayment is geared to the cash flow characteristics of the activity being financed. Loan officers are held accountable for most elements of the customer relationship, and the structure of loan officers' compensation packages include positive incentives for encouraging customers to repay their loans on time, as well as for attracting new customers. Specialized management information systems, many PC-based and some available off-the-shelf, play a complementary role in supporting implementation of these practices and in controlling and reducing costs. All of these features are relevant in China's circumstances.

The challenge is less to learn how to lend to small businesses and in rural markets on a consistently profitable basis, and is more how to import into China the lessons of international experience in a manner that makes tangible, systemic differences in rural markets. There have been, by some counts, over 350 pilots of small-scale finance in urban and rural markets sponsored by local and international donors over the past decade or so. Few have proven commercially sustainable and none have proven scalable. Despite all the effort and activity, impact on a meaningful scale seems elusive. Given the vastness of rural China and the large proportion of the population residing there, a primary criterion for evaluating ongoing and future initiatives must be scalability. We do not wish to downplay the particular challenges posed by some aspects of rural finance, such as agriculture financing, subject as it is to catastrophic crop failures, wide price swings, and the like. But, from our perspective, addressing the special challenges of financing agriculture is a secondary priority. The top priority is to create a strong orientation to the commercial sustainability of finance, and to promote the emergence of a range of competitive, commercially-oriented, formal financial institutions offering a wide range of financial services to businesses and households engaged in any type of economic activity in rural China.

Political Objectives for Rural Financial Sector Development

Party and State Council Pronouncements on Building a New Socialist Countryside

This year marks the launch of the 11th Five-Year Plan (2006-2010), a central theme of which is the building of a "new socialist countryside." In fact, for some time the tradition has been for the Party and State Council to articulate, at the beginning of each year, their proposals for support to rural development in the so-called Central Party Number One Document. These pronouncements cover a full range of issues relating to rural development, including commitments of central government budgetary support, and increasingly, rural financial development has figured prominently therein. For example, for 2006, the Party and State Council specify, among other matters, that:

- the results of the rural credit cooperative (RCC) reform pilot be consolidated and disseminated
- the Postal Savings and Remittance Bureau (PSRB) be given greater autonomy to invest its deposits, including in rural areas,
- the China Development Bank (CDB) continue to finance development of rural infrastructure,
- the authorities encourage the establishment of local financial institutions with diverse ownership (including private and foreign owners) at the county level
- microfinance institutions (MFIs) initiated by natural persons, corporate legal persons, or NGOs be promoted, and that
- the Agricultural Bank of China (ABC) “be given play” to support rural and agricultural development.

Recent developments with respect to each of these propositions are discussed immediately below.

Institutional Developments

The RCC Reform Program

A common perception is that the RCCs have a monopoly on the provision of financial services in rural China. Although not true, especially when recognizing the role of informal money lenders and group-based lending and deposit-taking schemes, the 30,000-plus RCCs, historically operating individually at township level, are in many ways the public face of rural finance in China, and in fact do potentially represent a significant national asset in meeting rural financial services needs. Together the RCCs held RMB 3.2 trillion in deposits at the end of 2005 (roughly 10% of total financial system deposits), and, according to the People’s Bank of China (PBC) -- the central bank, accounted for 87 percent of all agriculture loans in the financial system.⁴

The operating and financial condition of most RCCs, however, is considered to be severely impaired. Although nominally member-owned institutions, in practice the members of RCCs have virtually no role in their governance. Instead, local leaders as well as the central authorities (via the regulatory agency -- formerly the PBC, and since its establishment in 2003, the CBRC -- the China Banking Regulatory Commission) exert significant influence over day-to-day RCC operations. In part, this is because the RCCs historically have been the main instrument through which to execute central government policy in support of rural areas and farmers, including the provision of credit at low interest rates, often financed by advances from the PBC. One consequence is that RCC lending processes typically are bureaucratic and costly, and often involve interventions by local authorities.

Recognizing the nonetheless continued relevance of the RCC network and infrastructure to rural finance, a pilot RCC reform program was endorsed by the State Council in June 2003. Originally covering eight provinces, the program was quickly expanded to most other provinces during 2004 and 2005. The overall goal of the program is to improve

⁴ PBC Monetary Policy Report, Quarter 4, 2005.

corporate governance and operations through “ownership transformation,” and to shift more responsibility for RCC governance and financial liabilities to provincial and county governments. While the CBRC has overall responsibility for the implementation of the program, a key component is the provision of financial support by the PBC.

More specifically, with the support and encouragement of provincial and county governments, the RCCs are to raise additional capital to offset at least some of their capital deficiency. In return the central government agreed to purchase half the so-called “historical burden” of non-performing loans with special PBC bills which pay interest but cannot be sold or borrowed against. Beneficiary RCCs are then to raise additional capital and take steps to improve governance. If, after two years, the RCC has met these and other criteria, the PBC will redeem the bills. Going forward, beneficiary RCCs are to comply with the same regulatory standards as do commercial banks.⁵

The program also involves the consolidation of individual township level RCCs under the guidance of the provincial government. Generally, better-off RCCs in the most economically advanced regions are merged into single legal entities, either joint stock banks (rural commercial banks, or RCBs) or rural cooperative banks. Less well-off RCCs are merged into county level RCC Unions (RCCUs). In addition, provincial level RCC Unions are being established in most provinces, in part to ensure oversight of all individual RCCs, but also to offer services to RCCs that would enable, for example, achievement of economies of scale. By the end of 2005, the PBC had issued nearly RMB 160 billion in special bills to 28 provincial governments in exchange for non-performing loans (NPLs) in what were originally some 2,300 individual RCCs.⁶ The RCCs were amalgamated into some nine RCBs, 40 rural cooperative banks, and 175 county level RCCUs.

The design of the reform program was based in part on an earlier pilot in Jiangsu Province (the so-called “Jiangsu model”), where in late 2001 a number of individual RCCs were amalgamated into three county level RCBs. The transformation involved raising capital from new investors, and putting into place corporate governance arrangements resembling those for incorporated companies.

An evaluation subsequent to the launch of the RCC reform pilot of some of the previously established RCBs has suggested that the governance reforms may not have been as profound as thought. While ownership had been clarified, indeed an important step forward, there was little apparent distinction between the role of the board and that of executive management. In many cases, new capital had been raised with the promise of high fixed dividend payments (and in fact was quoted as an interest rate). As such, new shareholders could be expected to behave more like deposit or bond holders than equity investors. Shareholder incentives to contribute to governance were seen as further undermined by the widely dispersed nature of the new shareholdings. Moreover, concerns were expressed that high fixed dividend payments could actually decapitalize

⁵ See June 20, 2004, speech by PBC Governor Zhou Xiaochuan for PBC’s perspective on the nature and intent of the RCC reform program.

⁶ PBC Monetary Policy Report, Quarter 4, 2005.

the RCBs. Finally, the newly converted RCBs carried over the dual governance structure common to most state banks in China whereby the chairman of the board is the Party Secretary in the bank, and all executive managers are Party Committee members, such that respective responsibilities and authorities of the board and the bank's Party Committee were unclear.

Nonetheless, it appears the intention of the authorities that RCCs will continue to be transformed over the next decade into RCBs, rural cooperative banks or county level RCCUs (or alternatively, into non-deposit-taking and non-lending service or consulting organizations). A key positive outcome will be to have clarified ownership. But achieving the broader objectives of the reform program likely will require that the authorities take further steps to clarify those objectives, as well as the modalities of the program; to monitor and to evaluate actions taken; and to make adjustments where required. The CBRC has articulated the direction of the next steps, including adoption by 2007 of the rules for calculating capital adequacy and the five-category system for loan classification and provisioning that are already in force for commercial banks, and increased focus on establishing governance structures with clearer specification of the respective responsibilities and accountabilities of board chairmen, presidents and executive managements. The CBRC also will delegate greater responsibility for supervision of the transforming RCC network to its local offices.⁷

The Transformation of PSRB into the China Postal Savings Bank

PSRB, part of China Post, engages in deposit taking and remittance services in postal offices throughout China. It has over RMB 1 trillion (US\$ 120 billion) in household savings and demand deposits (some 9 percent of total household deposits in China) in 250 million accounts in the over 36,000 postal offices that are able to take deposits, two-thirds of which are in rural areas. It handles some RMB 200 billion in cash remittances and RMB 1 trillion in account remittances (electronic transfers) per year in the over 45,000 postal offices able to engage in remittances. It also sells insurance as agent, with a 25 percent market share of bank-sold-as-agent insurance business, and handles 25 percent of all pension payments and 10 percent of all salary payments in China. In major cities, it processes between a quarter and a half of all utility payments. It operates over 6,000 ATMs. PSRB has some 170,000 employees engaged in financial services. The revenues from financial services are significant to China Post's gross income.⁸

Since PSRB was granted deposit-taking authority in 1986, all deposits raised were placed in the PBC at negotiated, quite favorable, interest rates. In determining the interest rate, losses incurred by the Post in providing public services were taken into account. This led to criticisms in some circles that PBC was subsidizing China Post. Placing all its deposits with the PBC also fueled complaints that PSRB was diverting resources away from rural areas. RCC managers were among those making this point, coupled with complaints about unfair competition for deposits.

⁷ See February 20, 2006, speech by CBRC Vice Chairman Tang Shuangning for indications of the next steps in the RCC reform program.

⁸ These statistics are based on discussions with PSRB management.

In August 2003, the PSRB was granted authority to place its deposits at its discretion (subject to certain investment restrictions), and simultaneously the PBC reduced substantially the interest rate paid on new PSRB deposits. The balance of PSRB's funds at PBC is to be run-off by August 2008. PSRB now invests its funds in government and financial bonds (the latter issued by the CDB and some state-owned commercial banks) and in the interbank market, and lends some to RCCs and UCCs. The lending to RCCs may be an indication of the pressure PSRB is under to recycle funds back to rural areas.

Given its huge branch network, sizeable client and deposit base, and need to deploy its deposits prudently, but not in the central bank, there were strong arguments in favor of granting PSRB a banking license. In fact, the granting of a license was anticipated by the CBRC as early as 2004, when it stipulated that PSRB be administratively separated from China Post. In 2005, the State Council formally endorsed the undertaking of preparations for the launch of China Postal Savings Bank. In 2006, the CBRC established a new department that includes responsibility for supervising postal financial services.⁹ In announcing the new department, the CBRC stated that it will make effort to "actively forge ahead with the incorporation of the postal savings bank, encourage the postal savings funds to flow back to the countryside, and prompt the postal savings to press ahead with the pilot program on small secured loans." The last makes reference to a pilot endorsed by the CBRC and initiated by PSRB in March, 2006, first in Hubei Province, then subsequently in Fujian Province, which involves granting small loans fully secured by deposits held by PSRB. This is the first step in building the lending capacity of PSRB, and a precursor to the establishment of a Postal Savings Bank.

CDB Micro and Small and Medium Enterprise (MSME) Finance Pilot

CDB is mainly engaged in financing infrastructure, particularly in the energy, road and water sectors. To some extent this has involved financing urbanization at the county level in rural China. Executive management sees CDB as playing an important role in financial sector development in China, not only in infrastructure finance, but more broadly, including MSME finance.

As a key initiative in this regard, in 2005 CDB management established a new business department to provide lines of credit and technical assistance to medium and small-sized commercial banks (partner banks) that were interested in establishing new lending departments specializing in MSME finance. In doing so, CDB is acting, in cooperation with international partners, to import into China international experts with a track record of success in setting up and managing new small business banks, and departments of existing banks, in other countries. In effect, CDB intends to serve as an anchor to the necessary and planned build-up of similar expertise among a new cadre of Chinese bank managers and lending officers, leveraging upon best practices in small-scale lending that have increasingly been adopted around the world over the last decade. Loan sizes are intended to be quite small relative to what is typically referred to as SME lending in China (where loan sizes above RMB 1million are often cited). CDB is targeting loan sizes from as low as RMB 100 to a maximum of RMB 500,000. Among the key

⁹ CBRC Press Release April 18, 2006. In addition to postal financial services, the new department is responsible for policy bank and asset management company supervision.

performance measures it has adopted are the number of businesses that have not in the past had access to loans from formal financial institutions that are served by partner banks (expected to number in the hundreds of thousands) and the timely repayment performance of the related loans portfolios.

CDB launched the business in early 2006 on a pilot basis with the city commercial bank in Baotou, the largest city in Inner Mongolia, and the city commercial bank in Taizhou, Zhejiang Province, a more progressive and competitive market. With foreign expert assistance, newly recruited loan officers are being trained and broader management capacity is being put in place to roll-out the business throughout the branch networks of these partner banks. Once the approach has been tested and refined in these and other pilot partner banks, it will be expanded to all provinces. CDB's stated goal is to be engaged with partner banks in all provinces by 2008.

PBC Commercialized Microcredit Organization Pilot

Under the guidance of the PBC, a pilot is being launched in five provinces aimed at creating competition for RCCs and formalizing heretofore informal lending business. Like the RCC reform program, this pilot envisions a substantial role for local authorities and private investors.

By the end of 2005, two private microcredit companies had been established in Shanxi province. Under the guidance and initiative of the Pingyao county government and the PBC, two small groups of private investors were formed to found the new companies. Premises were set-up, and lending operations commenced in December.

While the Shanxi operations are locally sponsored, a company planned for Sichuan Province has international sponsorship. It is envisioned that the company in Sichuan will involve the use of international lending expertise and perhaps foreign investors.

This pilot is in its very early stages. The PBC has yet to articulate (at least publicly) the specific objectives of the pilot, and how success or failure will be measured. The intention seems to be that the microcredit companies will be unable to accept deposits, but rather will have to rely on capital contributed by shareholders and perhaps some wholesale funding.¹⁰ Local governments will have a large role in determining the operating parameters, but respective responsibilities and accountabilities as between PBC and local governments remain to be clarified.

Reform and Restructuring of the Agricultural Bank of China

The ABC is a \$600 billion bank, the second largest in China, with over 31,000 branches and 480,000 employees. It is one of China's four state-owned nationwide commercial banks. For the last several years, these banks (besides ABC, including the Industrial and Commercial Bank of China, the nation's largest, the China Construction Bank, and the Bank of China) have been under direction to commercialize their operations. This directive has, among other things, driven management to pay greater attention to costs. One consequence has been that all four banks have been closing many county level

¹⁰ See speech by PBC Deputy Governor Wu Xiaoling, March 22, 2006.

branches, especially in rural areas. The ABC reportedly has closed or consolidated some 20,000 mostly rural branches. Yet at the same time it seems clear, for example in this year's Number One Document cited above, that the leadership expects the ABC to continue to play an important role in rural finance. At this time, there are no clear indications of how this is to come about. We will return to the subject of the ABC in the next section.

Regulatory Developments

Interest Rate Policy

While its impact is not restricted to rural finance, perhaps the key development over the last few years has been increasing recognition by the leadership that increasing access to finance depends upon financial institutions being able to charge interest rates that provide for their long-run financial viability. The higher cost of processing smaller loans relative to large loans means that financial institutions must be able to charge higher interest rates for smaller loans if they are to have an incentive to lend. There is simultaneous recognition that many potential borrowers are less concerned about the interest rate than about having convenient and reliable access to credit.

This thinking began to be reflected in the public comments of the PBC in early 2004. It underpinned the decision by the PBC, endorsed by the State Council, that the upper cap on lending interest rates would be eliminated (as of October 29, 2004) for all financial institutions, with the exception of RCCs and urban credit cooperatives (UCCs). The lending interest rate cap for RCCs and UCCs was nonetheless substantially relaxed, up to 230 percent of the base rate. (The base rate for one year loans at the time of this writing is 5.85 percent.) The unwillingness to fully liberalize lending rates (i.e., to deny RCCs and UCCs full pricing flexibility) is understood to reflect ongoing reservations by some leaders that poorer borrowers are able to afford commercially sustainable interest rates. Nonetheless, interest rate reform represents a major milestone.

Guidelines on Banks' Lending to Small Business

In July 2005, the CBRC issued guidelines encouraging banks (commercial banks, RCBs, and policy banks) to service the small business market. While the guidelines might be seen as somewhat intrusive in areas of management prerogative (e.g., they require all banks to set up a separate business department or team to undertake small business lending, and to track separately in their accounts the cost and profit of the business), they represent an important milestone in several respects. First, the guidelines stress that achieving commercial sustainability must be a primary goal in undertaking the business, marking a clear departure from China's historically subsidy-oriented approach to promoting small business finance. Second, they seek to promote adoption by Chinese banks of the lending techniques employed successfully internationally in small business lending, including an attention to assessing borrower repayment capacity in terms of available cash flow, with less emphasis on formal collateral, and adopting incentive-based compensation for loan officers, with incentives to be based especially on performance in attracting new clients and in collecting loans. Third, they explicitly recognize the future role of policy banks (e.g., the CDB) in lending and providing

technical assistance to small and medium-sized banks for the purposes of penetrating the small business lending market.

Prospects and Recommendations

Despite the rather comprehensive coverage provided to rural financial sector development in Number One Document of 2006, China is yet to promulgate a coherent national strategy for expanding access to financial services in rural areas. As noted above, there are a number of relevant and potentially important initiatives underway that are sponsored by the central government. There is a risk, however, that some of the initiatives will not have fundamental consequence for the quality and availability of financial services in rural China. For example, the RCC reform program, addressing as it does a loose network of mostly very impaired institutions across the country, has uncertain prospects for a reasonably consistent and positive outcome. The results in some provinces likely will exhibit some success, though lack of success may well be more prevalent. Similarly, the new PBC microfinance initiative also seeks to organize and motivate a response from a diverse group of actors (local authorities and new investors), and therefore faces a significant challenge to ensure a positive systemic impact across rural China.

Perhaps in contrast, three initiatives, one already launched (CDB's new MSME finance business), one in preparation (transformation of the PSRB into the Postal Savings Bank), and one hardly even contemplated (rehabilitation of the ABC) may, in principle, hold out greater prospects for having systemic impact. Each is discussed below.

CDB MSME Pilot

While not oriented specifically toward rural markets at the outset, CDB management has as an explicit objective progressively to roll-out to rural markets its business of providing technical assistance and financing to help small and medium size banks establish MSME finance departments utilizing proven specialized lending practices. This pilot represents an important milestone in that it is the first to import into China international experts and best practices in an institutional setting designed explicitly for systematic, nationwide, scaling-up.

Despite being a policy bank, the CDB is one of the most commercialized of China's banks. Its development-oriented leadership, nationwide scope of operations, and solid financial condition provide a promising institutional foundation for the initial build-up -- already underway -- of a core group of Chinese experts on staff. The CDB has contracted the services of a well-regarded international consulting firm with global experience in small business lending. That firm has already built the capacity to deliver its services in Chinese language, and has begun to build-up its local expert staff. The firm has supported the initial partner banks in hiring and training new loan officers and in launching the small business lending business. The CDB intends to roll-out this basic approach throughout China, with the number of newly recruited and trained loan officers and other managers expected to number in the thousands. This new indigenous Chinese capacity, housed in the CDB itself, in the CDB's partner banks, and in the increasing domestically-staffed consulting firm, is expected to create for the first time in China a

critical mass of expertise in international lending practices for small businesses. This combination of sound domestic foundations coupled with high quality international expertise committed to a long-term capacity- and business-building engagement in China seems one of the most promising prospects for expansion of lending and financial services to new customer segments in rural markets.

China Postal Savings Bank

As noted, the PSRB recently launched a pilot of small-denomination, fully-secured lending as the first step in building the credit granting capacity necessary to underpin the launch of the China Postal Savings Bank. The CBRC and other central government institutions such as the PBC are taking an active role in supporting the establishment of the bank. The bank is likely to be licensed in 2006, as a subsidiary of the China Post. With its distribution network, lack of legacy lending problems (no “historical burden”), and sizeable core deposit base, the new bank has the strongest potential among all institutional alternatives to become a significant positive factor in developing the rural financial sector.

Yet the institutional challenges cannot be underestimated. It will be essential to build a professionally governed and managed institution capable of operating independent of outside influence. An essential condition for this, in turn, will be that the bank’s management leverages substantially upon relevant international expertise in nearly all facets of the establishment and operation of the bank. Such an approach may run contrary to the culture of the China Post. Yet there is awareness among the leadership of the nature of the challenge and the real potential for limited success. In fact, the extent of the challenge is surpassed only by that of rehabilitating the other key institution in China’s rural finance landscape, the ABC.

Agricultural Bank of China

As noted, the ABC is the second largest bank in China in terms of assets, and has over 31,000 branches. Clearly, this is an important potential asset in the context of promoting a competitive rural financial services market. At the same time, the ABC clearly requires massive operational and financial restructuring. The perceived nature of the challenge perhaps is indicated by the fact that the ABC is the last of the four state-owned nationwide commercial banks to be corporatized and to undergo restructuring. So far, the ABC management’s reform proposals have yet to be accepted by the State Council. The reluctance of the State Council may stem not only from the likely high cost of recapitalizing the bank (reported NPLs remain over 25 percent of the portfolio at year-end 2005), but also due to uncertainty as to how to ensure, in the course of the type of restructuring that has seen the other state-owned commercial banks withdraw from rural markets, that ABC continues to play a significant role in rural finance.

The leadership is likely correct in viewing the ABC as a potentially important player in rural finance. The challenge is to determine how best to achieve this objective. The approach taken with the three other state-owned commercial banks is unlikely to yield success. In those banks, steps were taken to strengthen the balance sheet by removing more bad loans and by providing new capital; to consolidate responsibility for ownership

functions by establishing the Huijin Central Investment Co., which holds most of the state's shares in the banks; to attract foreign strategic investors that could, in principle at least, contribute to better governance; and, in the case of two banks so far (and probably soon the other one), to raise capital by launching initial public offerings of shares to the public (in the two cases -- CCB and BOC -- on the Hong Kong Stock Exchange). The extent to which these steps sufficiently strengthen corporate governance to underpin further reforms and to attain the ultimate goal of full commercialization of the three banks remains unclear. But regardless, these steps are certainly inadequate to achieve the leadership's goal to ensure that the ABC, from its present weak condition, is restructured and commercialized, and also makes a significant ongoing contribution to supplying financial services to rural areas.

Should there be any chance for these goals to be achieved simultaneously, fundamental and dramatic measures would have to be taken with respect to corporate governance. Ownership functions (such as, especially, appointing board members and the board chairperson, and holding them accountable) would not fall to Huijin, but rather would be undertaken by a small expert team, headed by a minister level official and reporting directly to the relevant member of the State Council. The ownership team would agree high-level objectives with the State Council, to include the desired ongoing role of the ABC in rural finance. A board comprising professionals with expertise in finance, law, industrial restructuring and the like would be assembled,¹¹ and would be given a clear mandate by the ownership team guided by the objectives agreed with the State Council. There would be a clear delineation of the respective responsibilities and authorities of the ownership team and board. An immediate task of the board would be to supplement or replace, as necessary, executive managers with professionals drawn from the international financial services community. Perhaps controversially, the Party would best relinquish its traditional role in making board and executive management appointments.

With these basic governance arrangements in place, an extensive restructuring program would be formulated and agreed by the board and executive management. The board would organize itself into specialist committees, and would draw upon outside expertise in the context of formulating strategy and the restructuring program and overseeing the performance of executive management in executing them. An early priority would be to make a significant investment in putting into place a basic control environment (including policies and procedures, IT systems, an independent and professional internal control function, and management information systems), in no small part so that the board increasingly would be able to have a reasonable degree of confidence in the information being reported by management. Many staff members likely would be attracted from outside for this purpose alone. A similar investment would be required in upgrading lending policies and practices, again requiring recruitment from outside the bank. To attract the necessary new professionals, likely numbering in the hundreds if not thousands, market-based compensation policies and HR practices would need to be adopted.

¹¹ This is in contrast to the boards of the three other state commercial banks, on which there is a significant representation of former government ministry and central bank officials.

The restructuring program would require the government to inject new capital. To a large extent this capital will be required to cover the shortfall in value of the non-performing or under-performing loan portfolio. Some such loans would be retained by the bank, others jettisoned. And there will be other costs associated with restructuring, including mitigating the impact of staff redundancies. Government should not recapitalize until the management of the ABC implements a capacity to make the actual financial condition of the ABC substantially more transparent. An important task of the board would be to ensure such transparency. The amount of the recapitalization, and its timing and conditions, would be negotiated and agreed between the ownership team and the board.

The challenge is nothing less than a massive corporate turnaround, the results of which may not be evident for years. But, there is no fundamental conflict between the objectives of an ongoing, major role for ABC in rural finance, and of achieving a fully commercialized, financially sustainable bank. Achieving these goals simultaneously would contribute greatly to increased competition and greater access to financial services in rural China.

Concluding Remarks

In spite of many attempts at reform, the Chinese rural financial market clearly has a long way to go to meet the demands for financial services and products by rural households and businesses. In order to build a diversified and competitive rural financial market, there is a need to broadly rethink rural financial reform and development strategies. The government is increasingly demonstrating its recognition of the importance of better understanding the lessons of past reforms, and its willingness to take a more comprehensive approach to future reforms. That likely will involve many of the matters discussed in this paper.