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Thematic Study
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Picture on Cover page:

People's Republic of China,
Dai minority farmers in Jiangcheng Country work in rice fields irrigated by
the IFAD irrigation project.

IFAD photo by Lou Dematteis

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People's Republic of China
Rural Financial Services in China
Thematic Study

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Acronyms and Abbreviations

ABC	Agricultural Bank of China
ADBC	Agricultural Development Bank of China
AUSAID	Australian Agency for International Development
CAAS	Chinese Academy of Agricultural Sciences
CASS	Chinese Academy of Social Sciences
CGAP	Consultative Group to Assist the Poorest
FAO	Food and Agriculture Organization of the United Nations
GB	Grameen Bank
IFI	International Financial Institution
MOA	Ministry of Agriculture
MOF	Ministry of Finance
NGO	Non-governmental organization
PADO	Poor Areas Development Office
PBC	People's Bank of China
PMO	Project Management Office
RCF	Rural Credit Foundation
RCC	Rural Credit Cooperative
SOCB	state-owned commercial bank
SOE	state-owned enterprise
TVE	Township and Village Enterprise
UNDP	United Nations Development Programme
UNFPA	United Nations Fund for Population Activities
UNICEF	United Nations Children's Fund
VIG	Village Implementation Group
WFP	World Food Programme

The currency in the People's Republic of China is the yuan renminbi (yuan)

People's Republic of China
Thematic Study on Rural Financial Services in China
Executive Summary

I. INTRODUCTION

A. Context

1. To date, IFAD has provided 15 loans to the People's Republic of China on highly concessional terms (0.75% service charge), for a total commitment of USD 380 million. Most of these loans involve integrated agricultural development projects, and about two thirds of the loan funds are allocated to credit components. Recent projects have increasingly targeted rural women in terms of literacy programmes, health care and skills training.
2. Project design has shifted slowly from being entirely supply-driven, whereby government offices were responsible for credit delivery through project management offices (PMOs), to interventions using the services of local financial services institutions, namely, rural credit cooperatives (RCCs).
3. Under the PMO system, the Ministry of Finance (MOF) borrows from IFAD and, through two-to-three administrative levels, supplies the funds to Township Finance Offices. These offices bear the credit risk and are responsible for delivering credit to households and for repaying IFAD loan funds to County Finance Bureaux. With the help of village implementation groups, the township PMO identifies the borrowers for credit delivery. PMOs are staffed with government line agency staff, who provide project-related extension services and training to beneficiary households.
4. In the late 1990s, IFAD realized the importance of mainstreaming rural financial services. As such, its last four projects introduced a new concept whereby RCCs deliver financial services. It was thought that sustainability would be enhanced if project credit were to be channelled through the existing rural financial infrastructure; thus there was a strong argument for shifting credit delivery, recovery and associated risk to the RCCs. However, no proper formal study was ever undertaken to explore the in-depth institutional constraints on, and strengths/weaknesses of, the two models.

B. Thematic Study: Rationale and Objective

5. Stakeholders – IFAD included – are beginning to recognize the potential value of using a strengthened RCC system. However, many programmes have been based on grant finance: funds pass directly to RCCs, bypassing MOF [see paragraph 1.7 of main report]. In order to contribute to ongoing dialogue on ways of improving policy in support of RCCs, IFAD commissioned the present thematic study to formally assess the strengths and weaknesses of the RCC model vis-à-vis the PMO model; examine variations in the performance of RCCs; and develop a reform programme for stakeholders based on poverty alleviation by means of microfinance [see paragraph 1.8 of main report].

C. Projects Studied

6. The study was conducted in two phases and covered four ongoing representative IFAD projects in China [see paragraphs 1.9-11 of main report].

II. RURAL FINANCIAL INSTITUTIONS IN CHINA

A. Development and Clientele

7. The official rural financial organizations operating in China are the Agricultural Bank of China (ABC); Agricultural Development Bank of China (ADBC); and RCCs. Non-official financial organizations include rural credit foundations, mutual savings associations, the informal sector and microcredit projects targeted at poverty relief that have developed in recent years.

B. RCCs in Operation

8. RCCs are rural financial institutions whose main borrowing clients are farmers and Township and Village Enterprises (TVEs). RCCs are required [see paragraph 2.6 of main report] to allocate more than 50% of total loans to its members. Generally, loans of more than CNY 3 000 require the mortgaging of assets, and very large loans may require both mortgaging and other collateral security. At the present time, the People's Bank of China (PBC) – the Central Bank – has allowed RCCs to use, on a trial basis, a joint liability concept for granting small loans. In 1999, the RCCs were allowed to grant consumption loans to farmers, mainly for the construction of houses, education and medical treatment. RCCs lend for all activities, including production, consumption and business, to individuals, privately-owned enterprises and TVEs.

9. The RCCs are nominally independent cooperative banks at the township level, each RCC being responsible for its own profits and losses. At the county level, RCCs are linked through an RCC union. PBC is involved in RCC management (approval of staff and disciplinary action) [see paragraphs 2.11-12 of main report].

C. Trends in Financial Service Provision

10. In 1990-97, the annual growth rate of deposits in the formal financial system was as high as 31%. In 1997, total deposits in the official financial system in rural areas amounted to CNY 2 225 000 million, or 27% of total deposits in financial organizations nationwide. In 1990, loans outstanding in official financial organizations throughout the country amounted to a total of CNY 1 517 000 million, compared with CNY 440 000 million in loans outstanding in the official rural financial system. By 1997, total loans outstanding to TVEs (CNY 367 000 million) were over half the total RCC loan portfolio (CNY 727 000 million), while the household sector's share of loans (CNY 174 000 million) was 24% of the total [see paragraphs 2.13-14 of main report].

11. Credit obtained by farmers from the informal market is estimated at more than four times that obtained from official credit institutions. From the farmers' perspective, therefore, the informal credit market is far more important than the official credit market [see paragraph 2.15 of main report].

D. Interest Rates

12. China recently experienced its first year of net deflation. Inflation-indexed deposit rates were introduced in the mid-1990s, with Government paying out subsidy elements to commercial banks in order to stimulate domestic savings growth. Lending interest rates, however, remained relatively low. It has been argued that the two main reasons for keeping these rates low were to stimulate household consumption and demand, and to secure preferential and low-cost access of state-owned enterprises (SOEs) to much needed liquidity [see paragraphs 2.16-22 of main report].

13. PBC has recognized the relatively high cost structure of RCCs compared with that of institutions such as ABC or state-owned commercial banks (SOCBs). PBC allows RCCs to be flexible when setting lending rates in order to partially offset both the high costs associated with reaching large numbers of small clients and the burden of non-performing loans. PBC allows RCCs a 50% band spread over the normal lending rate ceiling. However, although it helps RCCs, this flexibility is insufficient. RCCs remain at a competitive disadvantage compared with other rural financial institutions, such as ABC or the state-owned Industrial Bank. All new 'innovative' microfinance projects charge interest rates higher than those of RCCs. Typical customer profiles in small townships differ from those in the larger county towns, where SOCBs, including ABC, operate.

14. The costs for RCCs to mobilize deposit funds and administer their loan portfolios are higher owing to difficulties in reaching dispersed rural households, and because transactions are comparatively small. The predictable result of interest rate regulation in a high-cost retail banking environment is that RCCs tend to prefer investments in bonds and securities in order to generate income, instead of advancing those funds as loans to rural people. Within the present system, RCCs find it difficult to compete with both formal and semi-formal institutions.

15. Interest rates on informal loans vary greatly. Borrowing between friends and relatives can be interest-free. Interest on loans for production and commercial purposes is generally one-to-two times higher than that of official financial institutions. Compound interest is generally not used: interest rates are flat rates based on the initial principal amount. In the coastal regions, where informal lending is popular, normal loan interest rates are generally a monthly flat rate of 2%.

E. Regulatory Framework

16. The RCCs are directly supervised and managed by the Cooperative Financial Management Department of PBC. RCCs in all areas are required to set up county-level apex institutions that provide a clearing house service for local RCCs. The apex institutions collect management fees from their affiliates and have their own financial service businesses.

17. Although RCCs are defined as rural cooperative economic organizations, no law on credit cooperatives has yet been enacted. PBC has published management regulations and guidelines to improve and strengthen farmer assistance services.

III. POVERTY ALLEVIATION STRATEGIES

18. China has made remarkable achievements in improving the standard of living of its people and in realizing sustained economic growth over the last two decades. The rural poor population – using the official poverty line definition – fell from 250 million in 1978 to 36 million in 1999, or from 30.7% to 4.2% of the total rural population. In 1997, the World Bank estimated the incidence of rural poverty at almost 13.5% (applying the USD 1 per day criterion), which indicates a poverty level of 2.5 times the official standard. This means that still more than 10% of the rural population still live in deprived conditions [see paragraph 3.1 of main report].

Government Loan Programmes for Poverty Alleviation

19. The Government has used three channels for poverty alleviation: subsidized loans; food-for-work; and budgetary grants. Resources have been increased substantially for all three components of the poverty alleviation programme, but the emphasis on food-for-work has been reduced over time. The Government approved a quantum jump in the resources allocated to the subsidized loan programme [see paragraph 3.18 of main report].

20. The Chinese authorities believe that subsidized loans constitute a helpful tool for poverty alleviation. This is based on the perception that, first of all, the poor are unable to access the formal credit market as they lack the assets necessary for mortgage and collateral; and, secondly, that the poor cannot afford to repay the loans at full market interest rates. Since its establishment in 1986, the Government's Poverty Alleviation Leading Group has provided subsidized loans for the poor as a key instrument for reducing poverty.

21. The national leading group approves subsidized loan allocations to the different provinces on an annual basis. Leading groups at provincial level, operating through Poor-Areas Development Offices, approve loan allocations to counties and townships. At the county level (and the provincial level for large projects), loans are allocated for approved projects. ABC administers the subsidized poverty loan programme for nationally designated poor counties, and is authorized to reject loans applications.

22. Targeting is an important issue still needing to be resolved by policy-makers. The normal annual interest rate for subsidized poverty loans has been 2.9%, or about one third of the regular rate of interest charged by RCCs, which were not used directly in the poverty alleviation lending programme [see paragraphs 3.18-25 of main report].

IV. EXPERIENCE WITH MICROFINANCE IN CHINA

A. Willingness to Experiment

23. In China, 'rural finance' refers to lending by formal financial institutions, whereby loans are granted under financial sector regulations set by PBC. The term 'microfinance' refers to poverty-focused credit operations of civil society and government departments that are exempt from PBC's normal financial sector regulations. In China, 'microfinance' has literally come to mean lending that is based on the group solidarity concept or joint liability and is seen as a potentially effective tool to transfer poverty reduction funds to poor families. Microfinance in China started with a pilot project mounted by the Agriculture Development Institute of the Chinese Academy of Social Sciences (CASS), based on the Grameen Bank model or the solidarity group model. Its emphasis is on production loans to poor families [see paragraphs 4.1-6 of main report].

B. Characteristics of Donor- and Non-Governmental Organization (NGO)-Assisted Credit Schemes

24. Rural credit schemes in China have four common characteristics that have a negative effect on prospects for building up viable financial services over the long term, and are not usually integrated into the mainstream rural banking system. Most existing credit schemes have adopted technologies and methodologies borrowed from other countries. They are project-based, i.e. they receive external funds, but are directly funded only during the life of the project. The staff of most credit schemes in China are, at one and the same time, employees of government departments or other agencies. There are no structured plans for developing core competencies in financial service provision across institutions and for mainstreaming microfinance into the rural financial infrastructure [see paragraphs 4.7-9 of main report].

C. Target Group

25. Microfinance programmes usually target resource-poor households, with special focus on women in poor regions. Governmental-funded projects for poverty reduction through microfinance using subsidized interest loans emphasize inclusion of the poorest families in the target group. Indeed, poor families registered with the Government form the basic target group. Such programmes do not, however, specially target women, whereas the main target group of most external donor-funded projects and the CASS Funding the Poor Cooperative are women [see paragraph 4.10 of main report].

D. Design of Financial Services

26. First loans provided under most government microfinance projects do not generally exceed CNY 1 000, with repayments over one year and an annual interest rate of between 2.9% and 7.2%. Civil organizations' microfinance projects generally grant loans of CNY 400-1 000, with repayment over 3-12 months. Such loans are either repaid in a lump sum on maturity or in weekly or monthly instalments. Civil organization- and donor-funded projects are authorized to charge higher annual interest rates ranging from 12% to 20%.

27. Microfinance projects implemented by civil organizations provide a compulsory savings scheme, but not a full range of financial services. A government-funded subsidized loan programme is being implemented through ABC, which provides a full range of financial services. Most projects implemented by civil organizations have poor accounting and financial reporting systems, with inadequate tracking of income and expenses, loan quality and business progress reporting [see paragraph 4.12 of main report].

E. Sustainability

28. Some pilot microfinance projects have achieved operational self-sustainability. PBC authorized an increase in interest rates for microfinance loans, and thus improved profitability. The CASS Funding the Poor Cooperative pilot projects in three counties achieved operational self-sufficiency by the end of 1997. Although the Qinghai project funded by the Australian Agency for International Development is located in a poor area, it does not specifically focus on resource-poor households except in terms of providing small loan amounts. The project, which is implemented by local agricultural banks, has achieved operational self-sufficiency through a policy of higher interest rates combined with strict control of costs and loan quality.

F. Policy Dilemma

29. In 1988, PBC and ABC undertook a joint study on microfinance projects. The study cast doubts on the legality of the Funding the Poor Cooperatives programme set up by the Government to handle subsidized poverty reduction interest loans as agents of ABC. It was argued that non-financial organizations have no right to act as intermediaries and/or handle microfinance activities that are essentially financial in nature. Since 1999, ABC has directly issued subsidized loans to rural families for the purpose of alleviating poverty. Insisting that microfinance should be integrated into the financial system is a step in the right direction. However, *in the absence of policies to mainstream microfinance and develop competition in the rural financial system*, the growth of microfinance institutions (MFIs) is constrained.

V. DEMAND FOR FINANCIAL SERVICES

A. Credit Access

Limited Credit for Poorer Households

30. Formal and informal loans are widely available to the public in rural China. Nevertheless, the detailed and unusual survey data used for analysing credit constraints in the present study clearly point to harsh constraints for the resource-poor strata of the population, implying that policy-makers and donors would do well to revisit their policies and procedures in this regard. The survey of farm households in six poor counties undertaken by CASS in 1997 shed much-needed light on resource-poor farmers' demand for, and receipt of, credit. The majority of households (54%) with outstanding formal loans are unable to obtain additional formal loans [see paragraphs 5.1-2 of main report].

31. The data suggest that, even when formal credit is obtainable, amounts are limited – especially to households in the poorest population groups. They also stress the great importance of informal credit in poor areas and the need to incorporate features of informal credit markets into microfinance strategies with a view to reaching resource-poor households. Another equally significant and unexpected finding is that rural households in the poorest quartile are indeed able to borrow and service an amount equal to the average borrowing of the richest quartile [see paragraphs 5.3-4 of main report].

B. Credit Supply

32. Rural credit cooperatives are cooperatives in name only. They are regulated and managed by PBC, supply the majority of formal loans in the rural areas and account for two thirds of all household deposits. Almost two thirds of all loans go to the household sector although, in more developed rural areas, the TVEs and county enterprises are the major borrowers

33. On average, households borrow from a network of 15 persons, varying from 12 in the poorest asset quartile to 18 in the richest. Not less than 80% of all important network members are relatives; 53% live in the same village. Households in the poorest quartile tend to be net borrowers in these relationships, borrowing on average four times more than what they lend. It stands to reason, therefore, that these households provide more exchange labour than they receive.

C. Credit Market Participation

34. It is surprising that richer households are much less likely to borrow, as one might expect such households to become involved in self-employment and other non-cropping activities calling for greater financing. The level of financial intermediation (ratio of loans to economic output) is generally expected to increase with the level of economic development [see paragraph 5.10 of main report].

35. Equally striking is the large percentage of the poorest households that take out formal loans. More than 40% of households in the poorest asset quartile took out formal loans in 1997 (mainly from RCCs) compared with 22% in the richest quartile [see paragraph 5.11 and Annex 2, paragraph A2.11 of main report]. About half of those who took out formal loans also borrowed informally. Lower-income households have little difficulty in using credit productively, but are restricted by limited access. In short, limited credit access and associated restrictions are more likely to explain borrowing behaviour than low productivity of enterprises for which low-income households seek credit. On the other hand, the relatively high incidence of formal borrowing on the part of the poorest people negates the proposition that credit rationing in China excludes the poor from formal financial markets. Indeed, subject to access to funds, the poorest group is more likely to borrow from formal sources than the richest people are. One explanation is that, in poorer areas, the lack of enterprises means that financial institutions are more likely to lend to households, especially when institutions have limited ability to intermediate funds through interbank markets.

D. Willingness to Borrow

36. Almost 50% of households in the lower income groups were willing to borrow from RCCs under current conditions, provided there was no need for collateral or a guarantor. In the richest quartile, only 30% expressed such willingness (but this is not to suggest that providing such loans would be desirable without building necessary safeguards to ensure repayment). *This implies that many of the poor are constrained by supply limitations or loan requirements: they do not lack suitable uses for available funds.*

E. Economic Activities, Cash Flow and Demand for Credit

37. The demand for productive loans generally depends on the economic activities of the households concerned. Nearly all households in the sample group pursued cropping and livestock activities, while less than half were engaged in wage earning (48%) and self-employment (29%). More households in the richest group were engaged in non-farm activities (56% in wage earning and 37% in self-employment), compared with those belonging to the poorer strata of the sample.

38. Economic activities have different financing needs. More was needed for livestock (75%), followed by self-employment activities (64%), cropping (27%) and wage income (5%). The borrowing propensity was highest for cropping (29%), followed by self-employment (22%) and livestock (10%). Borrowing for cropping was much lower in the richest asset quartile (17%) and, for livestock, it was much higher in the poorest quartile (17%).

39. It was found that, while borrowing more on average, the rich were much less likely to borrow than the poor. While they were more likely to engage in self-employment activities, only one fifth of all rich households so engaged borrowed to finance their activities directly. At the same time, the rich were much less likely to borrow for cropping or for consumption compared with the poor, and richer households were apparently able, and preferred, to self-finance most activities.

F. Potential for Savings Mobilization

40. There is huge potential for increased savings mobilization, meaning that rural production and growth could be made less dependent on external financial transfers. Only 16% of households were reported as having savings, the percentage (23%) being higher for the rich. In total, the value of liquid assets averaged CNY 2 767 per household compared with CNY 1 078 in average borrowing [see paragraphs 5.20-21 of main report].

VI. EVOLUTION OF FINANCIAL SERVICES

41. IFAD's projects in China have used two models (the PMO and RCC models) for the delivery of financial services. It is difficult to compare the two models by means of conventional performance measurement tools. They need, rather, to be analysed using a 'strengths and weakness' mode of analysis. The supply-driven credit delivery mode needs to be contrasted with the sustainable financial service delivery mode.

A. Comparison of Financial Services Delivery Models

Products

42. The IFAD projects using the PMO model offered only credit products, whereas the RCC model envisaged the integration of IFAD project funds into the financial system. Such arrangement was expected to develop the capability of RCCs to provide a full range of financial services to rural households, compared with the PMO model which provided only credit.

Targeting

43. The PMOs and RCCs established four primary criteria to select households for credit delivery: (i) potential loan repayment ability; (ii) skills or techniques to undertake an activity; (iii) households having designed and submitted a suitable plan for using credit funds; and (iv) ability to mobilize their own capital [see paragraphs 6.3-6 of main report].

Review of Targeting Performance

44. The projects' targeting criteria would have contributed to effectively excluding some of the poor households. The projects did not devise systems to develop the capability of resource-poor households to receive credit. Three factors contributed to excluding the resource-poor: (i) projects did not envisage that the initial requirements of resource-poor were small amounts of funds to deal with household emergencies and/or sickness; (ii) household choice was limited since project loans were for productive purposes only; and (iii) project loans excluded households that received food subsidies from the civil administration and had inadequate labour.

45. The survey data show that households that had received project loans were in the better-off strata of society. The mission interviewed 96 households, of which half had received loans and half served as a control group. The mean per capita income of households that had not received project loans was about 45% below that of households that had. Only 19% of households that received project loans had a food deficit compared to 38% that had not. A higher percentage of households with project loans had access to other institutional finance; in contrast, as expected, a higher percentage of households without project loans used informal credit. The value of durable goods in households that had taken project loans was 18 times that of households that had not taken out such loans [see paragraph 6.9 and Table 3 of main report].

46. It is true that in the poor areas of rural China, many resource-poor households may have limited credit absorption capacity, particularly for productive investments. The real issue, however, is that local officials, including RCC and PMO officials, are more inclined to grant loans to better-off households. Such officials are more concerned about the ability of clients to repay their loans than with finding ways to reduce poverty. Poor households are usually to be found in remote mountainous areas and the cost of outreach, for delivering credit and monitoring such groups, is high [see paragraphs 6.10-11 of main report].

47. Two lessons emerge here: (i) the perception that the poor cannot repay their loans is pervasive among project implementers; and (ii) the cost of delivery to poor households is very high. The targeting of poor households calls for a two-pronged strategy: loan products should match the requirements, absorption capacity and risk profile of the poor; and the financial institution involved should to be given incentives in the form of spread to deliver and recover credit [see paragraphs 6.12-13 of main report].

Financial Service Delivery

48. **Loan purpose.** IFAD projects have placed emphasis on credit to improve agricultural productivity, usually medium-term loans for crop and tree planting and livestock-related activities. With the PMO model, loans have been provided as envisaged in project design, but have neglected the consumption needs vital to resource-poor households. In contrast, the RCC model not only envisages providing loans for productive activities using project funds but also involves lending to cater for consumption, using RCC funding.

49. **Loan size and duration.** The size of loans in the PMO and RCC models depends on project loan regulations and the activities for which loans are sought. Generally, projects provide uniform loans that are not necessarily in line with household requirements. However, RCCs can provide loans according to the needs of the households, repayment capacity and collateral. Both institutional models were designed to provide mostly medium- and long-term loans as stipulated in the project documents, but as a general rule RCCs provide only short-term loans.

50. **Collateral requirements.** RCCs generally seek collateral, and in practice this excludes the resource-poor farmers. The PMO model does not require collateral for loans. The RCC model does not envisage collateral for loans of up to CNY 3 000 but, in practice, RCCs also request collateral for loans of less than CNY 3 000 [see paragraph 6.17 of main report].

51. **Repayment period.** The repayment period is dictated by the credit guidelines for both models and is fixed on the basis of the activity funded rather than the client's repayment capacity. Projects should not establish repayment schedules; this is better left to the financial institutions at the time of loan approval.

52. **Interest rates.** Borrowers pay less interest than the normal RCC lending rate. Charging a higher rate of interest continues to be a contentious issue. The project authorities still maintain that a low rate of interest is an essential requirement for credit uptake by resource-poor households.

53. **Flexibility to adjust lending rates.** Neither model has sufficient flexibility to adjust lending rates to cover cost and risk. Microfinance projects have been allowed to charge more interest than regular financial institutions. A case in point is the Grameen Bank pilot project in Yixuan County in Hebei Province, where the lending rate is 16% per annum. Higher rates of interest mostly act as a selection mechanism for targeting because, for resource-poor households, access to finance is more important than the rate of interest [see paragraph 6.20 of main report].

54. **Recovery performance.** PMO officials reported a 70-80% recovery performance, but no records were provided to substantiate this and there was some doubt about the reliability of data provided by PMOs. Supervision reports suggest that inadequate performance at the county level has also been caused by delays in communications and instructions from townships to counties. As the RCCs have not kept separate accounts for the IFAD project loans, it was not possible to assess recovery performance. However, overall, the recovery performance for RCC loans to households was about 80%.

55. **Credit risk.** The local township government bears the credit risk in respect of loans granted by PMOs. The RCC model envisaged passing on the credit risk to the RCCs. In reality, even for projects using the RCC model, the credit risk has continued to rest with the local government. When RCCs do not have autonomy in selecting borrowers, they are understandably not prepared to take the credit risk. Since township governments are responsible for repaying IFAD loans to higher levels of government, they wish to exercise control over borrower selection and loan disbursement.

56. **Training.** IFAD projects have trained PMO staff in credit delivery and preparation of credit guidelines for the PMO model. In projects using RCCs, allocations for training RCC staff were not being used as the RCCs were unwilling to use loan funds for capacity building. Instead, IFAD has collaborated with the German Agency for Technical Cooperation (GTZ) to provide technical assistance to RCCs.

57. Earlier IFAD projects provided little training to households, but this problem has since been redressed by collaborating with the World Food Programme (WFP). One very positive finding is that training programmes have been effective, with close links observed between the purpose of the loan and the training involved. Almost 90% of all credit recipients were trained in relevant economic activities.

58. In addition, about 20% of households without project loans received training, most of which focused on technical issues and skills necessary for maintaining project-funded activities. Training programmes on general and reproductive health were also provided to women. Collaboration with WFP effectively enhanced credit utilization. The study team also found that there was little awareness of credit terms, such as interest rates, repayment frequency and periods, especially in terms of the PMO model.

59. The mission found no hard evidence to suggest that WFP collaboration had helped to improve resource-poor households' credit uptake and the provision of appropriate credit products. To some extent, increased attendance at meetings was due to the fact that food was distributed free at such gatherings. As a general rule, credit projects have by-passed the poor. Although the study was not specifically designed to test the impact of food distribution associated with training, it would be worthy of further evaluation.

60. **Accounting system under the PMO model.** The PMO model's accounting system is inadequate. The situation in respect of RCCs is better, as their management information system is superior. However, procedures related to asset classification, loan loss provisioning and accounting practices do not conform to international standards.

61. **Revolving fund operation.** The extent to which funds are being recycled with the PMO model remains a moot point. The design of IFAD projects incorporated two important safeguards to ensure such recycling. First, IFAD set out to disburse only incremental credit, but this was not found to occur in all the townships visited by the mission. The amount recovered is kept in a separate account, and its use remains unclear. In contrast, with the RCC model, monies recovered remain within the RCC system and are used for credit delivery.

62. The second safeguard was that IFAD funds are meant to remain at the township level for 15 years, the intention being to ensure that they are used for providing credit to households even after project termination. This is more likely to happen in the RCC model, while for the PMO model it would depend on current local government priorities.

B. PMO and RCC Models Reassessed

63. In the absence of healthy and willing rural financial institutions, the PMO model has been instrumental in infusing much-needed capital into the rural economy. From a purely credit disbursement perspective, the PMO model appears more efficient. The coverage of households within localities with

the PMO model (Sichuan Livestock Development Project) was about 66% compared to 20% with the RCC model (Southwest Anhui Integrated Agricultural Development Project).

64. The PMO model is a short-term measure, however, and cannot be further strengthened to deliver sustainable financial services. This model can function as an allocation mechanism only for as long as the project funds remain at the township level. The PMO model represents a supply-driven credit-delivery model, and it suffers from the known limitations of this approach. Funds are allocated for disbursement with little attention to loan appraisal, repayment capacity, client credit history, and guarantee and collateral requirements. Moreover, it does not incorporate microfinance methodologies to assist the resource-poor households to ‘graduate,’ i.e. to progress from initial small loans with short repayment periods and higher frequency of repayment, to ultimately access larger loan amounts with longer repayment periods for agricultural investments.

65. Borrower selection is based on an annual planning process with no flexibility to provide loans to households if needed during the middle of the year. Activity selection, repayment terms (period and frequency) are insufficiently flexible for household requirements, determined as they are by the requirements of the Staff Appraisal Report and credit manual specifications. Two very important weaknesses in the PMO model, constraining development of sustainable rural financial services, are: (i) inability to mobilize savings and recycle them for investment; and (ii) potential moral hazard, since borrowers may perceive that loans from government departments can be simply written off.

66. Despite their current limitations, RCCs are the mainstay of the rural financial sector in China. They have established a large network and are the only formally authorized financial institutions to serve rural households. Their contribution in mobilizing and deploying savings for investment is substantial, but their problems derive from a skewed policy environment with regulated interest rates that makes it difficult to reach out to dispersed rural households. The RCC network also suffers from performance deficits caused partly by historic burdens of bad debts and partly by ongoing operating weaknesses. But with the efforts of the PBC and through its direct supervision, RCCs are slowly but steadily being restructured. To increase the effective yield of the funds employed, microfinance methodologies are being built into the credit delivery systems of selected RCCs on a pilot basis.

67. The RCC model is intended to pass on the credit risk to RCCs by allowing them full authority to accept or reject loan applications forwarded by the PMO. RCCs mobilize savings and are under Central Bank supervision. This model is the way to proceed to integrate the project-directed credit component into the financial system. This is in line with a State Council directive to stop all lending activities within government units [see paragraph 6.37 of main report].

68. IFAD is the first international financial institution (IFI) to start mainstreaming financial services into the financial system of the country. Even the most recent World Bank projects use ABC as the agent for delivery of credit, and it was found that efforts for complete integration of project credit delivery into ABC had yet to begin. Within the IFAD project framework, attempts are being made to integrate RCCs for delivery of financial services, although this is difficult to achieve [see paragraph 6.38 of main report].

VII. FACTORS IMPACTING INVOLVEMENT OF RCCS IN IFAD PROJECTS

A. Procedural Limitations Pertaining to Use of IFAD Loans

69. The MOF has placed severe procedural limitations on the use of IFAD funds. These funds are passed as loans to the township level, and township PMOs are ultimately responsible for repayment.

This makes it difficult to bring about the necessary interaction between PMOs and RCCs at the township level. The relevant regulations [see paragraph 9.1 of main report] constitute a twofold challenge to IFAD projects. First, MOF or finance departments at the provincial level cannot assign IFAD loans to PBC, RCCs or other financial institutions. Second, the township governments may not use IFAD funds for activities other than credit, as such funds have to be repaid. It does not appear to be a realistic proposition to expect governments of poor townships to repay the funds used for the development of rural infrastructure, training and other activities [see paragraphs 9.2-3 of main report].

70. The PMO model has been a convenient tool in the context of current MOF procedures, as the borrower of IFAD loans. IFAD loans are passed on directly to the provinces and are repayable in 30 years after a ten-year grace period, and with associated exchange risk. The provincial government bears the exchange risk and passes the loan on to the subsequent lower level, repayable in 15 years after ten years' grace. The township government, which ultimately receives IFAD loan funds, has to repay the borrowed amount to the higher levels of administration.

71. IFAD credit funds are used as intended for lending to the households, but MOF regulations prevent townships from using such funds for infrastructure development and other related activities. Instead, townships use them for providing credit to households, which can be recovered and repaid. This means that IFAD's intentions are thwarted: the projects provide funds for infrastructure development and other activities but these funds are not used as required. Township governments use 100% government funds for rural infrastructure, training and other activities, excluding credit. This is in conflict with IFAD's intention as allocations have been made for such components in the project documents. Instead, township governments claim reimbursement from IFAD *for all activities*. The reimbursements received from IFAD for rural infrastructure and other activities are again deployed for providing credit to households. This is in addition to funds allocated for credit.

72. The mission's discussions and fact finding suggest that the entire IFAD loan is used for the credit component, while the township governments use counterpart funds to undertake other activities. The rationale behind this is that the IFAD funds are loan funds and will have to be returned or repaid, so they need to be deployed as loans and not for infrastructure and other investments that cannot be recovered directly from private households as 'repayment.' For as long as MOF uses the current procedure of passing on IFAD funds as loans, local governments at the township level will find it difficult to absorb IFAD credit for infrastructure and other activities and repay the same at a later date. This conclusion is based on probing questions and discussions with project management staff. The success of RCCs is predicated on a set of complex institutional issues that range far beyond the apparently simple one of margin availability.

73. The township, county and provincial governments are unwilling to place the funds – which they will ultimately have to repay – with the RCCs and thereby relinquish control over their use. They see no role for themselves in IFAD projects if the funds allocated for the credit component are passed on to the RCCs. It will be impossible to integrate PMO and RCC activities within the IFAD project framework if MOF continues its current loan deployment procedure. Instead, one possible solution would be for township governments to receive IFAD funds as grants from MOF for rural infrastructure, training and other activities, together with loan funds for the credit component.

74. The MOF argues that the major constraint on a shift to the RCC model is the poor health of RCCs and the risk of non-repayment of funds provided to them. This argument is not valid. First, the poor performance of RCCs is not due to the above-mentioned problems of the institution alone. Second, macro factors linked to government policy – including governance issues, historic bad loans and the policy environment – militate against generating longer-term sustainable growth for RCCs. Third, to advance reforms and permit higher rural economic growth and employment, the Government will need to assist the RCCs to restructure, supported by relevant enabling policies and regulatory framework.

B. Limited Incentive Structure for RCCs

75. The RCCs have limited incentive to operate within the current framework of cooperation with PMOs. Four factors contribute, namely (i) high cost of funds; (ii) perceived high credit risk; (iii) inconsistencies in lending policies and procedures; and (iv) perceived non-requirement of external funding.

Cost of Funds

76. IFAD funds are channelled to the provinces by MOF at a very high cost, passing through five administrative layers before reaching the RCCs. It passes the funds with credit risk and exchange risk to the provinces, but it charges 4.5% to the respective provincial Finance Department as against the 0.75% charged by IFAD. It has, however, passed on World Bank project funds to the provinces at considerably lower rates. However, in 2000, IFAD secured more advantageous or reduced margin requirements in the transfer of funds to the provinces.

77. It may be argued that the cost structure for RCCs under IFAD projects unwittingly ensures failure of the RCC model. The interest rate spread for RCCs is too low for them to be interested in seeking IFAD funding. The rate of interest on loans to households varies from project to project. In the Sichuan Livestock Development Project, in the areas where the RCC model is being tried, the rate of interest charged to households is 12.06%, whereas in areas with the PMO model the rate of interest is 8%. The spread available to RCCs varies from 1.1% to 1.3% in the Southwest Anhui Integrated Agricultural Development Project. The RCCs have been promised an additional spread of 1.5% by PMOs. In practice, this would mean that the PMOs would have first to receive a 1.5% spread refund from MOF prior to passing this refund on to RCCs.

78. The average cost of RCC funds, as calculated by interest expenditure to outstanding deposits, has been declining steadily over recent years following PBC's downward revision of interest rates. The overall cost of funds declined from about 6% in 1997 to about 4% in 1999. The weighted average rate of interest for new deposit mobilization is much less than the RCCs' current average cost of funds. The latter ranges from 1.75% to 2.21% and is falling, with a declining proportion of time deposits of longer maturity.

79. It is definitely not a viable business proposition for RCCs to accept project funds at 6-7% when additional funds could be mobilized at a rate not exceeding 2.26% (excluding the cost of mobilization). In addition, the cost of deposit mobilization by RCCs is approximately 1.35% of the total deposit outstanding. The upper limit of total cost of funds is estimated at about 3.6%. To wit, PBC provides funds to RCCs at 2.9% interest. The high cost of funds has acted as a disincentive for RCCs, not only in terms of participating fully in IFAD projects but also with regard to taking the full credit risk. It can be safely assumed that RCCs would not be able to accept project funds at a cost exceeding 3-3.6%.

80. The design of IFAD projects has assumed that a spread of 4-4.5% should suffice to cover all costs of credit delivery, recovery and credit risk, and make for a reasonable profit. This hypothesis is also invalid. Based on the survey of RCCs in five provinces, it was found that the RCCs were able to employ a spread of 7% in 1995, but performance has not improved since then. The need for a larger margin remains, clearly indicating that the current incentive structure for RCCs does not encourage them to participate in IFAD projects.

Perceived Credit Risk

81. Even if a sufficient margin is provided to the RCCs to bear the full credit risk, they require complete independence in selecting the borrowers. Once the RCCs achieve complete independence, the RCCs will probably reject about 40-50% of all loan applications forwarded by the PMOs, since the RCCs rightly place emphasis on the credit history and the repaying capacity of the clients. This means a completely changed credit delivery scenario: the credit uptake will be far less than the current projections.

Differences in Lending Policies and Procedures

82. There are three inconsistencies between the project-propagated and RCCs' own credit delivery systems. They pertain to: (i) loan size; (ii) loan duration; and (iii) the requirement for a no-due certificate. The size of the loans provided to households under the project varies from CNY 500 to CNY 3 000. Most loans for agroforestry plantation, irrigation and land development are about CNY 3 000, and loans for pig raising, pig breeding, duck raising, etc., are about CNY 500. In comparison, the sizes of RCCs' own loans to the households are usually smaller.

83. The RCCs provide short-term loans not exceeding one year. This helps RCCs to recycle funds at a faster rate and achieve a higher effective rate of interest on loans. The loans provided under the project are medium to long-term in nature. Even duck- and pig-raising, which yield returns within one year, are supported through loans with a two-to-three-year repayment period.

84. The RCCs insist on a no-due certificate from prospective borrowers. This means the households with outstanding loans from ABC or a PMO cannot obtain a loan from an RCC. This procedure does not apply in PMOs, and therefore it is an important issue as it potentially lowers the quality of lending through PMOs.

Limited Demand for External Funding

85. The mission visited some RCCs that felt that external funding was not required for their operations. This was more evident in Jiangxi Province, where the RCCs felt that adequate deposits could be mobilized to fund their lending programme. At the current lending rate, RCCs find it risky to provide loans to poor households. In contrast, empirical evidence confirms unmet credit demand and willingness to borrow at higher interest [see Annex 2 of main report]. New credit products with flexible interest rates and incentives for on-time repayment could enhance both credit demand and the incentives for RCCs to expand lending.

C. Current Scenario

86. Given the constraints in implementing the RCC model as prescribed in IFAD project documents, the RCCs and PMOs in Anhui Province have reached a tactical arrangement to facilitate implementation. The PMOs continue to bear the credit risk and the RCCs deliver loans to all borrowers identified by the PMOs. This contrasts with the subsidiary loan agreements signed between the RCCs and the PMOs, where the PMOs stipulate that the full credit risk remains with RCCs and that the latter will have complete autonomy to select borrowers. According to PBC, this is an 'agent arrangement' between the PMOs and RCCs.

VIII. THE FUTURE

A. Shift Towards Sustainable Financial Service Delivery

87. The strengths and weaknesses of the PMO model need careful analysis. It is true that, in the absence of more mature local-level financial institutions, the PMO-administered credit lines have satisfied a need. It is also true that the users (borrowers) of the credit disbursed by PMOs may put a premium on accessing credit and be less concerned about their ability to pay back. In this context, one particular weakness in the PMO model stands out. It is inherent in all project administered credit lines, and is not unique to China. Government officials who administer credit can rarely acquire the information necessary for proper appraisal of clients and their proposed ventures. For a proper review of

loan applications, they need information from local informal networks about clients' suitability to reduce the risk of low recovery and of bad debts. In technical literature, limited access to such data is termed 'information asymmetry'. On the other hand, such knowledge is held by local informants or obtained when systems are used for peer review of credit applications. Local financial institutions that operate at the township, county and community levels build up such information. The PMO model of credit delivery using the Finance Offices does not form part of the local financial infrastructure: PMOs have limited access to reliable information for assessing and reducing risk. Errors in loan appraisals are thus more likely to arise and the probability of bad debts and low loan recovery increases.

88. In China, RCCs are the necessary entry point into the local financial infrastructure. The overall financial activity in the rural areas originates from the RCCs and returns to them. Apart from helping integration with the local financial infrastructure, a shift to the RCC model has two distinct advantages. First, given the evidence of the huge demand for credit in the rural areas of China, no donor will be able to satisfy such demand by adopting solutions that are institutionally non-sustainable.

89. Donors should, instead, consider using funds to leverage local resources in order to develop local financial infrastructure capable of shifting from traditional to poverty-focused lending. The efficiency gains that could be captured by leveraging local resources or unshackling part of the local resources for poverty alleviation are immense. For example, the Jiangxi/Ganzhou Integrated Agricultural Development Project covers 47 townships. Using the PMO model of credit delivery, CNY 193 million are to be allocated for five years. The annual credit disbursement is estimated at about CNY 39 million. In contrast, total savings for all the RCCs involved were found to be not less than about CNY 380 million (each RCC in the project area had an outstanding savings balance of approximately CNY 8 million). Were IFAD projects able to leverage only 10% of these funds for microfinance every year, the allocation for credit would double.

90. The second advantage is that the management information system of the local financial infrastructure is generally well developed compared with that of non-financial institutions. The former are transparent with regard to utilization of funds and under the supervision of the Central Bank.

91. These reasons rightly prompted IFAD to move towards use of RCCs. In addition, the Government has also realized the importance of integrating credit services with those of the local financial infrastructure. It has issued guidelines prohibiting all credit-related activities through government departments. IFAD was the first IFI to experiment with integrating project-funded credit operations with those of RCCs. As with any first effort, it has not been without difficulties but what is positive is that lessons are being learned.

92. The findings of the present study were presented at a Technical Review Workshop in Beijing in July 2000, the aim being to: (i) disseminate study findings; (ii) arrive at a common understanding of issues confronting the implementation of credit components under IFAD projects; and (iii) reach broad agreement on future action. Details of the workshop are provided as Annex 6 of the main report. The recommendations set out below are broadly in line with the workshop deliberations.

B. Overall RCC Reform

Developing Management Capabilities

93. Depending on the direction that the RCC network takes in the future, two broad recommendations emerge. First, RCCs could be transformed into small, joint-stock single-unit banks, probably with much-reduced minimum capital and other licensing requirements; the related governance issues would need to be addressed in the framework of the existing commercial banking law. A second possibility is that the RCCs develop as genuine cooperative banks. To that end, an internal management structure with apex organizations at different levels would need to be developed for management support, training, audit and supervision.

94. For the second course of action, it is imperative that the demand for apex-level structures should be mobilized from, and driven by, the primary level RCCs. Otherwise, a supply-driven

institution-building approach will too easily appear, with limited efficiency and expensive recurrent cost implications for the RCC network. The latter alternative must be avoided at all costs.

A Specialized Legal Framework?

95. It is uncertain whether RCCs will emerge as thrift-and-credit cooperatives, cooperative banks or single-unit joint-stock banks. For the last-named option, no specialized legislation would be required as joint-stock banks are fully and entirely covered by national banking legislation. For the first two – cooperative – options, those carrying out reforms should draw upon the expertise of leading modern cooperative associations with extensive experience in legal matters, such as the Raffeyen Foundation in Germany. Desjardins International Development is another source of detailed knowledge in facilitating microcredit operations.

Savings-Based Development Approach

96. Deposit instruments need to maintain their current range of term diversification and pricing. RCCs have had a higher proportion of deposits from households and a higher proportion of time deposits. Moreover, the proportion of time deposit to household deposits was around 70% compared with 55% for ABC. Compulsory deposit insurance available to rural depositors in RCCs and ABC instead of a *de facto* state guarantee for state-owned financial institutions would diversify risks and increase the robustness of the financial system.

Transparency of Loan Rescheduling

97. Tracking down rescheduled loans in a bank's portfolio is neither an impossible nor a mysterious undertaking. However, the statement of accounts on which the accounting frame is based needs to be updated. In the 'Loan Assets' heading of the accounts, a separate item for rescheduled loans needs to be added. If loans are rescheduled with different maturities sub-accounts should be inserted, classified by repayment period. To achieve consistency, development projects should avoid putting rescheduling routines in their credit manuals; instead, they should promote adequate loan loss provisions for treating rescheduled past-due loans.

Loan Write-Off Based on an Adequately Classified Loan Portfolio

98. Procedures for asset classification need to be revised. Capital infusions similar to the inflows into SOCBs could be considered after RCCs have been classified into four categories: insolvent, potentially recoverable, operating with problems, and operating satisfactorily. Similarly, the distortions of fictitious income from outstanding loans that have no chance of being recovered can be ameliorated in part by a shift to cash accounting procedures. Inadequately trained and supervised RCC staff may contribute to unwarranted practices, such as inflating loan portfolio size and net incomes.

Strengthening Commercial Lending Capacities

99. The banking skills of RCC staff need upgrading to a level that will allow for sound financial and elementary technical screening of loan applications. The recent trend to separate policy-based lending from commercial lending is a welcome step. In the longer run, the rural finance system requires a level playing field between the different institutions and the phasing-out of preferential and subsidized lending to priority target groups.

Promoting Complementary Between Non-Financial and Financial Services

100. Complementarities at the client level should be pursued to avoid an imbalance between loans and technical services through state extension and support services or through innovative ways of promoting small enterprise development. For non-credit financial services, insurance schemes and loan and deposit services have been introduced and are on offer through the Animal Husbandry Bureau for livestock insurance. These would broaden the scope of financial services and encourage a shift from a credit-based approach to a broader service approach.

Improved Mechanisms to Facilitate Learning

101. There is no harm in not having it right the first time an activity is undertaken, but there is a need for a structured process to be put in place for drawing relevant lessons from past experience and incorporating them into future activities. The onus is on donors to put in place more objective and transparent monitoring and evaluation systems and to make results available to other agencies planning to replicate a service delivery approach. Once this system is in place, the debate will be greatly facilitated. The pros and cons will clearly emerge for the government-staffed parallel financial intermediation structures set up by a number of microfinance projects. Their performance and prospects need to be compared with those of the RCCs that operate within the existing framework of rural financial institutions. Such a broader comparative analysis is beyond the scope of this study. It is, however, recommended that the donor community follow up with a broader, possibly jointly launched, evaluation of rural finance and microfinance approaches in China. Involvement of the different government ministries and agencies would be imperative. Such an objective performance assessment could then guide future decisions regarding support to financial systems.

IX. DESIGN CONSIDERATIONS FOR FUTURE IFAD PROJECTS

102. Despite its imperfections, microfinance is still a key element in poverty eradication policies. No one approach can be applied uniformly across all regions of China. In some areas, where no local financial infrastructure exists in the form of RCCs, the PMO model may still be a valid option. In the Chinese context, the limitation of IFAD's loan instrument becomes apparent in mainstreaming IFAD project funds into the local financial infrastructure. It uses only the loan instrument, and volume is small compared with other major IFIs. Using its own resources and instruments, IFAD may not be able to negotiate reform of RCCs, which would be part of the overall financial sector reforms, as well as public sector reform. Issues can be addressed by encouraging RCCs to experiment and by creating a system of rewards and sanctions. The pilot experiments assisted by IFAD ought to be jointly evaluated for replication. This would serve and assist all Chinese partner institutions in learning and reassessing policy.

A. IFAD Loan-Use Procedures

103. In China, the system of resource transfer from the central to local governments is unique, with two distinct features. First, IFAD funds are transferred as loans through to the township level, and the township local government is responsible for repayment. In most other countries, IFAD loans either flow as grant funds from the central government or as loan funds only to the level of provincial government. The foreign exchange risk always remains with the central government. The townships receive IFAD loan funds as grants. Second, the provincial, prefecture, county and township governments are responsible for mobilizing the necessary counterpart funds. In most other countries, counterpart funds are provided either by the central government or by the provincial government.

104. The present system in China for transfers of loans needs to be changed. If funds reach the county and township level as 'loan funds' to be repaid, it is too optimistic to assume that the local governments will hand over funds for the credit component to RCCs. Local governments prefer to retain firm control in their final allocation, since they themselves ultimately have to pay them back. At the same time, funding under projects for rural infrastructure, training and extension services needs to reach the township government as 'grants.' Credit funds should be made available to the RCCs as loans. Funding for capacity building and infrastructure to improve RCC outreach and client access will have to be provided in grant form. Following the theory of 'seeing is believing,' it would be appropriate to organize a study to permit policy-makers in China to study and understand the procedures of IFAD loan use in other countries.

B. Case for Changed MOF Regulations on Transfers of Funds

105. It is not easy to understand why MOF has one set of regulations for IFAD funds and another set for other IFIs. IFAD funds are transferred to provinces at 4.5% and the provinces have to bear all the risks. In contrast, World Bank funds are transferred to provinces at 2%, or at considerably lower rates. Such disparities need to be minimized. If arrangements similar to those of the World Bank are established, provinces will be able to lend to RCCs at an acceptable interest rate. RCCs, under the IFAD project framework, borrow from the county or township, but it would be appropriate for RCCs to borrow directly from the provinces to avoid co-ownership of funds at the local level. Participants in the above-mentioned Technical Review Workshop also recommended that credit funds be transferred directly from the provinces to RCCs.

C. Incentives for the RCCs

106. The main reason for including RCCs in all efforts to improve a given region's financial infrastructure is to encourage them to take an active interest in microfinance. This is not an easy task. RCCs may not readily use any of their sources of refinancing (deposits from clients, refinancing from PBC and loans from other banks) for microcredit operations. Strong, credible incentives are required to convince RCCs to change the way they operate, but getting them interested is particularly difficult given their current situation. Crises in the financial sector have induced PBC to tighten controls under which RCCs and other financial institutions operate. Taking RCCs into account in the design of credit projects and placing them at the centre of the local financial infrastructure is only the first step.

107. The first issue to be addressed should be the cost at which RCCs receive funding within the IFAD project framework. It has been assumed that the cost of funds for RCCs should cover operational cost and credit risk. However, RCCs need to be provided with funds at attractive costs and terms compared with those of other sources of refinancing but will not reduce the incentive to mobilize deposits. A dependency or 'lock in' to donor funding must be avoided. It would be appropriate that the RCCs receive funding at a rate not exceeding the rate at which PBC lends to RCCs.

108. Financial intermediation at the local level improves once complementarity among the interlinked elements of the local financial infrastructure is strengthened. This calls for the various civil-society organizations and other actors to collaborate with RCCs in providing credit in rural areas. However, the present financial situation of the RCCs does not allow them to invest in enhancing outreach capability and capacity building, so RCCs require grant funding for these purposes.

D. Product Development

109. There exists a clear mismatch between the current range of products offered by RCCs, credit instruments designed in IFAD projects, and the products required by resource-poor households. RCC credit instruments have four basic features: (i) they are short-term in nature, repayable within one year; (ii) repayment can be made in one instalment at the end of the repayment period; (iii) interest rates are stipulated by PBC; and (iv) reliance on credit history and collateral of the applicants. IFAD project loans are mostly medium-term, for agriculture and livestock development [see Annex 5 of main report]. Client selection and provision of technical services rest with the PMO and credit delivery with RCC. No collateral is insisted upon and a client's credit history is not normally reviewed. Such shared responsibility has led to RCCs insisting on shifting the credit risk to PMOs. In contrast, most resource-poor households initially require small loans for consumption. With time, their credit absorption capacity should increase and they will be able to develop the necessary credit history to obtain larger loans.

110. It is essential that RCCs be permitted to design products that meet the requirements of resource-poor households while yielding the required spread to RCCs to cover the cost of funds, transaction

costs, credit risk and reasonable profit. The essential features of the microfinance instruments to be built into the IFAD project framework are:

- (i) **Flexibility in activities for which loans can be provided.** Currently IFAD project design stipulates the activities for which funding is available. There needs to be complete flexibility concerning activities for which a loan can be made available. Households should be able to borrow for a broad range of activities, including consumption.
- (ii) **A ladder approach to develop credit history.** RCCs need to focus on developing a credit history for clients by providing small loans initially and allowing clients to graduate to larger loan amounts.
- (iii) **Pro-poor lending policies.** Lending policies such as requirements for collateral and guarantees need to be modified, adopting instead joint liability concepts and credit-history-based lending. RCCs need to move away from ‘bullet’ repayment practices that lump all payments at the end on the loan period, to more structured weekly or monthly repayment plans.
- (iv) **Incentive for prompt repayment.** The clients need to understand the importance of prompt repayment and the advantages linked to it. The client who has promptly repaid the loan should be able to easily access a larger loan amount. Persons with a better credit history might even be given a discounted interest rate.
- (v) **Flexible lending rates.** RCCs need to be allowed to adjust lending rates to reflect their perception of credit risk, transaction cost and cost of funds.

E. RCC/PMO Collaboration

111. IFAD projects have attempted to foster collaboration between PMOs and RCCs. The PMOs are responsible for tasks related to client identification and activity selection; the RCCs are responsible for credit delivery and recovery. However, project design gives the RCCs ‘imaginary’ powers to appraise loan requests and to accept or reject them. Two factors contribute to the inability of RCCs to resist pressures from PMOs and local government. First, the RCCs have limited technical competence to appraise agriculture development activities. Second, the funds are provided by the PMO and the RCCs are obliged to follow PMO instructions.

112. The most successful credit projects have been those handled directly by one agency without local government interference. Such an agency needs to be a financial institution or an institution with a clear vision of establishing itself as a sustainable financial institution. Unless the funding is routed directly from MOF to the RCCs through their supervisory bodies, it is unlikely that RCCs will be able to act independently and to shoulder the credit risk.

113. Any meaningful financial service-based rural development effort to reach the resource-poor in China requires a two-pronged approach in IFAD projects. First, the funding track for RCCs needs to be completely delineated, with independence from local government. Grant funding should be provided to RCCs to strengthen their capacity, incorporate the microfinance strategies evolving in China into their regular lending strategies and increase outreach by employing village agents. RCCs should be authorized to select and fund clients using newly developed microfinance strategies. RCCs will have to be encouraged to use funds from their own savings mobilization by providing incentives for microfinance lending, rather than providing funds for lending operations. In the case of RCCs facing liquidity constraints, their access to the PBC refinance window could be enhanced.

114. Second, the size of the credit components of IFAD projects needs to be substantially reduced. Since the current financial situation of many RCCs may not permit their active involvement in medium- and long-term credit, the capacity of PMO to provide medium- and long-term loans should be enhanced. Systems need to be built to ensure that PMOs do not offer unhealthy competition to the RCCs. The rate of interest on loans should be equal to the yearly interest rate

charged by RCCs. The PMOs should be allowed to provide only one loan per client to ensure that they can obtain subsequent loans from the RCCs. Record keeping, loan account monitoring and maintenance of a revolving fund will have to be substantially improved to improve transparency.

F. Technical Backstopping

115. The provision of technical services to households continues to be the core competence of various line departments under the umbrella of PMOs set up under IFAD projects. WFP collaboration in the provision of training has helped enhance credit utilization. This arrangement needs to be strengthened with grant funding for PMOs to undertake these activities.

G. Reaching Those Not Reached by Financial Institutions

116. For poverty alleviation lending, complete dependence on formal financial institutions such as RCCs is a double-edged sword. On the one hand, it improves efficiency and therefore institutional sustainability is a distinct possibility. On the other hand, it may exclude a set of people who do not possess the necessary credit history and demonstrated ability to effectively use credit. Even with well-intentioned microfinance product design and delivery systems, it would take a long time to develop RCCs as poverty-focused institutions. In addition, there exist areas without local financial infrastructure. A PMO-led strategy for reaching such areas and households remains a valid proposition.

117. A self-help group (SHG) strategy with groups as the elements of local financial infrastructure is a better option compared with the direct lending strategy adopted by various civil-society organizations. The example of cooperatives in Germany could be borne in mind. A different initiative to create financial services groups came from Asia after World War II. Constituted by banks to group together small borrowers, as in the German example, the Asian groups were also intended to collect savings and distribute credit among themselves.

118. Financial groups are now well established aspects of the financial infrastructure in many developing countries. In most parts of Asia, SHGs have become channels of microlending operations through systematic links with financial institutions. In Africa, groups have been used in monetization actions and as a channel for microlending operations. The groups perform the core function of risk absorption essential for the development of financial infrastructure. To perform this function more efficiently, the groups need to build equity with member contributions and, when possible, with donor money. The main issue is the need for institutions to take the initiative to create groups.

119. With their network extending to the village level, and with necessary capacity building, PMOs are best suited to take over the responsibility of group mobilization. The essential features of SHG mobilization in China need to be group mobilization, capacity building, provision of a small revolving fund and subsequent linkage with the RCCs. Collaboration with WFP could be used to help build up the capacity of the groups, improve credit uptake by resource-poor households and, for RCCs, develop a set of new clientele with requisite credit history.

People's Republic of China
Thematic Study on Rural Financial Services in China
Agreement at Completion Point

I Core Learning Partners

1. The Core Learning Partnership (CLP) in China extended from the central agencies in Beijing to the Provinces. In Beijing, the CLP comprised representatives of the Ministry of Agriculture, the People's Bank of China (PBC) and the Ministry of Finance (MOF). Representatives of the Provincial Governments of Hunan, Jiangxi, An'Hui and Sichuan, their project management offices (PMOs) and the rural credit cooperative (RCCs) unions, were also consulted. Researchers from the Chinese Academy of Social Sciences participated in the study. The World Food Programme (WFP) also took part in the learning partnership.

II Study Context

2. The thematic study examined the institutional context and effectiveness of the credit components of IFAD loans provided to the People's Republic of China since 1987, and covered four diverse project areas.

3. Under IFAD projects, methods for delivering credit to rural resource-poor households have changed. At the outset, projects delivered these services through PMO, but more recently RCCs have been used in the expectation of credit components being integrated into local rural financial infrastructures. The study examined the advantages and disadvantages of the two approaches, and made an empirical analysis of credit demand and supply based on data gathered from both rural financial institutions and households. The aforementioned analysis suggests that a large proportion of resource-poor households are constrained by limited availability of formal credit rather than by poor capacity to absorb it. Furthermore, such households are not constrained by formal institutions' lending rates, even though such rates may be higher in real terms.

4. The above findings confirm that the RCC network has the potential to become a fully-fledged, poverty-focused rural financial institution, and point up the wide scope for an evolving RCC system of financial services in China. Nevertheless, unless resolved, outstanding issues relating to governance, non-performing loans and policy constraints will prevent RCCs from playing their full role in delivering sustainable financial services in rural areas.

5. The thematic study made a comparison of two models: project-funded credit delivered by PMOs, versus the new system under which it is delivered by RCCs. It is true, if viewed in isolation, that the PMO model supported by IFAD projects is an efficient credit-delivery model. PMOs provide loans in accordance with prescribed plans, with limited appraisal of repayment capacity and of the activities for which the loans are provided. In contrast, RCCs provide fewer needs-related loans to borrowers that have the capacity to repay loans.

6. The study shows that the IFAD project-propagated RCC model is, in reality, a modified PMO model: funds flow through RCCs while the PMOs continue to bear the credit risk. While project design gives the RCCs the authority to accept or reject loan applications, in fact, this power remains with the PMOs and local governments.

7. If the potential for dynamic growth in the income of rural resource-poor households is to be exploited, a restructured and vibrant RCC network is essential. Macro constraints, such as governance, a stock of historical bad debt and other operational difficulties will need to be addressed through a well structured reform programme. In the final analysis, RCCs will need to adopt a more flexible approach to loan criteria and procedures.

III Lessons Learned

8. Lessons learned with regard to the provision of financial services across many countries confirm that the most successful credit projects are those where only one financial service provider is involved and when, in addition, that provider's independent status is assured.

9. In China, a two-pronged approach is warranted for the purpose of reaching resource-poor households under the umbrella of IFAD projects. The thematic study concludes that unless MOF routes funding directly to the RCCs through their supervisory bodies, it is unlikely that the RCCs will be in a position to act independently or to bear the credit risk.

10. The procedure for providing funds to RCCs needs to be redefined in order that the use of such funds is not influenced by local government decision-making. Grant funding should be provided to RCCs for capacity building in such a way that the positive evolving features of microfinance strategies are incorporated into their lending strategies. Employing village agents would increase outreach. RCCs should be fully authorized to select and fund clients, and encouraged to expand their lending operations financed under IFAD projects by using funds from the savings they mobilize. RCCs facing liquidity constraints should be given greater access to the PBC refinancing window.

11. With regard to PMOs, measures should be taken to avoid that they compete with RCCs on favoured terms. The current financial situation of many RCCs may not allow them to participate actively in medium- and long-term credit provision. In these cases, for projects already funded, the involvement of PMOs in providing non-seasonal credit will need to be decided on a case-by-case basis. Moreover, the rate of interest on loans should be equal to that charged by RCCs on an annual basis. PMOs will be allowed to provide only one loan per person so as to ensure that once the client has repaid the loan, he/she will approach the RCCs for subsequent credit. Record-keeping, loan account monitoring and maintenance of revolving funds will need to be substantially improved so as to improve transparency.

12. PMO staff, who comprise representatives of all line agencies, effectively provide technical services to households. In collaboration with the PMOs, WFP has provided training to improve credit use. Further grant funding, to enable PMOs to provide training, is warranted.

13. It is true that the previous system, whereby formal financial institutions such as RCCs were fully responsible for providing poverty-alleviation loans, may have been less than satisfactory. Whereas that system has improved efficiency and ensured institutional sustainability, it might well exclude households that neither possess the necessary credit history nor have demonstrated ability to effectively use credit. It stands to reason that even with well-intentioned microfinance product design and delivery systems, considerable time would be needed to develop RCCs to expand their outreach and become fully poverty-focused institutions. In addition, for areas with no local financial infrastructure, a PMO-led self-help group strategy is a valid proposition.

IV Agreements Reached

14. A meeting, chaired by Mr Tang Zheng Ping, Director General of the Department of International Co-operation, was held at the Ministry of Agriculture in Beijing on 6 July 2001 (see Executive Summary for findings and recommendations). Representatives of PBC, MOF, and the PMOs in Hunan, Jiangxi, An'Hui and Sichuan Provinces attended the meeting, as well as Messrs Per Eklund, Roy and Martens of IFAD. The Chinese Government representatives welcomed the report, its analysis and recommendations, and considered it to be a useful starting point for restructuring the RCCs.
15. The Chinese Government expressed its desire to initiate discussions with IFAD on the possibility of obtaining an IFAD policy loan to initiate this restructuring process and invited the Fund to participate in the restructuring exercise.

V Summary of Recommendations

16. Agreement was reached on the importance of restructuring the loan products provided to farmers served under current IFAD loans and on the benefits to be accrued from better outreach of microfinance to rural development in China. Restructuring of the RCCs would ensure that a larger share of the savings mobilized by them is transformed into productive investments.
17. Representatives of PBC and MOF confirmed the Chinese Government's interest in the RCCs becoming independent financial institutions with a transparent ownership and equity structure. The Government would welcome both capital infusion from donors and a cooperative relationship with IFAD in the necessary restructuring exercise.
18. In line with the recommendations of the thematic study, in order for the RCCs to develop into fully viable financial institutions they would need to:
- be made accountable and responsible for their actions;
 - be endowed with a qualified management structure;
 - become creditworthy; and
 - serve not just the farmers but the poor farmers.
19. In line with the recommendations of the thematic study, RCC loan products and services will need to be made more flexible to better respond to user demand; PBC is presently exploring how this may be achieved.

VI Conclusion

20. In closing the meeting of evaluation partners, the Chairman summarized the agreements reached.

- I. The Chinese Government would welcome a cooperative endeavour with IFAD in the restructuring of the RCCs;
- II. RCC operations and performance are extremely mixed. it is not foreseen that the use of a uniform model would be suitable in terms of rcc restructuring; and
- III. a pilot approach is called for. such an approach would translate into adopting eligibility and selection criteria with regard to RCCs qualifying for assistance.



Source: IFAD

The designations employed and the presentation of the material in this map do not imply the expression of any opinion whatsoever on the part of IFAD concerning the delimitation of the frontiers or boundaries, or the authorities thereof.

CHAPTER I INTRODUCTION

A. Context

1.1 Since 1981, IFAD has provided 15 loans to the Government of the People's Republic of China, a total commitment of USD 380 million. These loans have been provided on concessional terms; they carry an annual service charge of a mere 0.75%, with a repayment period of 40 years, including a grace period of 10 years.

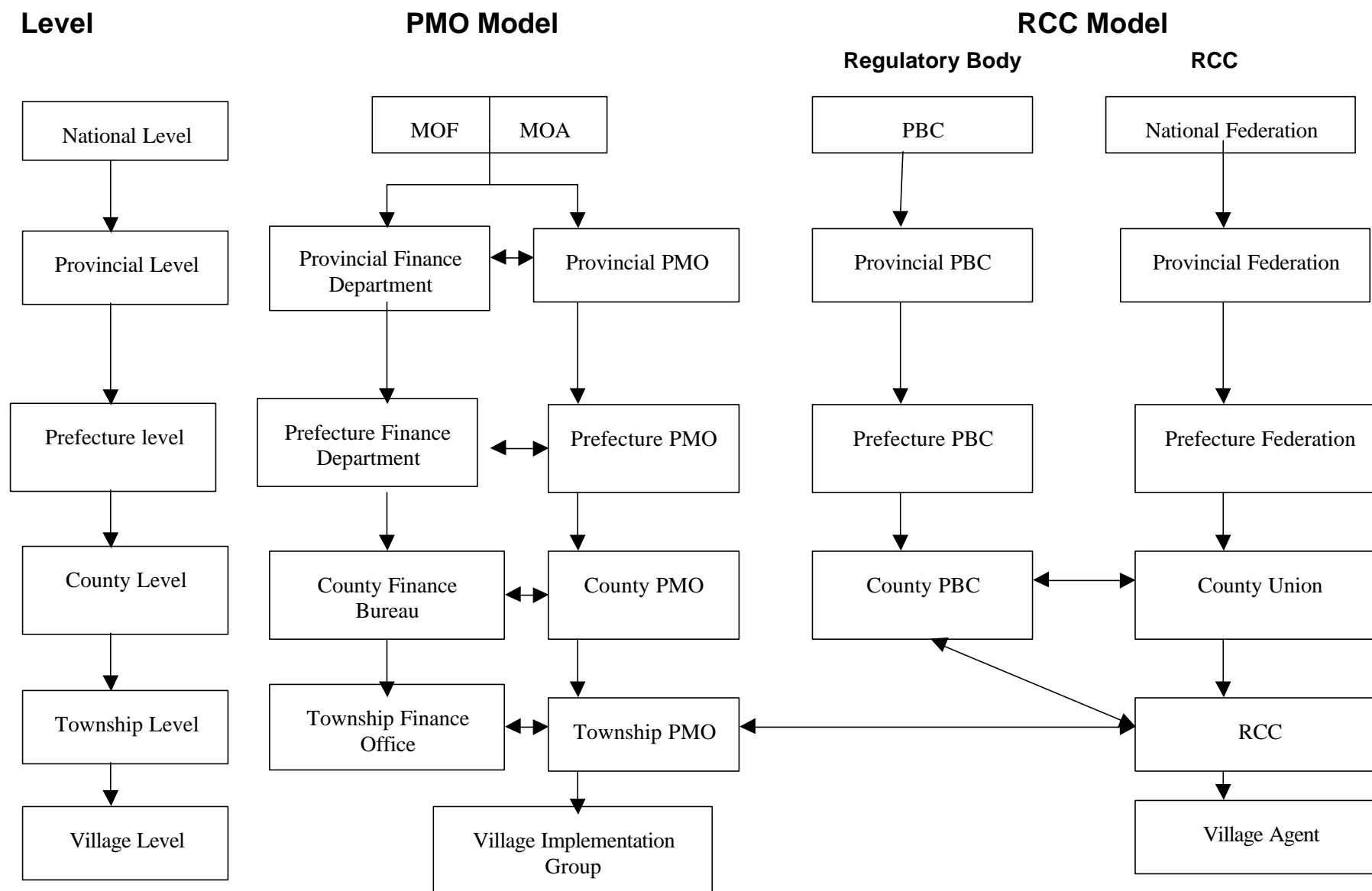
1.2 Most IFAD investments have concerned integrated agricultural development projects (IADPs). On average, IFAD has allocated about two-thirds of its funding for the credit components. However, physical infrastructure, agriculture and livestock components are important, and have been largely financed by Government of China counterpart funds and WFP contributions. Efforts have been made to include social sector activities in the new-generation projects. Programmes directed at rural women for literacy, health care and skills training have been funded. The South West Anhui Integrated Development Project is a case in point.

1.3 Project designs have gradually shifted from being entirely supply driven – with government offices deciding on credit delivery – towards seeking to use local financial services institutions, the Rural Credit Cooperatives (RCCs). In the early years, provincial and sub-provincial government Project Management Offices (PMOs) and their finance departments were made responsible for credit delivery.

1.4 In the PMO system, the Ministry of Finance (MOF) borrows from IFAD and re-lends the funds to the provincial finance departments, who in turn on-lend the funds to the prefecture- and county-level financial bureaux. The county financial bureaux in turn on-lend to the township finance offices. Finally, the township finance office delivers the credit to the households. Meanwhile, the township PMO, with the help of the Village Implementation Groups (VIGs), identifies the borrowers for credit delivery. The township finance office bears the credit risk, and is responsible for repaying the IFAD funds to the county finance bureau. PMOs are staffed by government line agency staff, who provide project-related extension services and training for household beneficiaries.

1.5 In the last few years, IFAD has recognized the importance of mainstreaming rural financial services, so its projects introduced the new concept that RCCs would deliver financial services. Of the 15 projects funded, 11 projects used the finance department for delivering project credit and four projects have sought to integrate project credit into the RCC financial system. The overall management structure for credit delivery as used by the IFAD projects is set out in Figure 1.

1.6 IFAD shifted towards use of RCCs because of experience with the earlier projects. The county and township governments were responsible for raising counterpart funds, undertaking rural infrastructure development and repaying the IFAD loan passed on to them from MOF. However, observers questioned the ability of these departments to continue the credit operation once the project had been closed. Sustainability would be enhanced if project credit were channelled through the existing rural financial infrastructure. There was a strong *a priori* argument for seeking to shift credit delivery, recovery and associated risk to the RCCs, although a proper formal study was not undertaken to explore in depth the institutional constraints and the strengths and weaknesses of the two models.

Figure 1. Management Structure for Credit Delivery in IFAD Projects

B. Thematic Study: Rationale and Objective

1.7 The case for studying properly the feasibility of full use of a strengthened RCC system is beginning to be recognized by stakeholders, not only by IFAD. However, the contributions to the discussion that have taken place or are emerging are mostly based on the concept of grant finance: the funds flow directly to RCCs, bypassing MOF. The Government of Germany has provided a DM 4 million grant to provide technical assistance for RCCs; DesJardins International (an NGO) has established a pilot project with RCCs; UNDP is considering the use of RCCs as potential micro-finance institutions; and UNFPA has commissioned FAO to implement a credit scheme through RCCs.

1.8 In order to contribute to the ongoing dialogue between IFAD and the Chinese authorities on how to improve policy with which to support the RCC, IFAD commissioned this thematic study. It sets out to:

- (i) assess formally the strengths and weaknesses of the RCC Model of credit delivery, in comparison with the PMO model;
- (ii) explore the causes for variation in performance of RCCs across project areas; and
- (iii) develop a reform programme to improve the performance of the stakeholders in using micro-finance in poverty alleviation.

C. Projects Studied

1.9 The study was conducted in two phases, and covered four representative, ongoing IFAD projects in China:

- ◆ Sichuan Nanchong Integrated Agricultural Development Project – a sub-project of Northeast Sichuan and Qinghai/Haidong Integrated Agricultural Development Project;
- ◆ Southwest Anhui Integrated Agricultural Development Project;
- ◆ Jiangxi/Ganzhou Integrated Agricultural Development Project; and
- ◆ Wulin Mountains Minority-Areas Development Project.

1.10 The mission¹ visited the Sichuan and Southwest Anhui Integrated Agricultural Development Projects during the first phase (5-26 March 2000), and visited the other the two projects during the second phase (18 June to 6 July 2000).

1.11 The Jiangxi/Ganzhou Integrated Agricultural Development Project uses the PMO model. The Sichuan Nanchong Integrated Agricultural Development Project also employs the PMO model, but incorporates a pilot operation to begin shifting credit operations to rural financial institutions. In the Southwest Anhui Integrated Agriculture Development Project, a full shift to the RCC model has been planned. In the Guizhou/Hunan Wuling mountain project, the project design envisages support to at least 92 RCCs.

D. Conceptual Framework

1.12 The basic conceptual framework for analysing the financial environment in which micro-finance projects are implemented in the developing countries can be found in the seminal works on financial

1. The IFAD-OE Study Team comprised Messrs Shreekantha Shetty (Team Leader), Enjiang Cheng, Wu Guobao and Zhang Youhang in both phases of the study. Mr Per Eklund (Senior Evaluation Officer) and Ms Mayumi Ozaki (Associate Professional Officer) joined the team during the initial period to start-up the first phase. Mr Rauno Zander and Mr Wang Sangui joined the study team during the second phase. Mr Per Eklund participated in the Technical Review Workshop conducted at the end of the second phase.

liberalization written more than two decades ago by McKinnon and by Shaw.² According to these economists, a strong, positive correlation exists between the extent of institutional development of financial services and economic growth. Developing economies enhance their growth potential by liberalizing and strengthening their financial sector institutions. Such institutional strengthening would permit a more discretionary use of credit. It would facilitate an improved intertemporal allocation and recycling of resources across economic agents. This would be beneficial for sustained economic growth.

1.13 The conceptual framework for this current study has been adapted from the McKinnon-Shaw model. Four dimensions of this model have been considered in analysing the importance of financial intermediation and financial intermediaries. They represent the necessity of:

- (i) overcoming excessively fragmented and disconnected markets;
- (ii) financial intermediation and use of positive real interest rates;
- (iii) building up the financial services sector; and
- (iv) combining anti-poverty policies with local financial deepening.

1.14 **Overcoming fragmentation.** Developing economies are typically characterized by fragmentation – namely, by the existence of separate and disconnected credit outlets and initiatives isolated one from the other predominantly by government-imposed regulations, powerful local monopolies and tariff and trade barriers, as well as other types of restriction. Direct government interventions are of two kinds. There is a need for a regulatory framework of interventions that are positive in the sense that they support the growth of independent and strong financial institutions, nurture transparency in accounting and audit, and protect the assets of households and economic agents from fraud and mismanagement. At the same time, there are other types of interventions that may prolong the weakness and undermine the independence of financial institutions. Many government interventions in developing countries restrict the development of economic activity since service provision and access to capital remain isolated activities. Service providers are not benefiting from economies of scale. Households and firms do not gain access to flexible services and financial products in line with their potential and needs. Such interventions prevent efficient resource allocation and retard a country's overall development.

1.15 Cases of immature or static financial structures are found in many countries. The situation in China fits this description, where government departments use the IFAD credit funds in isolation from the local financial infrastructure and without programmed efforts to arrive at any "convergence."

1.16 **Necessity of financial intermediation and use of positive real interest rates.** The view has prevailed that credit programmes need to be subsidized by governments and donors because poor farmers can afford to borrow only at low rates. In addition, it has also been widely argued that low rates of interest were needed to induce widespread adoption of new technology, such as improved seeds and mineral fertilizers. This implies that government-promoted networks administer the low-interest credit programmes. The earlier generation of IFAD projects fit this description.

1.17 Gradually, an understanding has evolved that farmers are prepared to pay positive interest rates to access services and technology for which they see a direct need. However, they need access to funds while keeping their own transaction costs low. Access to capital and flexibility in service provision is rightly viewed as more important in serving farmers – even poor ones – compared to maintaining excessively low interest rates. Deregulation of interest rates to permit positive rates and to permit market "arbitrage" becomes a necessary tool with which to increase deposit mobilization and to nurture financial intermediation, that together ultimately create economic growth.

1.18 **Importance of developing financial intermediaries.** Financial intermediation is recognized as a critical process that develops over a long period. Throughout this process, the relationship between the savers and investors changes from being personal, discrete and bilateral, to one that is impersonal, continuous and universal. On the one hand, savers have a greater choice of financial assets in which to

2. McKinnon, R.I. 1973. *Money and Capital in Economic Development*. Washington DC: Brookings Institution.
Shaw, E.S. 1973. *Financial Deepening in Economic Development*. New York NY: Oxford Univ. Press

hold their savings; on the other hand, investors become more sophisticated in their choice of financial instruments through which they seek to access external capital.

1.19 The government's emerging understanding of the importance of the financial sector has started to influence credit dispensation. Credit is no longer viewed merely as an input easing implementation of the overall project. Different stakeholders have begun to see the benefits of transforming credit components and revolving funds into credit lines extended by the local financial services institutions in project areas.

1.20 This understanding has necessarily meant a shift from mere emphasis on credit disbursement towards the need to explore how local financial intermediaries could be assisted to become effective agents in the provision of more mature financial services. Institutional growth and sustainability issues become paramount in defining mechanisms for integrating project credit components into local financial intermediary operations.

1.21 ***Anti-poverty policies and local financial deepening.*** Policies that incorporate the principle of micro-finance are intended to create, nurture and develop financial intermediation at the local level, but local-level government regulation and customs typically have been associated with inefficient practices and emerging bad debts for local financial intermediaries. Micro-finance policies need first to address the issue of how local non-bank institutions and political structures can be made to support the growth of a sound local intermediation process that serves savers and lenders as well as borrowers.

1.22 At the same time, experience in several countries shows that micro-finance policies need to go beyond the development of internal organization intermediation at the local level and approach financial intermediation from a broader perspective. Developing market intermediation at the national level should represent an objective of the government and donors. In short, evolving micro-finance policy needs to address local governance issues while simultaneously taking into account the national perspective on financial intermediation. They should promote active linkages between micro-finance institutions working at the local level – the local financial infrastructure – and the financial institutions operating at national level.

E. Methodology

1.23 The methodology of this study reflects this conceptual framework. The methodology translates into five groups of questions for which answers are sought.

Question 1. What is the comparative performance of the two models for financial service delivery used in IFAD projects?

- (a) Compare their efficiency in delivery of financial services in four dimensions:
 - (i) loan and savings products that meet the needs of the rural households;
 - (ii) delivery terms and efficiency;
 - (iii) recovery performance of the loans granted; and
 - (iv) ability to meet the unmet credit demand.
- (b) Compare the ability of the two models to reach poorer households. Assess the credit demand of low-income households at higher rates of interest and the need for technical backstopping to undertake income-generating activity.
- (c) Compare the two models from a sustainability perspective, with special reference to lending rate policy, ability to mobilize financial resources, and management practice.

Question 2. Is there a need to shift towards integrating delivery of project-funded financial services into local financial institutions?

- (a) Estimate multiplier effects by strengthening the financial intermediation at the local level.

Question 3. Would the shift affect the outreach of financial services to resource-poor households?

Question 4. What are the constraints on integrating project-funded credit component into the local financial institutions?

- (a) Seek the reasons for MOF and finance bureau disinclination to allow integration of financial services into RCCs.
- (b) Assess the macro-constraints impacting performance of RCCs and the ability of available IFAD instruments to address these constraints.
- (c) Analyse the incentive structure for RCCs to participate in IFAD projects.

Question 5. What needs to be done to improve the efficiency of financial services delivery within the IFAD project framework, and how to reach resource-poor households?

1.24 To seek answers for these five questions, the team purposively selected for the study two counties in each project and two townships in each county. Of each pair of two townships selected, one represented better-off areas and the other represented a less-well-off area. The two models were compared from two perspectives, namely the outreach and credit delivery perspective; and the sustainable financial service delivery perspective. Comparison from two perspectives was necessary as the two models are not equal models. The outreach-oriented model is supply driven and has scant regard for developing long-term, client-service provider relationships, and implies the necessity to charge an interest rate that covers all costs. This model is able to achieve quick disbursement of loans. The sustainable financial service model, in contrast, provides the entire gamut of basic financial services, including savings mobilization; operates within the financial regulatory framework; and charges interest to cover all costs and make a reasonable profit to continue and expand its operation.

1.25 The study used several methods to obtain information:

- (i) collecting and analysing data on credit operations and financial status of the participating institutions;
- (ii) limited field surveys or interviewing the households; and
- (iii) thematic discussions with the officials of MOA, MOF, PBC, PMO (provincial, prefectural, county and township levels), County RCC Unions and RCCs.

Data were obtained through:

- (i) unstructured informal discussions;
- (ii) guided or thematic discussions;
- (iii) questionnaires; and
- (iv) collection of published and official data.

The study team undertook a rapid household survey of 48 beneficiary households and 48 control households in two projects to assess the formal and informal financial service delivery situation, outreach of formal financial institutions, and transaction costs. The mission also collected data from RCCs with regard to their service delivery and fund costs. The study team also used secondary data on performance of RCCs from studies conducted by Chinese scholars.

CHAPTER II

RURAL FINANCIAL INSTITUTIONS IN CHINA

A. Development and Clientele

2.1 Three official rural financial organizations operate in China, namely the Agricultural Bank of China (ABC); the Agricultural Development Bank of China (ADBC); and Rural Credit Cooperatives (RCCs). Non-official financial organizations include Rural Credit Foundation (RCFs), Mutual Savings Associations, the informal sector, and micro-credit projects that have developed in recent years targeting poverty relief.

2.2 In August 1951, the State Affairs Council founded the Agricultural Cooperative Bank to handle fiscal appropriations for agriculture, provide long-term loans (defined as loans with terms of one year or more) in accordance with State Plans, and support the development of RCCs. The bank was, however, promptly abolished in 1952 as part of an effort to rationalize administrative structures. In order for the state to support the credit requirements of the agricultural cooperatives, and following approval by the State Council, the ABC was officially founded in March 1955. A four-level system was established, with a headquarters, provincial branches, main branches in special regions and sub-branches in counties. ABC was placed under the leadership of the People's Bank of China (PBC) and made responsible for directing RCCs. In April 1957, ABC was again abolished, and its personnel and organizational structures were merged into PBC, but in November 1963, ABC was re-established. In November 1965, due to retrenchment, ABC was integrated with PBC.

2.3 RCCs were organized on a trial basis, mainly for the purpose of preventing exploitation of the farmers and usury by local moneylenders. The RCC network developed further with the progress of rural mutual-aid activities through an official government programme. After 1958, with the founding of rural people's communes, the businesses and management of the RCCs were transferred to the communes and production brigades; the latter to a great degree becoming the local party and political organizations. The production brigades recorded profits and losses of the RCCs on a unified basis. The RCCs lost their original cooperative nature. Nationwide, RCC savings by the end of 1962 had dropped to yuan 970 million, down from yuan 2 000 million in 1958. PBC intervened. With PBC control, the characteristics of its collective financial organization largely disappeared and RCCs came under the control of the "formal government structure."

2.4 Until February 1979, the RCCs were part of the communes and production brigades, when the RCCs came under the leadership of ABC. ABC became responsible not only for various rural savings and agricultural loans, but also for rural industrial loans, loans for procuring agricultural products and by-products, and loans for the cooperative supply and distribution system.

2.5 ADBC was founded in December 1993, with the aim of separating agricultural policy finance from commercial finance. In April 1995, ADBC completed its establishment of organizations at the provincial level; in 1997, the separation of its operations from ABC was largely complete. The government transferred the ADBC's poverty relief loans and comprehensive development loans back to ABC, while ADBC retains its responsibility for managing lending for purchasing and storing grain, cotton and oil.

2.6 In 1996, the State Council (State Council [1996] No. 33) proposed that the development of the rural financial system should be based on cooperative principles and that the commercial lending should be separated from policy lending. In essence, this reform process for rural finance reform gradually transformed the RCCs into cooperative financial organizations; farmers would buy shares and they or their representatives would manage the RCCs to serve local farming needs. The first step of the reform was to separate the RCCs from ABC. The management of the RCCs was made answerable to a county-level apex organization that would be directly supervised by PBC.

2.7 After 1978, various forms of non-official rural finance outlets quickly emerged. Their funds mainly came from the original collective assets and share capital contributed by farmers. Similar

organizations under different names include Agricultural Economic Service Companies, Agricultural Economic Service Stations, and Rural Mutual-Aid Funds. The Ministry of Civil Affairs established Rural Mutual-Aid Funds after the reform to undertake the difficult task of distributing relief funds to scattered farmers. All these Funds experienced dramatic growth between 1986 and 1988.

2.8 With the active encouragement of the government, RCFs emerged in 1986 and 1987 as service providers, adopting a cooperative shareholding system. They competed with the official financial organizations but had no legal status. The PBC always regarded RCFs as illegal financial organizations, but MOA and local governments gave them positive support. However, in the face of the Asian financial crisis, the government placed special emphasis on controlling financial risks and hence promoted RCF re-organization and closure. Currently, all RCFs have ceased operation nationwide and are either being merged into RCCs or liquidated.

2.9 Various forms of informal rural credit, such as private money shops, moneylenders, Rotational Savings and Credit Associations (ROSCAs) in various forms, pawnbroking, and borrowing between farmers developed rapidly. Government action suppressed private money shops and moneylenders, or forced them to withdraw into the hidden economy. However, various forms of "Union" and mutual lending have continued to develop, although farmers' credit has mainly relied on the informal market.

2.10 ABC is a state-owned commercial bank focused on promoting economic development by supporting: (i) enterprises, enterprise groups and large-scale agricultural production bases engaged in primary agricultural production; (ii) profit-earning enterprises engaged in primary agricultural production; and (iii) development of the social service system. ABC's clients are mainly Township Village Enterprises (TVEs), supply and distribution cooperatives, commercial organizations and private businessmen or individuals. Although ABC during 1986 and 1987 started functioning more as a commercial bank, it still retains some policy lending activity in rural areas, such as agricultural development and poverty relief lending. In 1998, ABC's policy lending amounted to yuan 156 000 million, representing 28% of the year's total loans (some yuan 553 800 million³). In contrast, ADBC is engaged mainly in lending to enterprises for agricultural products and by-products purchasing, with re-assignment of agricultural development and poverty relief lending to ABC.

B. RCCs in Operation

2.11 RCCs are rural financial institutions. Their mandate is to serve the rural population. The main borrowing clients of the RCCs are farmers and TVEs. The State Council Resolution on Rural Financial System Reform (State Council [1996] No.33) requires RCCs to allocate more than 50% of total loans to their members. By the end of 1998, the outstanding portfolio of RCC lending to farmers was about yuan 184 000 million, representing only 25% of the total loan portfolio of about yuan 727 000 million. Generally, loans require mortgage of assets for loans greater than yuan 3 000, and large loans may require both mortgage and other collateral security. At present, RCCs have been allowed by the PBC to use the joint liability concept on a trial basis for granting small loans. In 1999, the RCCs were allowed to grant consumption loans to farmers, mainly for house building, education and medical treatment. RCCs lend for all activities, including production, consumption and business, to individuals, privately-owned enterprises and TVEs.

2.12 PBC involvement in RCC management starts with approval for appointment of staff, transfer of staff and taking disciplinary action against erring managers. The RCC management structure is similar to that of government organizations. They have independent cooperative banks (each RCC is responsible for its profit and loss) at the township level. These RCCs are linked at the county level by forming a County RCC union. At higher levels, such as prefecture, province and national, federations are nominally formed, but except for county unions, all other levels are dormant.

C. Trends in Financial Service Provision

3. Analysis and Forecast of Rural Economic Situation in China 1998-1999. China Social Science Documentary Publishing House. April 1999 edition, p. 200.

2.13 The annual growth rate of deposits from 1990 to 1997 in the formal financial system was as high as 31%. In 1997, total deposits in the official financial system in rural areas were yuan 2 225 000 million, or 27% of total deposits in all financial organizations nationwide. In 1990, the total loans outstanding in the official financial organizations nationwide were yuan 1 517 000 million, as against yuan 440 000 million loans outstanding in the official rural financial system. By 1997, total loans outstanding had increased by not less than 393%, to yuan 7 491 410 million; meanwhile, total loans outstanding in the official rural financial system had risen by 427%, to yuan 2 322 000 million.⁴

2.14 In 1997, RCC deposits amounted to yuan 1 056 000 million, including yuan 913 000 million (87%) belonging to households, and the balance from the collective agriculture sector, including TVEs. Total loans outstanding to the TVE sector made up over half of the total RCC loan stock in 1997. Total loans outstanding to TVEs were yuan 367 000 million out of the total of yuan 727 000 million. The household sector represented 24% of the total loans outstanding, yuan 174 000 million. In 1997, the total loan portfolio of ABC amounted to yuan 1 018 000 million (including short-term loans of yuan 918 000 million).

2.15 The volume of informal loans to farmers increased at an average annual rate of 20% during 1980 - 1996. In 1997, the rate of increase fell to 1%, and became negative in 1998. In contrast, the farmers' loans from official institutions increased at an average annual rate of about 7% during the same period. Loans to farmers from official credit institutions recorded a negative growth of 8% in 1998.⁵ The credit obtained by the farmers from the informal market is over four times that from official credit institutions. Thus, from the farmers' perspective, the non-official credit market is far more important than the official market.

D. Interest Rates

2.16 Inflationary pressures have receded over the past five years. Two years ago, China experienced the first year of net deflation of the economy. At the same time, economic growth remained strong, while domestic money supply was scaled down. Domestic savings remained comparatively steady, given the continuous reductions in interest rates over recent years.

2.17 The PBC reduced interest rates; its reference rates for the domestic money market were reduced four times in 1998 and 1999. Average interest rates for loans and deposits declined significantly. Together with a fiscal stimulus package that increased public investment for infrastructure, the government was successful in helping the country to achieve a robust growth rate in an environment where external demand was weak (Asian Crisis, currency devaluation of neighbouring countries).

2.18 Table 1 illustrates the downward movement of key Chinese interest rates over recent years, following the easing of inflationary pressures and the need to stimulate economic development through internal growth.

Table 1. Interest rate movements in Chinese financial markets

	1996 (May)	1996 (Aug.)	1997 (Oct.)	1998 (Mar.)	1998 (July)	1998 (Dec.)	1999 (June)
Demand deposit	2.97	1.98	1.71	1.71	1.44	1.44	0.99
Retail deposit (1 year)	9.18	7.47	5.67	5.22	4.77	3.78	2.25
Loans <6 month	9.72	9.18	7.65	7.02	6.57	6.12	5.58
Loans 12 month	10.98	10.08	8.64	7.92	6.93	6.39	5.85
Loans up to 3 year	13.14	10.98	9.36	9.00	7.11	6.66	5.94
Inter-bank lending rate	8.82	8.28	7.56	5.32	3.51	3.24	2.07

2.19 The two key benchmark rates in the system are the 12-month lending rate and the deposit reserve rate. The former at the end 1999 stood at 5.85%.⁶ This rate is set to include inflation and the

4. China Statistics Yearbook 1996, p. 614. China Statistics Publishing House.
China Statistics Yearbook 1998, p. 668. China Statistics Publishing House.

5. Survey data of the State Agricultural Inspection Team, from 1980 to 1996.

6. This rate also serves as an indicator rate for credit ceilings of loans from commercial banks (incl. ABC) and other financial institutions (incl. RCCs). By law, the maximum rate charged for loans could be up to 50% higher than the 12 months

spread between costs and revenues from lending operations. The deposit reserve rate acts as a *de facto* interbank lending rate in the system; at the end of 1999 it stood at 2.07%. This rate “includes” inflation, but since the transaction is effected prior to contact with the borrower, it does not include a spread for the financial institution.

2.20 Downward movements in key indicator interest rates, such as the 12-month lending rate, have been pronounced. In the period from 1998 to the end of 1999, rates declined on average between 50 and 100%.

2.21 The PBC, according to the Central Bank Law of 1995, determines key lending and deposit rates.⁷ In China over the past five years, interest rates showed a general downward trend, in line with developments in the eastern Asia region after the 1997 Asian financial crisis. RCCs are permitted to provide loans with recourse to the key rate set by the PBC, the 12-month lending rate. Financial reform was initiated in the mid-1990s, yet the liberalization of interest rates and freedom for financial institutions to charge prices for their credit products has not been fully established. As a result, deposit and lending rates have been lower than inflation rates and sectoral developments would indicate. As far as deposit rates are concerned, inflation-indexed deposit rates were introduced in the mid-1990s, with subsidy elements paid out by the Government to commercial banks to stimulate domestic savings growth.

2.22 As far as lending rates are concerned, it has been argued that the two main reasons for keeping these low are to (i) stimulate household consumption and demand, and (ii) to ensure that state-owned enterprises (SOEs) have preferential and low-cost access to much-needed liquidity.

2.23 For the RCCs, the 50% band that they are permitted to charge over and above the rates prescribed by the PBC puts them at a competitive disadvantage to other rural financial institutions, such as ABC or the state-owned Industrial Bank. The reason is the different typical customer profile in the small townships compared to that in the larger county towns, in which state-owned commercial banks (SOCBs), including ABC, are operating. The costs for RCC to mobilize deposit funds and to administer its loan portfolio are higher because of access constraints for rural households. In addition, the unit volumes transacted are usually smaller for the RCCs. The predictable result of interest rate regulation in a high-cost retail banking environment is that RCCs tend to prefer investments in bonds and securities as income-generating business, instead of advancing these funds as loans to rural people.

2.24 The interest rate on informal loans varies greatly. Borrowing between friends and relatives can be interest free. The interest rate on informal loans for production and commercial purposes is generally one to two times higher than on those of official financial institutions. Compound interest is generally not used: interest rates are flat rates based on the initial principal. In the coastal regions, where informal lending is popular, normal loan interest rates are generally a monthly flat rate of 2%.

E. Regulatory Framework

2.25 The relevant banking laws date from 1994-95, with subsequent amendments.⁸ PBC has taken steps to control financial risk by instituting liability and risk management practices vis-à-vis ABC and SOCBs.⁹ The PBC Cooperative Financial Management Department directly supervises and manages

lending rate stipulated by the PBC. In December 1999, this resulted in an interest rate cap of 8.775% to be charged on the declining balance of any loan in the financial sector of PRC.

7. As a result of the banking reform in the 1990s, PBC – that had operated both as a commercial bank and the *de facto* central bank of the country – was designated as the central bank and stopped its commercial banking operations.
8. The Banking Laws of China, Banking Laws for Commercial Banks of China, Insurance Laws of China and Billing Laws of China were promulgated for implementation in 1995. In 1994, Management Regulations of Financial Institutions were published.
9. The accounting system of ABC is accrual based. ABC is allowed to participate in the interbank market, but after 1996, in order to control financial risk, new regulations were issued for interbank borrowing that require that borrowing be conducted through the head office. Beginning in 1998, PBC cancelled its loan quota control over SOCBs and instituted asset liability and risk management procedures. Source: Albert Park, *Rural Financial Market Development in China*, draft for the World Bank, 1998.

the RCCs. The RCCs in all areas are required to set up county-level apex institutions to provide a clearinghouse service for the local RCCs. Some apex institutions also handle financial business directly. Currently, regional-level apex institutions have been set up in some areas on a trial basis. The apex institutions collect management fees from their affiliates.

2.26 Although RCCs are defined as rural cooperative economic organizations, a Law on Credit Cooperatives has not yet appeared. PBC has published Management Regulations for RCCs, Management Regulations for County-level Apex Institutions of RCCs, and has printed and issued guidelines for RCCs to improve and strengthen farmer assistance services.

CHAPTER III

POVERTY ALLEVIATION STRATEGIES

3.1 China has made remarkable achievements in improving the standard of living of its people, and in realizing sustained economic growth in the past two decades. What really draws the attention of international observers is the sustained economic growth, combined with a sharp reduction in the proportion of its population defined as poor. The rural poor population – using the official poverty line definition – fell from 250 million in 1978 to 36 million in 1999; or from 30.7% to 4.2% of the total rural population.¹⁰ However, the profiles of China's poverty vary according to which poverty definition is applied. The World Bank estimated the incidence of rural poverty in 1997 at nearly 13.5% by applying the \$1-one-day criterion, which indicates poverty 2.5 times the official figure.¹¹ This would mean that more than 10% of the rural population still live in deprived circumstances.

3.2 In this context, an urgent issue facing the government is how to transform the current credit delivery approach towards sustainable solutions when the 8-7 *Poverty Reduction Plan* ends in 2001.¹²

A. History of Poverty Reduction

(1) Phase I: Prior to 1978 – Reducing Rural Poverty by Improving Farmers' Access to Assets

3.3 **Land Reforms.** China in 1949 started to build an ideal socialist country without exploitation and class disparity. The government established a highly centralized planning system to ensure relatively equal sharing of limited physical and other resources. The poverty reduction in this phase was mainly realized by enlarging farmer access to land. Before 1949, land tenure in China had been quite unequal. China after 1949 undertook a nationwide land reform by redistributing land to poor farmers and tenants. Land reform helped all the farmers to acquire land in a short period of time and resulted in relatively equal distribution of land among different classes in rural areas by 1952.¹³ Landlessness had been the main reason behind the poverty of the rural households and the land reform attacked the core of this problem. However, after the mid-1950s, land owned by the rural households was transformed into cooperative and collective ownership.

3.4 **Improving farmer access to physical assets.** From the 1950s to the mid-1970s, the government organized nationwide capital construction in rural areas, improving irrigation and roads. It was estimated that during this period the total length of road increased by about a factor of nine and irrigation areas by 125%.¹⁴

3.5 **Improving farmer access to financial services by building nationwide rural credit cooperative networks.** By 1978, China had established a rural financial service network with nearly 60 000 township-level offices and more than 350 000 village credit stations. From 1952 to 1978, rural credit agencies had provided farmers with agricultural loans worth yuan 137 350 million.¹⁵

3.6 **Extending farmer access to extension services.** During this period, China established 40 000 agricultural extension agencies, from central to township level, covering almost all townships. With the help of extension stations, new agricultural technologies were introduced into rural areas.

10. World Bank. 1992. *China: Strategies for Reducing Poverty in the 1990s*. Washington DC.

11. World Bank. 1999. *China: Weathering the Storm and Learning the Lessons*. Country Economic Memorandum. Washington DC.

12. The *Baqi* (8-7) Poverty Reduction Plan was elaborated by the Government of China in 1994 to lift the remaining 80 million rural poor out of poverty by 2000 (within 7 years).

13. State Statistical Bureau [of China]. *Chinese Statistical Yearbook for 1984*. Beijing: China Statistics Publishing House.

14. State Statistical Bureau [of China]. *Chinese Statistical Yearbook for 1990*. Beijing: China Statistics Publishing House. Ministry of Agriculture [of China]. *China Agricultural Yearbook for 1983*. China Agriculture Publishing House.

3.7 ***Improving farmer access to basic education and primary health services.*** In this phase, China increased the number of primary schools by a factor of 1.6, and middle schools by a factor of 28. Primary enrolment rates of children increased from less than 50% to 96%. By developing a cooperative medical system, China established more than 50 000 township-level hospitals and over 600 000 village clinic stations, covering 68.8% of all administrative villages.

3.8 ***Establishing a community-based social security system.*** During this period, China built a community-based rural social security system in the country, providing basic social protection also for rural residents unable to work.¹⁵

3.9 Reflecting the effects of these combined efforts, from 1949 to 1978 total agricultural production doubled and grain output increased by a factor of 1.69. The average calorie intake of rural residents increased 20% during this period and poverty incidence in rural areas declined from about 80% to 50%.¹⁶ Important indicators – adult literacy rate and life expectancy – increased sharply in this period. It was estimated that the adult literacy rate increased by over 50%, whilst life expectancy increased nearly 50%.¹⁷

3.10 Perhaps unavoidable was that the improvement in wellbeing of households in this phase was achieved by sacrificing some economic efficiency in resource allocation. Increased control over the economy by the state and equal distribution of products gave rise to misallocation of resources and reduced farmers' incentives in production and management, hampering the pace of poverty reduction.

(2) Phase II: 1978 to 1984 - Reducing Rural Poverty by Economic Growth

3.11 In 1978, China introduced in rural areas the so-called household responsibility system. Farmers resumed their rights in the use and management of land and labour; farmers' incentives to invest and actively manage their assets increased. Farm productivity rose. In this phase, China's government also improved the terms of trade for farmers by increasing prices of agricultural products. It was estimated that the benefit gained from increase of agricultural production accounted for 15.5% of total increased income generated in this period.

3.12 With economic reform and price increases for agricultural produce, China sustained a high economic growth rate from 1978 through 1984. Per caput income of rural residents increased by 132% during this period. With this economic growth in rural areas, the part of the rural population who lived under the poverty line fell from 260 million (33% of total rural population) in 1978, to 89 million (11% of the total rural population) in 1984.¹⁸

15. It is called the "five guarantees" system: farmers are guaranteed food, clothing, housing, health care and schooling.

16. Zhou B. 1993. "Poverty in the period of People's Commune". Tribune of Economic Development, No. 6, 1993.

17. State Statistical Bureau [of China]. *Chinese Statistical Yearbook for 1990*. Beijing: China Statistics Publishing House.

18. World Bank. 1992. *China: Strategies for Reducing Poverty in the 1990s*. Washington DC.

(3) Phase III: after 1985 - Reducing Rural Poverty by Implementing a Targeted Poverty Reduction Programme Combined with a "Trickle-Down" Development Strategy

3.13 With the introduction of market-oriented economic reform, economic growth no longer automatically led to significant poverty reduction. To wit, in China, economic growth after the mid-1980s enlarged income inequality. A part of the rural poor could not benefit from national economic growth and remained below the poverty line. As a result, in the mid-1980s, the government started a targeted poverty reduction programme. This programme set out to reduce rural poverty by mobilizing resources to assist targeted areas and households and to move them out of poverty. The government mobilized resources from various sources to help the poor regions to initiate activities for income generation and poverty reduction. This phase can be divided into three sub-phases, based on targeting criteria and macro-economic policy.

3.14 From 1985 to 1989, poverty reduction was mainly undertaken through regional targeted poverty reduction programmes without support from macro-economic policies. In spite of large investments in officially-defined poor areas, the pace of poverty reduction in these five years was slow. According to official statistics, the size of the poor population in rural areas declined by 19 million during this period, or 3.8 million per year. However, according to a World Bank estimate, the number of poor increased by 7 million during this period.¹⁹

3.15 The issue is not primarily the number of poor households but rather the speed of poverty reduction in this period, which was much slower than in the first eight years after economic reform in 1978. This had two main causes. First, macro-economic policies in this period were unfavourable for poor areas and poor households. The government made policies to support faster economic growth in coastal regions, with no special considerations given to assisting the poor regions and poor farmers to participate in and benefit from national economic growth. Second, the regional targeted poverty reduction programme did not cover the majority of the poor areas and poor households.²⁰

3.16 After 1989, China adjusted its macro-economic policies to permit and promote the participation of poor areas and poor farmers in the national economic growth process, by relaxing controls on farmer migration among regions and by supporting development of labour-intensive industry. At the same time, the Leading Group for Poverty Reduction also adjusted the distribution of poor counties; and the government increased the ability of the poverty reduction programme to cover poor counties and poor households. These adjustments reduced the poor population from 106 million in 1989 to 65 million in 1995, a fall of 5.86 million persons per year.

3.17 After 1996, the government adjusted the targeting basis, from poor regions to poor villages and poor households. At the same time, the funds available for poverty reduction programmes were substantially increased. The allocation of funds for three government-supported poverty programmes almost doubled between 1995 and 1998. At the macro-policy level, the government gave top priority to developing the economy in backward central and western regions, where the poor population was concentrated. It was found that the household-targeting programme combined with the change in macro-economic policy had a pronounced positive impact on poverty reduction. The size of the poor population had declined to about 36 million by 1999.

B. Government Loan Programmes for Poverty Alleviation

3.18 The government used three approaches to poverty alleviation, namely (i) subsidized loans; (ii) food-for-work; and (iii) budgetary grants. Since 1986, the government has provided yuan 131 300 million for poverty alleviation through its three main poverty programmes. Of this,

19. World Bank. 1992. *China: Strategies for Reducing Poverty in the 1990s*. Washington DC.

20. Jalan, J., & Ravallion, M. 1996. Are there dynamic gains from a Poor Area Development Programme? *World Bank Policy Research Paper*, No.1695.

72 600 million (55%) was in the form of subsidized loans. The government's total allocation for poverty alleviation increased about 17-fold: from yuan 7 600 million in 1993 to yuan 131 300 million in 1999. Resources were substantially increased for all three components of the poverty alleviation programme (Graph 1), but the emphasis on food-for-work was reduced over time. The government permitted a quantum jump in the resources allocated to the subsidized loan programme.

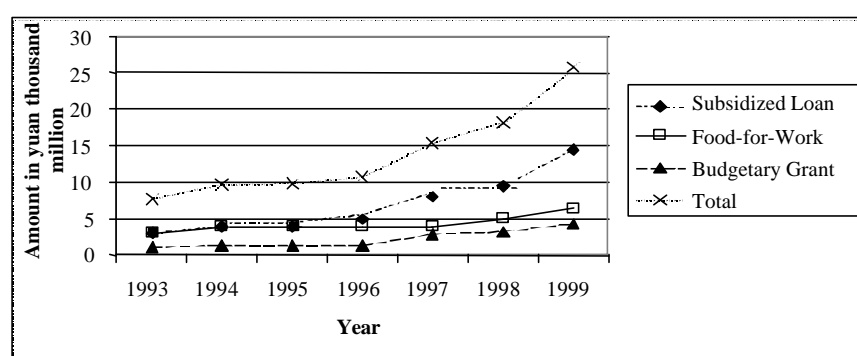
3.19 Chinese decision-makers believe that providing subsidized loans is necessary and a helpful tool in poverty alleviation. This emanates from their two perceptions regarding the economic situation of poor households. First, that the poor do not have access to the formal credit market, as they lack the assets necessary for mortgage and collateral. Second, the poor cannot afford to repay the loans at full market interest rates. With these perceptions, the government's Poverty Alleviation Leading Group System, since its establishment in 1986, has provided subsidized loans for the poor as a key instrument with which to reduce poverty.

3.20 The National Leading Group, with representatives from all ministries concerned with poverty and rural development, approves each year the subsidized loan allocations to different provinces. The Poor Areas Development Office (PADO), the implementing office, makes recommendations to the Leading Group and oversees fund allocation. Leading Groups and PADOs at provincial and county levels perform similar functions in approving loan allocations to counties and townships. At the county level (and the provincial level for large projects), loans are allocated for approved projects.

3.21 ABC continues to administer the subsidized poverty loan programme for nationally designated poor counties. Projects were approved by the ABC from 1994 to 1998, and ABC disbursed the loans and had the right to reject loans. ABC provides the loans at the stipulated low interest rate and collects a subsidy payment from the central government for the difference in spread. Loans are typically for a period of three to five years.

3.22 With time, this programme became the largest and most important loan programme targeting poor areas and poor households. The normal interest rate of the subsidized poverty loans has been 2.88% annually, which is about one-third of the regular rate of interest charged by the RCCs. RCCs were not used directly in poverty alleviation lending by the government.

Graph 1. Graphic presentation of government allocations for poverty alleviation (1993-1999)



3.23 China's subsidized loan programme has been widely criticized for not reaching the poor. Many of the reasons centre on the political economy of local government institutions in China. One issue relates to the twin goals of the programme: reaching the poor and promoting economic development. First, to provide incentives for effective loan use and repayment, local poverty officials often incorporate past performance as a criterion; when past performance is considered, this often may reduce loan allocations that are based solely on poverty status. Second, many local officials believe that the poor are incapable of managing projects successfully and prefer to promote economic development by lending to enterprises, economic entities and large farmers.

3.24 An even more important reason for the poor targeting is found when the incentive structure for local officials is considered. There are three local players with a stake in the use of subsidized loans: the local Leading Group and PADO; the local government; and ABC. Usually, local poverty officials may

compromise targeting objectives to meet the dual goals of the programme. Local government officials are also concerned with generating revenues and furthering overall economic development, not just in poor areas, which may lead them to support diversion of funds to enterprises or investment in more promising regions. This is especially true given the acute fiscal crisis facing local governments in poor areas.²¹ Agricultural Bank officials face strong profit incentives, and loan repayment is their primary concern. As they are responsible for fund disbursement, they can veto proposed projects put forward by the local PADO, if they feel the likelihood of repayment is low. This has led to numerous conflicts between bank officials and poverty officials, with the resolution favouring different sides in different cases.²² Even when loans are approved, ABC officials have an incentive to shorten the period of the loan (so that loans can be re-lent quickly at higher rates), delay loan disbursement, or divert loans outright.

3.25 There are numerous anecdotal reports of low repayment rates on poverty loans in China, including claims that 50% of all subsidized poverty loans and 60% of loans for industrial projects were not repaid on time. A report by China's Science and Technology Commission (1995) summarized national data on timely repayment, overdue loans, and defaulted loans for four main subsidized loan programmes for 1991 to 1993. Average repayment rates for these three years of the ABC administered subsidized loan programme were 54%. Such low repayment rates are well below the norm for ensuring sustainable financial institutions, and considerably lower than repayment rates on regular ABC loans.

21. Wu Guobao. 1994. Goal conflict in poor areas: Growth, Budget solvency and poverty alleviation. Paper presented at a discussion forum on China's poverty policies sponsored by Ford Foundation, Beijing 1994.

22. Li J. and G. Li. 1993. "The Use of Poverty Alleviation Funds and Economic Development in China's Poor Areas" Rural Economy and Society, Beijing 1993.

CHAPTER IV MICRO-FINANCE EXPERIENCE IN CHINA

A. Openness to Experimentation

4.1 In China, “rural finance” refers to lending by the formal financial institutions, wherein loans are granted within the financial sector regulations set by PBC. The term “micro-finance” refers to poverty-focused credit operations of civil society and the government departments that are exempt from PBC’s normal financial-sector regulation. However, it should be understood that in the vernacular, “micro-finance” literally has come to mean lending that is based on concepts of group solidarity or joint liability.

Micro-finance is seen in China as a potentially effective tool to transfer poverty reduction funds to poor families. Micro-finance in China started with a pilot project on micro-finance poverty reduction implemented by the Agriculture Development Institute of the Chinese Academy of Social Sciences (CASS). It embraced the Grameen Bank (GB) Model, or Solidarity Group Model, as practised by GB in Bangladesh.²³ Its emphasis is on providing productive loans to poor families. As a production-oriented micro-finance project, its basic target is to explore effective methods of funding the poor.

4.2 Experiments with micro-finance in China can be divided into two phases, reflecting government poverty-reduction policies. The first period started in 1994 and lasted until October 1996. In this period, the feasibility of the GB Model was explored. Civil society organizations were administering the projects. Operations were standardized without any policy interference or funding from the government. The second trial period began in October 1996 and is still ongoing; the government is now a significant actor. It sets out to realize its poverty reduction targets using micro-finance projects and contributes capital and human and organizational resources.

4.3 Four types of organizational structures are used for delivery of micro-finance in China: (i) special governmental organizations (offices) manage and operate donor funds; these projects operate according to the requirements and regulations of donor organizations such as UNDP or UNICEF, and bilateral donors such as Canada (the Xinjiang project) or Australia (the AUSAID Qinghai project); (ii) civil organizations (non-governmental organizations) implement micro-finance poverty reduction projects, such as the *Funding the Poor Cooperatives* of CASS; (iii) specialized organizations established by government manage and operate poverty reduction subsidized interest micro-finance loan projects, the size and influence of which are great in Shanxi and Yunnan provinces and in Guangxi autonomous region; and (iv) financial organizations operate micro-finance projects directly, such as the RCC Union project of Luanping County (Hebei Province), and the AUSAID Qinghai project, both of which were transferred to ABC once project funding expired.

4.4 The projects of the different organizations have their own characteristics: projects of civil organizations and donor-assisted projects place emphasis on continuous social development; government projects focus on the speed and scale of development; and projects of financial organizations place great importance on continuity, supervision, risk control and sustainability.

4.5 Governmental micro-finance poverty reduction projects (e.g. *Funding the Poor Cooperatives*) had disbursed yuan 600 million in 605 counties and 22 provinces by August 1998.²⁴ By the end of 1998, UN-executed projects (including UNDP, UNICEF, IFAD, WFP, ILO and UNFPA) and World Bank projects covered 150 counties and 22 provinces and regions, with a total funding of yuan 160 million. Projects of bilateral and civil organizations include: (i) the AUSAID Qinghai Haidong project, with funding of yuan 12 million; (ii) the CIDA Xinjiang project, with funding of

23. It promotes five-member groups with a 2+2+1 approach to credit delivery. This means that two members out of five get the first loans, and the next two members get loans after observing the recovery performance of the first two borrowers. The Chairperson of the group would be the last one to receive a loan.

24. Wang Sangui, 1999. *Micro-finance Sector in China*. Institute of Agriculture Economy, Chinese Academy of Agricultural Sciences.

yuan 1.1 million; (iii) *Funding the Poor Cooperative* of Chinese Academy of Social Science, aided by Bangladesh Rural Trust Investment Co. and the Ford Foundation, with funding of yuan 8 million; (iv) Yunnan and Guizhou projects aided by the Hong Kong Leshi Association, with funding of yuan 1.2 million; (v) Jiangxi Jianghu project aided by GTZ, with funding of yuan 600 000; and (vi) the Development International Desjardins project, with funding of yuan 1.0 million.

B. Characteristics of Donor- and NGO-assisted Credit Schemes

4.7 Most international donors became involved in Chinese poverty alleviation in the 1990s. Earlier, during the 1980s, only a limited number of international organizations, mainly NGOs, were involved. After 1994, more and more international donors and NGOs have become involved in poverty alleviation. In the 1990s, an increasing number of projects have been designed by international donors and NGOs to reduce poverty by enabling poverty-stricken households to gain better access to income-generating opportunities and basic services. Participatory micro-finance was considered as a good tool for poverty eradication.

4.8 The rural credit schemes in China have four common characteristics that negatively affect prospects for the longer-term building up of viable financial services. Schemes typically are not integrated into the mainstream rural banking system, and they do not generate sustainable outcomes that can be replicated and continued after project closure. First, with the dependence on externally-funded projects, most existing credit supporting schemes adopted foreign technologies and methodologies, with most schemes directly adopting the GB model, or a somewhat modified GB model. Second, most credit schemes that receive external funds are project-based: the schemes continue only during the life span of the project. Third, the majority of the credit schemes depend for their operation on the availability of funds from donors. Fourth, the staff of most of the credit schemes in China are concurrently employees of government departments or other agencies. This negatively affects development within these organizations of core competence for delivery of sustainable financial services.

4.9 Structured plans for developing core competencies in financial service provision across institutions and for mainstreaming micro-finance into the rural financial infrastructure are not in place. Because of the distinct social system, historical and cultural traditions, China has structured institutions and instruments that act as a barrier to institutional innovation, hindering absorption of lessons learned from these pilot efforts.

C. Target Group

4.10 Resource-poor households represent the normal target group for micro-finance programmes with special focus on women in poor regions. Government-funded micro-finance poverty reduction projects using subsidized-interest loans emphasize inclusion of the poorest families in the target group. In fact, the poor families registered with the government form the basic target group.²⁵ However, such programmes do not emphasize inclusion of women. Most external donor-funded projects and the CASS *Funding the Poor Cooperatives* emphasize women as the main target group. Exceptions are the projects of AUSAID (Qinghai project) and Development International DesJardine's (Luanping project), which are sited only in poor regions but do not specifically emphasize poor families or poor women.

D. Design of Financial Services

4.11 The first loan of most government micro-finance projects is generally up to yuan 1 000, with a repayment period of one year. The loan is repaid in instalments every one to four weeks, with a rate of interest between 2.9 and 7.2% per annum. These projects use the joint liability system. The micro-finance projects of civil organizations generally grant loans in the range yuan 400 to 1 000, and the repayment period ranges from 3 to 12 months. The loan is repaid either as a lump sum on maturity, or in instalments every one to four weeks. The civil organizations and the donor-funded projects have the flexibility to charge higher interest rates, which range from 12 to 20% per annum.

25. The government uses the Ravallion model for calculating the poverty line. At the time of writing, it is yuan 635 per caput.

4.12 The micro-finance projects implemented by the civil organizations involve a compulsory savings scheme, but do not provide a full range of financial services. The government funded subsidized loan programme is being implemented through ABC, which provides a full range of financial services. Most projects implemented by civil organizations have poor accounting and financial reporting systems, with inadequate tracking of income and expenses, and poor loan quality monitoring and business progress reporting.

E. Sustainability

4.13 Some micro-finance pilot projects have achieved operational self-sustainability.²⁶ PBC has permitted an upward revision of interest rates for micro-finance loans; this has improved profitability. The pilot CASS *Funding the Poor Cooperative* projects, active in three counties, achieved operational self-sufficiency by the end of 1997. The AUSAID Qinghai project is located in a poor area, but without an explicit focus on resource-poor households, except in terms of permitting only small loan amounts. Local agricultural banks implement the project. The project has achieved operational self-sufficiency through a policy of higher interest rates combined with strict control over costs and loan quality.

F. Policy Dilemma

4.14 PBC and ABC in 1988 undertook research on government micro-finance projects. The findings of this study cast doubt on the legality of the *Funding the Poor Cooperatives*, a programme set up under the Poverty Reduction Office of the Government to handle subsidized poverty reduction interest loans as agents of ABC. It was argued that non-financial organizations have no right to act as intermediaries and handle micro-finance activities that are essentially financial in nature. Since 1999, ABC has issued subsidized loans direct to rural families for poverty reduction. On the one hand, this is a step in the right direction, to insist that micro-finance be integrated into the financial system. But on the other hand, *in the absence of policies to mainstream micro-finance and to develop competition in the rural financial system*, growth of micro-finance institutions is being constrained. This is a crucial point.

26. Operational self-sustainability is defined by the Consultative Group to Assist the Poorest (CGAP) as having cash receipts from financial-service clients at least sufficient to cover the non-financial (that is, excluding cost of funds) cash costs of providing those services. A programme is defined by CGAP as reaching full financial self-sustainability when it is profitable after adjusting its financial statements for the following non-cash items: (1) loan loss provisions; (2) depreciation; and (3) adjustments for inflation and subsidies, treating all of its funding as if it had a commercial cost.

CHAPTER V DEMAND FOR FINANCIAL SERVICES

A. Credit Access

(1) Access to Formal Financial Institutions

5.1 The Chinese Academy of Agricultural Sciences' 1997 survey of farm households in six poor counties cast much-needed light on farmers' actual demand for credit.²⁷ In the sample of 446 households, 31% reported having an outstanding formal loan, whilst 36% reported the ability to get a new formal loan. Overall, many of those who could not get a new loan did not want a loan (nearly half), or if they wanted a loan, already had an outstanding formal loan (over 66% for the poorest group). Thus, only 10% of the entire sample reported "not having a formal loan, not being able to get a new formal loan, and desiring a formal loan." Nearly all households (over 90%) reported being able to borrow "new" from informal sources. It should be understood that the ability to obtain a formal loan did not mean that there were no constraints in obtaining credit, e.g. amount of credit, and lending policies and procedures. This indicates that access to financial institutions *per se* was not an important obstacle to obtaining credit.

(2) Limited Credit for Poorer Households

5.2 The public's access to formal and informal loans in rural China is substantial, but the finer and unusual survey data used here for analysing credit constraints clearly point to harsh constraints in obtaining credit by the resource-poor strata; there is much to be said for policy-makers and donors to re-think policy and procedures in the light of the extent of the identified restricted credit access. The majority of households with an outstanding formal loan reported their inability to get an additional formal loan (54%) compared to 47% of those *without* an outstanding formal loan. The percentage of those reporting an inability to borrow was highest in the poorest group (63% could not get new loans, compared to 39% in the richest group and 50% for the whole sample).

5.3 With increasing household wealth, formal and informal credit limits rise. Households in the richest asset quartile reported average formal and informal credit limits of yuan 2 774 and yuan 5 338, respectively, while those for the poorest quartile were yuan 876 and yuan 1 652. Informal credit limits were about twice those of formal credit limits, and this ratio did not vary with wealth. The average total credit limit from both formal and informal sources was yuan 4 633, roughly equivalent to one year of household income.²⁸ In contrast, the average amount of outstanding loans was yuan 1 078. On average, the households had only used up less than one-fourth of their credit limit, although this proportion was much higher for the poorest quartile (35%) than for other quartiles (about 20%).

5.4 Overall, these data suggest that even when formal credit is available, the amount of available credit is limited, especially to the households in the poorest quartile. It also points to the great importance of informal credit in poor areas, and the need to incorporate features of the informal credit markets in the micro-finance strategies so as to reach the resource-poor households. Another equally significant and unexpected finding is that the rural households in the poorest quartile are indeed able to borrow and service an amount equal to the average borrowing of the richest quartile.

B. Credit Supply

(1) Formal Credit Supply

27. The six survey counties were Quxian in Sichuan, Weining in Guizhou, Tongwei in Gansu, Shangzhou in Shaaxi, Yucheng in Henan, and Xingguo in Jiangxi.

28. Sample averages for income per caput and household size in 1997 were yuan 1 100 and 4.3 persons.

5.5 RCCs are cooperatives in name only; they are regulated by China's state banking system (earlier by ABC, and currently by PBC). They supply the majority of formal loans, account for two-thirds of household deposits, and almost two-thirds of loans go to household sector. In more developed rural areas, the township and county enterprises are the major borrowers.

5.6 PBC appoints RCC staff and imposes reserve requirements and interest rate restrictions. RCCs have some flexibility in setting interest rates for lending, within a band linked to regulated rates. They are less subject to policy lending (i.e. government-directed lending) responsibilities compared to other state banks. In poor areas, their inability to transfer excess liquidity across regions and the non-availability of profitable enterprises and investment opportunities increase the RCC loan disbursements to households.

(2) Informal Credit Supply

5.7 On average, households borrow from a network of 15 persons, varying from 12 in the poorest asset quartile to 18 in the richest. Not less than 80% of important network members are relatives; 53% live in the same village. For the richest quartile, slightly fewer network members live in the same village (47%). Network members for the richest quartile are much less likely to engage in agriculture (46%, compared to 65% for the poorest) and much more likely to live farther away (54 km), compared to 19 km for the poorest.

5.8 The households in the poorest quartile tend to be net borrowers in these relationships, with borrowing on average four times greater than what they lend. It stands to reason that these households provide slightly more exchange labour than they receive.

5.9 One of the two main network members provides not less than 55% of all informal loans. Very close relatives (parents or children) account for another 7% of informal loans. Of other lenders, two-thirds live in the same village, about half are relatives, 90% are men, and 40% enjoy better economic conditions than the borrower. Overall, there are distinct differences in the characteristics of social networks among different asset groups, which help explain the differences in credit limits reported earlier.

C. Credit Market Participation

5.10 Richer households *are much less likely* to borrow. The percentage of households reporting no borrowing in 1997 was 47% in the richest asset quartile, 39% in the second quartile, 32% in the third quartile, and only 23% in the poorest quartile. This is surprising, because one might expect richer households to become involved in self-employment and other non-cropping activities that require greater financing. The level of financial intermediation (the ratio of loans to economic output) is generally expected to increase with the level of economic development.

5.11 Equally striking is the large percentage of the poorest households taking formal loans. Almost one half (42%) of households in the poorest asset quartile took a formal loan in 1997 (mainly from RCCs) compared to 22% in the richest quartile. About half of those borrowing formally also borrowed informally. The participation rate trends across asset quartiles are just the opposite of those for credit limits, which suggests that differences in credit demand are more likely to explain observed borrowing behaviour than supply-side factors. The high incidence of formal borrowing among the poorest represents *prima facie* evidence negating the proposition that credit rationing in China excludes the poor from formal financial markets. In fact, conditional on borrowing, the poorest group is more likely than the richest to borrow from formal sources. This surprising finding is worth stressing, because it runs counter to numerous anecdotal accounts, including interviews. One explanation is that, in poorer areas, the lack of enterprise activity makes financial institutions more likely to lend to households, especially when the ability of the institutions to intermediate funds through interbank markets is limited.

D. Willingness to Borrow

5.12 Nearly half of the households in the lower half of the asset distribution were willing to borrow from the RCCs under current conditions, if there were no need for collateral or a guarantor. In the

richest quartile, only 30% expressed such preference.²⁹ *This implies that many of the poor are constrained by supply limitations or loan requirements, not the lack of suitable uses for available funds.* Moreover, of those expressing a willingness to borrow, 62% of the poorest asset quartile wanted to finance a productive activity rather than consumption.³⁰

5.13 The 40% of the sample willing to borrow reported an average “acceptable” highest interest rate of 28% annually; this acceptable interest cost rose with asset wealth (from 25% to 34%). Findings suggest that the rich were less likely to feel credit constrained, but at times of need they were willing to pay higher interest. In contrast, among those not willing to borrow at current rates, almost 80% (or about half of the full sample) were not interested in an RCC loan at *any* interest rate. Overall, there appeared to be great heterogeneity, both between and within asset groups, in the extent to which loan demand was constrained by the rate of interest.

E. Use of Loan Funds

5.14 The richest households were much less likely to borrow funds for fertilizer or other agronomic inputs (7% of loan amount compared to 25, 23, and 12% for the other three quartiles). They were most likely to borrow for small businesses (by number), less likely to borrow for consumption (by amount), and more likely to borrow for housing (surprisingly, along with the poorest quartile). *The poorest households, however, were more likely to borrow for consumption purposes, especially for medical expenses, which accounted for 15% of loan amounts, and daily expenses (7% of loan amounts).*

5.15 A strong positive association was found between formal sources and production loans, and between informal sources and consumption loans: 62% of formal loans were for production (52% by amount) versus only 17% for consumption (13% by amount). For informal loans, only 35% by number (33% by amount) were for production, whilst 36% by number (32% by amount) were for consumption. For production loans, 63% by value (48% by number) were from formal sources, while 70% (by value) of consumption loans derived from informal sources (81% by number of loans). Despite these average differences, for many activities, whether production or consumption, both formal and informal sources played an important role. Informal sources financed nearly half of cropping inputs and provided the majority of loans for fixed assets or small businesses. Formal sources financed a majority of loan amounts for daily expenses and housing, and financed 40% of loan amounts for weddings, funerals, etc.

F. Economic Activities, Cash Flow, and Demand for Credit

5.16 The demand for production loans generally depended on the type of economic activities in which households were engaged. Cropping accounted for 62% of net income, followed by wage income (20%), self-employed income (11%), and livestock (7%). The top quartile, however, had a very high percentage of income from self-employed income (20% of net income, 35% of total income, and 52% of cash income), and also a high proportion of livestock income (13% of net income).

5.17 Nearly all households in the sample engaged in cropping and livestock activities, while less than half engaged in wage and self-employment activities (48 and 29%, respectively). The share of households engaged in non-farm activities was highest for the richest group (56 and 37% in wage and self-employment activities, respectively) and lowest for the poorer half of the sample.

5.18 Economic activities had different financing needs. The activity with the greatest financing needs was livestock (75%), followed by self-employed activities (64%), cropping (27%), and wage income (5%). The borrowing propensity was highest for cropping (29%) followed by self-employment (22%) and livestock (10%). Borrowing propensity for cropping was much lower for the richest asset quartile (17%) and that for livestock much higher for the poorest quartile (17%). One explanation for the low

29. This is not to suggest that providing such loans would be desirable without building necessary safeguards to ensure repayment.

30. This compares to 41, 68 and 64% for productive activities in the first, second and third asset quartiles.

propensity to borrow for livestock, despite the high ratio of expenses to income, is that the main input is grain feed, which is not financed by cash but is from own production.

5.19 The rich, while borrowing more on average, were much less likely to borrow compared to the poor. While they were more likely to engage in self-employed activities, only one fifth of rich households so engaged borrowed to finance the activity directly; self-employment could explain less than 10% of rich households participating in credit markets. At the same time, the rich were much less likely to borrow for cropping or for consumption, compared to the poor. Richer households apparently were able and preferred to self-finance most activities.

G. Self-finance and Savings

5.20 One explanation for the preference for self finance is that the cost of funding for the household was much lower, *since deposit rates were far below lending rates (including implicit costs attached to informal lending)*. A second, reinforcing, explanation could be the lack of opportunities for profitable self-employment or other non-wage activities in poor counties, which lack vibrant industrial centres. Wage employment, mostly through seasonal or long-term out-migration, is often the most remunerative activity available to households in remote regions; this activity does not require much finance.

5.21 Only 16% of households reported having savings deposits at the beginning of the year, with the percentage higher for the rich (23%). On average, the amount of cash balances, which were held by all households, was over twice as great as savings deposits. Grain stocks were also significant, worth yuan 1 654 per household at the beginning of the year – more than the value of savings and deposits if the grain has an imputed average price of yuan 1.2/kg. In total, the value of liquid assets averages yuan 2 767 per household, compared to yuan 1 078 in average borrowing. In short, the potential would be huge for increasing household's deposits were attractive savings instruments to be provided. This is a major lesson for policy makers.

CHAPTER VI

EVOLUTION OF FINANCIAL SERVICES DELIVERY IN IFAD PROJECTS

A. Overall

6.1 IFAD's projects in China have used two models for the delivery of financial services. The first model is commonly referred to as the PMO Model (for description, see Introduction above). The second is the RCC model. It is difficult to compare these two models using conventional performance measurement tools. They need instead to be analysed using the "strength and weaknesses" mode of analysis. The supply-driven credit delivery mode needs to be contrasted with sustainable financial-service delivery mode.

B. Comparison of Financial Services Delivery Models

(1) Products

6.2 The IFAD projects under the PMO model offered only credit products. The RCC Model envisaged integration of the IFAD project funds into the financial system. Such an arrangement was expected to develop the capability of the RCCs to provide a full range of financial services to rural households, compared to the PMO Model's providing only credit delivery.

(2) Targeting

(a) Design

6.3 Under both the PMO and RCC models, IFAD projects use two levels of targeting. First, projects are generally located in the poorer areas. The main criteria for selection of the project area are: (i) poor townships in terms of lower per caput income; (ii) poor townships in terms of lower grain availability; and (iii) contiguity of the project areas, to facilitate better management.

6.4 Second, within townships, the mechanism of a Village Development Plan and socio-economic stratification is used. The project design of Southwest Anhui Integrated Agricultural Development Project grouped the households into four socio-economic groupings:

- ◆ **Less poor:** about 5-10% of rural households fell into this category, with a per caput annual income of yuan 650-750 (corresponding to USD 78-90). They were able to buy sufficient food for family consumption, obtain some formal education, and benefit from relatively good health with ability to participate in farm and off-farm employment.
- ◆ **Poor:** about 10% of the households in a village were grouped into this category, having a per caput annual income of yuan 550-600. These households experienced occasional food shortages because of limited financing capacity.
- ◆ **Very poor:** about 65-70% of the rural households fell into this category, suffering from severe food shortage for more than five months in a year and with an average per caput annual income of yuan 500. Other features of such households used in targeting were: (i) one or more members of the family suffering from poor health; (ii) more young children; and (iii) more aged, handicapped or infirm members.
- ◆ **The poorest:** about 10-15% of the rural households in a village were in this category, representing the poorest, with an average per caput annual income of only yuan 100-200. Such households had limited family labour and education. They were exposed to more than eight months of food shortage annually, and depended on government food support supplemented by some coarse food, such as sweet potato and pumpkin, produced by themselves.

6.5 The project target households would be those at the bottom of the above four economic groupings, who were able and capable of participating in project activities. The poorest households would not necessarily be excluded from the project, but more guidance would be given to them by the project to involve them where practical. Several targeting mechanisms were employed, according to circumstances.

- ◆ Working through VIGs, consisting of village elders and farmers' representatives, which play a key role in disseminating information on the project. VIGs mobilize the community and prepare a village development plan, for targeting and implementation purposes.
- ◆ Activities such as the provision of food assistance, road construction, drinking water supply and other social support services that should benefit all sections of society.
- ◆ Four criteria were set for individual targeting: (i) a credit ceiling of yuan 3 500 per household; (ii) a ceiling of 2 pigs/household, 1 head of cattle for two households, and 2 mou³¹ of chestnut; (iii) only one member of the household to benefit from long-term WFP food aid, with priority for poorest households; and (iv) no single household to receive more than one medium-term loan.

6.6 The PMOs and RCCs established four major criteria to select households for credit delivery: (i) potential ability to repay the loan; (ii) possessing skills or techniques to undertake an activity; (iii) have designed and submitted a good plan to use the credit funds; and (iv) have ability to mobilize own capital.

(b) Review of Targeting Performance

6.7 The targeting criteria employed in the projects would have contributed to effectively excluding some of the poor households. The projects did not devise systems to develop capability of the bottom poor to receive credit. Two factors contributed to effective exclusion of the bottom poor. First, the projects did not envisage that the initial requirements of the bottom poor would be small amount of funds to effectively deal with household emergencies and/or sickness. Household choice was constrained since the project loans were directed solely towards productive purposes. Second, the project loans excluded the households receiving food subsidies from the Civil Administration and having inadequate labour.

6.8 The mission survey data show that the households with project loans represented the better-off sections of the society (Table 2).³² For the purpose of comparison, the project beneficiaries were selected who had been recently funded but had not yet accumulated benefit. The mean per caput income of the households without project loans was about 45% below the mean per caput income of the households with project loans.

6.9 The general situation of households with project loans was found to be far better than those without project loans. Only 19% of the households with project loans had a food deficit, compared to 38% of the households without project loans. A higher percentage of households with project loans had access to other institutional finance; in contrast, as expected, a higher percentage of households without project loans used informal credit sources. The value of durable goods in the households who had taken project loans was 18 times that of households without project loans (Table 3).

31. Chinese unit of areal measure. 1 mou usually equals 670 m². Also spelt mu.

32 The data is from a limited number of households, but confirms the impressions gained by the mission during the field visits.

Table 2. Average annual per caput income of farmer households (yuan)

Townships	Households without project loans	Households with project loans
Sichuan, Langzhong, Erlong	600	925
Sichuan, Langzhong, Dongxing	735	1 632
Sichuan, Yilong, Dafeng	300	1 505
Sichuan, Yilong, Fengyi	500	3 250
Anhui, Taihu, Mituo	1 100	875
Anhui, Taihu, Liufan	500	596
Anhui, Jinzai, Youfangdian	750	1 120
Mean per caput income	653	1 477
Total sample size	48	48

Table 3. Socio-economic comparison between households with and without project loans

	Without project loans	With project loans
Households with food shortage	38%	19%
Households with access to normal credit	38%	44%
Households with access to informal credit	88%	69%
Average amount of informal credit value per household	yuan 2 686	yuan 4773
Average amount of savings in cash per household	yuan 163	yuan 493
Average value of the grain holding per household	yuan 325	yuan 458
Average value of the durable goods per household	yuan 106	yuan 1 807
Average amount of deposit in a formal financial institution per household	yuan 25	yuan 321
Average amount lent by the household	yuan 0	yuan 1 567

6.10 True, in poor areas of rural China, many bottom poor category households may have limited credit absorption capacity, particularly for productive investments. The village leaders in Zhutang village (Anhui Jinzai Youfangdian), in a focus group thematic discussion, stated that of the ten poorest households, three had disabled persons, four had persons with limited thinking capacity, and three had sick persons.³³ The village leaders argued that such “poorest” households should be provided with subsidized food assistance by the Civil Administration and should not be supported by credit, because they have no labour, no plan, no productive potential, and no intelligence. They fear that if credit is delivered to such households, the households will not necessarily repay the loans.

6.11 The real issue, however, is that the local officials, including RCC and PMO officials, prefer to give loans to better-off households. The officials’ concern is ability of the client to repay, rather than finding ways with which to achieve poverty alleviation. The poor households are usually found in remote mountainous areas, and the cost of outreach for delivering credit to and monitoring such groups is high.

6.12 Two lessons emerge: (i) the perception that the poor cannot take loans and repay is omnipresent amongst project implementers; and (ii) the cost of delivery for poor households is very high.

6.13 The targeting of poor households requires a two-pronged strategy. First, loan products need to match the requirements, absorption capacity and risk profile of the poor. Second, the financial institution needs to be given requisite incentives to deliver and recover credit, such as greater spread.

33. The meaning of “persons with limited thinking capacity” is found to be synonymous with “persons not toeing the line of village leaders.”

(3) Financial Service Delivery

(a) Loan Purpose

6.14 IFAD projects have stressed credit delivery with which to improve productivity in agriculture and related activities. The commonest categories were medium-term loans for crop and tree planting and livestock-related activities. With the PMO model, loans are provided as envisaged in the project design, but neglects the consumption needs that are vital to the resource-poor households. In contrast, the RCC Model not only envisages providing loans for productive activities using project funds, but also permits lending to cater for consumption and other needs of the clients.

(b) Loan Size

6.15 The loan size in both PMO and RCC models depends on the project loan regulations and the activity for which loan is sought. Generally, loans of uniform size are provided under the projects. Typically, such fixed loan sizes are not in line with the requirements of the households. The use of fixed norms reflects the understandable limited loan appraisal capacity of the project implementers who have to assess the needs of individual clients. However, RCCs have the capability to provide loans depending upon the needs of the households, after assessing their repayment capacity and also their ability to provide collateral.

(c) Loan Duration

6.16 Both models have usually provided medium-term and long-term loans as stipulated in the project documents. However, RCCs, in their normal course of business, only provide short-term loans for consumption purposes.

(d) Collateral Requirement

6.17 The PMO model does not require collateral for obtaining a loan, while the RCC model does not envisage collateral for obtaining loans. This is in contrast to the general practice of RCCs. They require collateral to provide loans, yet their loan regulations permit them to provide loans without collateral, up to yuan 500, although better-performing RCCs are more relaxed in practise, going up as high as yuan 3 000 without collateral requirements.

(e) Repayment Period

6.18 For both models, the repayment period is dictated by the credit guidelines. The repayment period is fixed based on the activity funded and not according to the client's repayment capacity.

(f) Interest Rates

6.19 Borrowers pay interest rates that are lower than the normal RCC lending rate. Charging a higher rate of interest continues to be a contentious issue, as project authorities still continue to believe that low rates of interest are an essential requirement for credit uptake by resource-poor households.

(g) Flexibility to Adjust Lending Rates

6.20 In neither model is there sufficient flexibility to adjust the lending rates to cover both costs and risks. This is in contrast to common practice in the micro-finance pilot projects in China, which have been allowed to charge higher rates of interest than the normal rate of the regular financial institutions. A case in point is the Grameen pilot project in Yixuan County in Hebei Province, where the lending rate is 16% per annum. Another is the Australian-funded Qinghai Community Development project. Higher rates of interest mostly act as a self-selection mechanism for targeting, as the access to financial service is more important to the resource-poor households than the rate of interest (this point is consistent with findings noted earlier regarding credit exclusion for resource-poor households (rationing). This is an important point to grasp.

(h) Recovery Performance

6.21 PMO officials reported 70-80% recovery performance, yet the PMOs could not furnish the required records to substantiate this claim. For example, the data provided by Fu Tou Township indicate yuan 635 000 as amount due and yuan 537 000 as the amount collected. The recovery performance was not less than 91%. At the same time, when the amount due is calculated based on disbursement and repayment periods, it totals an estimated yuan 836 000. On this basis, recovery performance plunges to 64%. The reliability of the data provided by PMOs is in doubt. The RCCs do not keep separate accounts of the IFAD project loans to assess the recovery performance. However, the overall recovery performance of the loans granted by the RCCs to households has been about 80%.

(i) Credit Risk

6.22 The local township government bears the credit risk in respect of loans granted by PMOs. The RCC Model envisaged passing on the credit risk to the RCCs. In reality, even in the case of projects adopting the RCC model, the credit risk continues to rest with the local government. The township government is responsible for repayment of the IFAD loan to higher levels of government. Because of this responsibility, the township governments want to exercise control over borrower selection and loan disbursement. Because of this interference, the RCCs are not prepared to take on credit risk. They demand full independence in selecting borrowers.

(j) Training

6.23 IFAD projects have made arrangements for training the PMO staff in credit delivery and preparation of credit guidelines under the PMO model. In the projects using the RCC model, allocations have been provided to train RCC staff. This allocation is not being used by the RCCs; they do not want to use loan funds for capacity building. IFAD instead has been successful in collaborating with GTZ in providing technical assistance to RCCs.

6.24 The earlier IFAD projects were weak in providing training to households. IFAD has addressed this weakness by forging collaboration with WFP. A very positive finding is that the training programmes organized have been effective. A close linkage is observed between the purpose for which loans are granted and the contents of the training programme. Almost 90% of those who have received credit have also received training in the economic activity for which the loan was taken.

6.25 In addition, about 20% of the households without project loans have also received training. Most training programme focused on technical issues and skills for maintaining the activities funded under the project. In addition, training programmes in general and reproductive health were provided for women. The extension staff of the respective line agency conducted the programmes. WFP food was provided to those attending the training programme. Availability of food from WFP helps the poor to take an active interest in the training programmes. In part, wages foregone by attending training are compensated for by receipt of WFP food.

6.26 The study team during the household survey requested the participants of the training programme to explain their practical use of the training inputs. The participants in livestock training consistently identified parasite control and preparation of better feed. The participants in economic tree plantation training identified fertilizer application and pest control. This indicates that the collaboration with WFP has been effective in enhancing the utilization of credit. However, general dissatisfaction with regard to supply of canned fish as a part of the WFP food was apparent. The study team also found a low level of awareness with regard to credit terms such as “rate of interest,” “repayment frequency” and “repayment period.” This situation was conspicuous where the PMO model of credit delivery was in use.

6.27 The mission did not obtain any *evidence* with which to firmly suggest that the WFP collaboration has helped in improving the credit uptake by the resource poor households. Credit uptake by resource-poor households is linked to efforts to target and empower poor households and to provide credit products suited their needs. Probably, exposure and attendance in meetings increased because of

the food distributed free, since, in China, credit projects have generally left out the poor. However, this study was not designed to test the impact of the food distribution associated with training.³⁴

(k) Accounting System under the PMO Model

6.28 The accounting system under the PMO model is inadequate. As a result, the management information system is weak. The situation in respect of the RCC model is better, and it has a better-developed management information system. However, the procedures related to asset classification, and loan loss provisioning and accounting practices are not in line with international standards.

(l) Revolving Fund Operation

6.29 The extent to which funds are being recycled with the PMO model remains a moot point. The design of IFAD projects incorporated two important safeguards to ensure recycling of funds. First, IFAD set out to disburse only incremental credit. This means the local governments can only claim reimbursement of total disbursement during the each period, net of amount recovered. However, this practice was not found in all the townships visited by the mission. The amount recovered is kept in a separate account: its utilization under the PMO model remains unclear. In the RCC model, however, amounts recovered remain within the RCC system and will have to be used for credit delivery.

6.30 The second safeguard was that the IFAD funds would remain at the township level for 15 years. The intention of this is to ensure that the funds are used for providing credit to households even after project closure. This is more likely to happen under the RCC model, and under the PMO model it would depend on the priorities of the local government at that time.

(m) Strengths and Weaknesses

6.31 From a purely credit disbursement perspective, the PMO model appears more efficient. The coverage of localities and/or households with the PMO model (Sichuan Project) is about 66%, compared to 20% for the RCC model (Anhui project) (Table 4). It should be noted that this does not take into account the lending by RCCs using their own resources. To begin with, parameters other than the outreach factor need to be included. Factors related to sustainability and outreach to bottom poor are other important factors to be considered for assessing performance.

Table 4. Outreach of IFAD project loans (mission sample)

Village	Total no. of households [1]	No. of households with project loans [2]	Outreach (%) ([2] × 100)/[1]
Sichuan, Langzhong, Erlong, Liuyachang	307	201	65.47
Sichuan, Langzhong, Dongxing, Yuhuangguan	301	232	77.08
Sichuan, Langzhong, Dongxing, Duyingzui	280	200	71.43
Sichuan, Yilong, Dafeng, Lianggui	284	196	69.01
Sichuan, Yilong, Fengyi, Qingyan	202	30	14.89
Average for whole Sichuan Project	1 374	859	65.52
Anhui, Taihu, Mituo, Huchang	372	93	25.00
Anhui, Taihu, Liufan, Fengshu	343	150	43.73
Anhui, Jinzai, Youfangdian, Zhutang	536	12	2.24
Average for whole Anhui Project	1 251	255	20.38

34. In March 2000, the IFAD mission, in meetings with the WFP Resident Representative, suggested that this area of investigation was a worthy one and might be considered in a further evaluation.

C. PMO Model and RCC Model

6.32 In the absence of healthy and willing rural financial institutions, the PMO model has been instrumental in infusing much-needed capital into the rural economy. However, it remains only a short-term measure and cannot be further strengthened to deliver sustainable financial services. This model can function as an allocation mechanism, but only for as long as the project funds remain at the township level. The PMO model represents a supply-driven credit delivery model: it suffers from the known limitations of this approach. Funds are allocated for disbursement with little attention to loan appraisal, repaying capacity, client credit history, and guarantee and collateral requirements. Moreover, it does not incorporate micro-finance methodologies to assist the resource-poor households to “graduate,” i.e. to progress from having initially small loan amounts with shorter repayment periods and higher repayment frequencies, to ultimately access larger loan amounts for agricultural investments, with longer repayment periods.

6.33 Borrower selection is driven by a yearly planning process with no flexibility to provide loans to households if needed during the middle of the year. The management information system is inadequate, not least the system of reporting recovery performance. Activity selection, repayment terms (period and frequency) are not flexible enough to suit the requirements of the households, but rather driven by the design set out in the Staff Appraisal Report/Credit Manual Specifications.

6.34 The two most important weaknesses of the PMO model from the perspective of developing sustainable rural financial services are: (i) inability to mobilize savings and recycle them for investment; and (ii) potential moral hazard, since borrowers may perceive that loans from government departments can be simply written off.

6.35 The RCCs, despite of their present limitations (discussed later), are the mainstay of the rural financial sector in China. They have established a large network, with a presence in each township. They represent the only formally authorized financial institution to serve the rural households. Their contribution to mobilization of savings and subsequent deployment of them for investment is substantial. Their problems derive from a biased policy environment, with regulated interest rates that make it difficult to reach out to dispersed rural households. The RCC network also suffers from performance deficits caused partly by historical bad debt burdens, and partly by ongoing weaknesses in operating performance.

6.36 Efforts are now afoot to slowly and steadily re-structure the RCCs. These efforts depend on the speed with which the re-structuring is undertaken of the township and village owned enterprises to which RCCs have granted substantial loan amounts in the past. From a micro-management perspective, PBC is directly supervising RCCs. Management support is provided by the RCC unions at the county level. Micro-finance methodologies are being built into the credit delivery systems of select RCCs on a pilot basis to increase the effective yield of the funds employed. The RCCs cannot be ignored. They need to be strengthened and re-structured so that they become efficient financial service delivery vehicles in the rural areas.

6.37 The RCC model, as incorporated into the recent IFAD projects, is the normative or “idealized” model. This model passes on credit risk to RCCs by allowing them full authority to accept or reject loan applications forwarded by the PMO. RCCs mobilize savings and are under Central Bank supervision. This model is the way to go forward to integrate the project-directed credit component into the financial system. This is in line with the State Council direction to stop all lending activities within government units, dated 1 January 1999.³⁵

6.38 IFAD is the first international financial institution (IFI) to start mainstreaming financial services into the financial system of the country. Even the most recent World Bank projects use ABC as the agent for delivery of credit, but efforts for complete integration of project credit delivery into ABC are

35. This ruling originated from a study by PBC and ABC of the rural financial institutions, looking to control financial risks and also ensure consolidation of financial sector activities within the formal financial institutions.

yet to begin. Within the IFAD project framework, attempts have been made to integrate RCCs into delivery of financial services, but this integration has been difficult to achieve.

CHAPTER VII OVERALL PERFORMANCE OF RCCs

A. Overall

7.1 RCCs represent the only legal rural financial institution with a nationwide network of offices at and below the township level in rural China.³⁶ RCCs are the principal providers of financial services to rural households and communities in China. Since the 1950s, the rural credit cooperative system has throughout its various institutional reorganizations been one of the mainstays of the rural financial system in China. By 1998, it was second-largest institution in terms of individual savings deposits in the country, after the Industrial and Commercial Bank; it was the fifth-largest financial institution in terms of total deposits. By the end of 1998, total deposits in RCCs stood at yuan 1 219 000 million (or USD 146 000 million) and total loans stood at yuan 834 000 million (USD 100 000 million), with a loan deposit ratio of 64%.³⁷

7.2 In term of loan portfolio size and outreach, the RCC system is the largest grass-roots level rural financial institutional system in China. As of December 1998, 41 719 RCCs operated in the country, with 220 000 village agents, 650 000 full-time staff and 240 000 part-time staff. As far as profits are concerned, a rough (conservative) estimation suggests that about one-third of RCCs nationwide were suffering from financial loss. About half of the RCCs in poor areas of China record financial losses. This estimate is based on the Chinese accounting standards and policies for loan provisions and write-offs. The proportion of non-performing RCCs would be much higher were international accounting standards applied.

7.3 The ability of RCCs as a whole to serve rural production, smooth household consumption and alleviate poverty has been crippled by their deteriorating financial situation. Some loss-making RCCs in small townships (mainly in poor areas of China) have been closed, or merged, with negative impact on rural poorer households. Many RCCs provide loans only to those who can provide certificates of deposits as collateral for loans over yuan 1 000 (USD 120).

7.4 RCCs are the only financial institutions with the outreach required to serve rural households. Improving their performance and incorporating poverty-alleviation-oriented financial products into their portfolio remains the key for developing sustainable rural financial service in China.

B. Performance

(1) Resource Mobilization

7.5 Outreach sufficient to satisfy the credit demands of rural households requires financial resources far beyond the levels that the government and the donors can deploy. Rural financial institutions need to mobilize additional resources, including deposits from households, to satisfy the demand for credit. The decision of the rural households to hold financial savings are influenced by: (i) the security of savings and the confidence and trust in the repository of the savings; (ii) the liquidity of savings; (iii) their total transaction costs; and (iv) the real rate of interest.

7.6 Savings mobilization benefits the rural financial institutions by:

- ◆ enabling them to expand and deepen their outreach. A large number of poor households may use savings services more than credit services. The poor households are most likely to use savings services before they have an effective demand for credit. Deposits from the public are

36. ABC also operates at the township level, but, following the financial reforms in 1996, ABC started to withdraw from the financing of rural households and agricultural production in rural China and to close down some of its business offices at the township level. ABC does not operate at the village level.

37. Almanac of China's Finance and Banking 1999, p. 491.

a stable source of resources and can help in expanding credit operations to benefit the households; and

- ◆ contributing to sustainability of the rural financial institution with the necessary ability to price loan products according to the cost of funds.

(2) Sources of Savings

7.7 RCCs have historically been the major depositories for rural household savings. Prior to the liberalization and reform programme initiated by the Chinese government, the role of RCCs as a rural financial intermediary was very limited. Per caput financial savings in the countryside were low. At that time, a very high percentage of RCC deposits was kept in ABC in the form of required reserves. Even as late as 1986, RCC deposits in ABC were equivalent to more than one-half of all deposits in the RCCs. The RCCs were primarily a mechanism for channelling rural household savings to ABC and the state, in order to support government interests in collective agriculture, industry, etc. Deposit mobilization for undertaking lending activity, amongst others, is the key to development of sustainable financial service. RCCs score very high in this aspect. The share of deposits stood at about 90% of overall funds for the RCCs surveyed by the mission in Sichuan and Anhui Provinces; this proportion has been increasing over the years. This estimate is consistent with those generated by a survey undertaken by the Chinese Academy of Agricultural Sciences (CAAS), covering 91 RCCs and 52 ABC branches. The study found that the share of deposits of overall funds in Sichuan province increased from 88% in 1994 to 96% in 1998. In Shanxi province, it increased from 89% in 1994 to 91% in 1998 (Tables 5 and 6).

Table 5. Fund sources of RCCs by Province (%)

Province	1994		1997		1998	
	Deposit	Others	Deposit	Others	Deposit	Others
Zhejiang	82	18	87	13	NA	NA
Jiangsu	81	19	90	10	NA	NA
Sichuan	88	12	91	9	96	4
Shanxi	89	11	91	9	91	9
All	83	17	89	11	94	6

Note: NA = information not available.

Source: Survey of Rural Financial Institutions conducted by CAAS.

Table 6. Fund sources of ABC by Province (%)

Province	1994		1997		1998	
	Deposit	Others	Deposit	Others	Deposit	Others
Zhejiang	33	67	44	56	NA	NA
Jiangsu	67	33	54	46	NA	NA
Sichuan	78	22	86	14	80	20
Shanxi	54	46	78	22	73	27
All	44	56	50	50	75	25

Note: NA = information not available.

Source: Survey of Rural Financial Institutions conducted by the Academy of Agricultural Sciences.

7.8 RCCs receive deposits from households and an assortment of collective sources, including TVEs. Deposits from the household sector are clearly the most important. The share of share deposits from the collective sector is on the decline and is estimated to be less than 5%. The two other major sources of funding are own capital and borrowing. Between 1994 and 1998, an overall 10 percentage point increase in deposits was observed and most of it is estimated to be from increases in household deposits.

(3) Type of Deposits

7.9 Time deposits form a major part of the total deposits mobilized by RCCs. A study of Erlong, Tong Xing Dafeng, and Feng Yi township RCCs conducted by the mission showed that the share of time deposits changed had only marginally, from 91% in 1997 to 89% in 1999. The share of time deposits of 5-8-year maturity declined from 2.4% in 1997 to nil in 1999. The share of deposits of 1-5-year maturity declined. The share of deposits with a maturity of 1 year or less increased substantially, from 41% in 1997 to 56% in 1999. In Tong Xing and Dafeng townships, demand deposits have shown a substantial increase in relation to total deposits, from 11% in 1997 to 32% in 1999. The share of deposits with a maturity of 1 year or less increased by about 20 percentage points between 1997 and 1999, whereas the share of 1-3-year maturity time deposits declined dramatically, from 40% in 1997 to less than 1% in 1999. In the case of Dafeng Township, the deposit structure by type of deposit remained almost the same (Table 7).

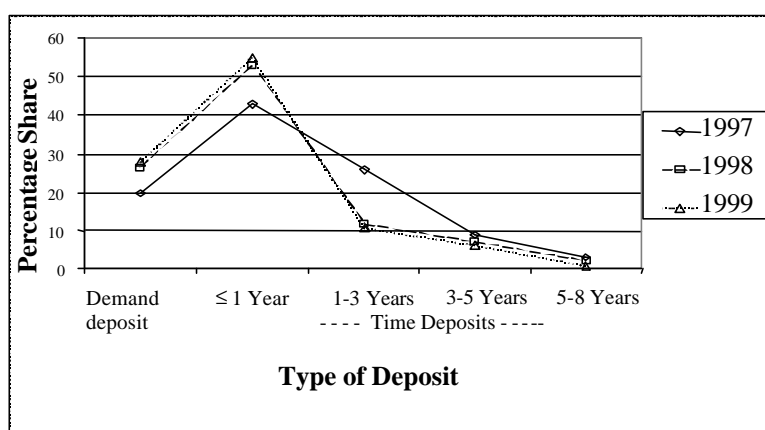
Table 7. Savings mobilization by type of deposits for four township RCCs in Sichuan Province (%)

Year	Demand Deposits	Time Deposits			
		≤1 year	1-3 year	3-5 year	5-8 year
Erlong					
1997	-	-	-	19.83	2.36
1998	9.22	50.99	22.74	15.63	1.41
1999	10.63	55.66	20.37	13.35	0
Tong Xing					
1997	11.22	48.02	39.77	0.66	0.33
1998	29.76	67.61	1.88	0.56	0.19
1999	31.51	67.55	0.47	0.31	0.16
Dafeng					
1997	39.12	39.31	9.69	5.67	6.22
1998	39.88	40.48	10.27	5.21	4.17
1999	40.96	41.73	10.51	4.6	2.19
Feng Yi					
1997	38.22	48.05	3.34	4.64	5.75
1998	41.30	45.73	3.64	4.59	4.75
1999	38.07	42.96	7.22	8.32	3.43

Source: Data provided by RCCs

7.10 The overall trend in Sichuan province indicates a sharp increase in deposits of less than or equal to one-year maturity. The decline in time deposits of longer maturity is steep (Graph 2).

Graph 2 Trends in savings mobilization by type of deposits in Sichuan Province



(4) Rate of Interest

7.11 The nominal rate of interest on deposits declined substantially from 1997 to 1999. The government effectively curbed inflation through inflation-indexed deposits. The consumer price index declined from 124 in 1994 to 98.6 in 1999. The rate of inflation is currently negative. Interest rates have been adjusted downwards (three times in 1998 and once in 1999); the rate of interest on household demand deposits declined from 1.71% in 1997 to 0.99% in 1999. The rate of interest on 5-year maturity time deposit fell from 6.66% in 1997 to 2.88% in 1999 (Table 8).

Table 8. Nominal rates of interest on deposits (%)

Type of deposit	23 Oct. 97	25 Mar. 98	1 July 98	7 Dec. 98	10 June 99
Demand Deposit	1.71	1.71	1.44	1.44	0.99
Time deposit – 3 months	2.88	2.88	2.79	2.79	1.98
Time deposit – 6 months	4.14	4.14	3.96	3.33	2.16
Time deposit – 1 Year	5.67	5.22	4.77	3.78	2.25
Time deposit – 2 Years	5.94	5.58	4.86	3.96	2.43
Time deposit – 3 Years	6.21	6.21	4.95	4.14	2.70
Time deposit – 5 Years	6.66	6.66	5.22	4.50	2.88

Source: The People's Bank of China Quarterly Statistical Bulletin

(5) Performance

7.12 The deposit mobilization track record of RCCs has been excellent. It is second only to the SOCBs in ability to mobilize deposits. The deposits of SOCBs increased by 65% during the period 1996 to 1999. In the same period, the deposits of RCCs grew by 52%. In 1999, the RCCs' share of total deposits among formal financial institutions was about 13%. The total volume of deposit mobilization of finance companies increased rapidly, from yuan 81 000 million in 1996 to yuan 160 000 million in 1999 (Table 9).

Table 9. Comparative deposit mobilization performance (yuan thousand million)

Sector	1996	1997	1998	1999
State Commercial Banks	4 240	5 191	5 948	6 977
Other Commercial Banks	570	638	758	897
Rural Credit Cooperatives	879	1 061	1 216	1 336
Urban Credit Cooperatives	400	538	609	664
Finance Companies	81	104	132	160

Source: The People's Bank of China Quarterly Statistical Bulletin

7.13 RCCs continue to be mainly self-reliant. The performance of RCCs in deposit mobilization is closely linked to the public perception that the RCCs represent a government-owned institution, hence deposits are safe. Any action contrary to this is likely to have negative impact on deposit mobilization efforts of the RCCs. This impression is strengthened by the results of the rapid household survey conducted in Sichuan and Anhui provinces. RCCs were perceived as government-owned institutions by all the 96 households surveyed. Households did not feel that their deposits with RCCs were insecure, but, at the same time, households were not ready to contribute to RCC equity or capital. The reason for this is the poor performance of the RCCs' loan portfolio, and especially the loans disbursed to Township Enterprises.

C. Credit Delivery

(1) Lending Procedure

7.14 Village agents are employed by the RCCs to deliver credit to the households living in distant villages. RCC offices also deliver loans directly to households and TVEs, as well as monitoring the lending activities of the village agents.

7.15 Obtaining a loan from an RCC is relatively simple. Clients have to fill out an application giving their personal details and credit needs. The Village Agent or the Credit Officer undertakes pre-sanction inspection to assess the client's financial situation and credit needs. If the village agent or the credit officer does not know the applicant and the pre-sanction inspection casts doubts on the capacity, commitment and character of the client, a guarantee or sponsorship agreement is requested, to be signed by a third party acceptable to the RCC. For loan amounts requiring collateral, an agreement on collateral will have to be signed and notarized. Thereafter, the loan is approved and released by the village agent or the credit officer.

(2) Collateral Policy

7.16 PBC regulations allow RCCs to provide loans up to an amount of yuan 500 without collateral. There is no standard practice with regard to collateral and it varies from RCC to RCC. Collateral requirements are stringent in RCCs that are performing badly. In better performing RCCs, depending on the credit history, no collateral requirement is stipulated for loan amounts up to yuan 3 000. However, in most cases, personal guarantee by a person acceptable to RCC would be necessary.

(3) Loan Approval Delegation

7.17 The village agents are authorized to approve loans up to yuan 500. In some RCCs, the credit agents have powers to sanction loans up to yuan 2 000. Loans above yuan 100 000 have to be referred to the RCC Union at the County Level. Loan approval powers of different functionaries are shown in Table 10.

Table 10. RCC loan approval limits

Functionary	Loan Limit (Yuan)
Village Agent	Up to 500
RCC Credit Officer	501 – 2 000
RCC Branch Manager	2 001 – 3 000
RCC Branch Loan Committee	3 001 – 10 000
RCC Manager	3 001 – 10 000
RCC Loan Committee	10 001 – 100 000
County RCC Union	100 001 – 300 000
Regional/Prefecture RCC Federation	Above 300 000

Source: Data provided by RCCs

(4) Repayment Procedures

7.18 One month prior to loan maturity, the village credit agent or credit officer will, either in writing or by a personal visit, notify the client of the amount falling due for repayment. The village agent collects repayments for loans disbursed by them at the village level. Loans disbursed by the RCC will have to be repaid at the RCC Office. This system reduces the transaction costs of clients who have taken small loans.

(5) Rate of Interest

7.19 The rate of interest on loans is prescribed by PBC. The lending rate has been declining sharply over the last three year. In 1996, PBC allowed RCCs the flexibility to charge an interest rate of 40%

above the nominal rate of interest on loans disbursed by the RCCs. In 1999, this ceiling was raised to 50%. The nominal rates of interest prescribed by PBC are shown in Table 11.

Table 11. Nominal rates of interest prescribed by PBC for the RCCs (%)

Category	1 May 1996	23 Aug. 1996	23 Oct. 1997	25 Mar. 1998	1 July 1998	7 Dec. 1998	10 June 1999
6 months	9.72 ⁽¹⁾	9.18 ⁽¹⁾	7.65	7.02	6.57 ⁽²⁾	6.12 ⁽²⁾	5.58 ⁽³⁾
1 year	10.98 ⁽¹⁾	10.08 ⁽¹⁾	8.64	7.92	6.93 ⁽²⁾	6.39 ⁽²⁾	5.85 ⁽³⁾
3 years or less	13.14	10.98	9.36	9.00	7.11	6.66	5.94
5 years or less	14.94	11.70	9.36	9.00	7.11	6.66	5.94
More than 5 years	15.12	12.42	10.53	10.35	8.01	7.56	6.21

Notes: (1) The lending rate could be 10% higher or 10% lower than the nominal rate of interest; for RCCs, the lending rate could be 40% higher or 10% lower than nominal interest rate.
 (2) As of November 1998, the lending rate for small-sized enterprise could be 20% higher than nominal interest rates; while for RCCs, the lending rate could be 50% higher than nominal interest rates.
 (3) As of September 1999, the lending rate for medium- and small sized enterprises could be 20% higher than the nominal interest rates.

Source: The People's Bank of China Quarterly Statistical Bulletin

(6) Loan Structure

7.20 The data provided by the RCCs during this thematic study indicate that about 90% of the loans outstanding belong to households and only 10% to TVEs. However, other data show a different picture. The CAAS study, using a large sample of 92 RCCs in four Provinces, reported that, in 1994, about 55% of the loans were granted to TVEs, 7% to “private firms” and 38% to others. The share of household credit categorized in “others” was 35%. In 1997, the households’ share increased by six percentage points and outstanding loans to the TVE sector declined by five percentage points (Table 12).

Table 12. Loans structure of RCCs (%)

Province	1994				1997			
	TVEs	Private Firms	Others	of which households	TVEs	Private Firms	Others	of which households
Zhejiang	58.62	10.24	31.14	NA	50.94	20.33	28.72	NA
Jiangsu	71.28	5.89	22.83	NA	63.93	14.52	21.55	NA
Sichuan	56.56	1.93	41.56	30.21	50.01	4.38	45.60	35.97
Shanxi	29.05	9.13	61.82	38.64	26.30	10.11	63.59	45.01
All	55.02	7.25	37.74	35.44	50.02	13.61	36.36	41.60

Source: Chinese Academy of Agricultural Sciences’ Survey of Rural Financial Institutions.

(7) Recovery Performance

7.21 Data were difficult to obtain on RCC recovery performance. The secondary data on recovery performance of RCCs present a dismal picture. The recovery performance of the RCCs is closely linked to the performance of TVEs. By year-end 1996, the non-performing loans of RCCs comprised 38% of their total portfolio.³⁸ PBC has sought to increase supervision and regulation to comprehensively deal with those RCCs facing high-risk exposure and insolvency. It is very difficult for outsiders to assess the progress of this effort.

7.22 The CAAS survey in four Provinces (Zhejiang, Jiangsu, Sichuan and Shanxi) revealed that the non-performing loan rate of 31.7% of the RCCs declined during the period 1994 to 1997, compared to a 68% increase in RCC non-performing loans. The RCCs in Sichuan Province registered a better

38 Nicholas R. Hardy, The challenges of bank re-structuring in China (mimeo).

performance; non-performing loans in 44.44% of the RCCs declined, compared to 55.56% of RCCs with increased non-performing loans. Of RCCs in Zhejiang and Shanxi, only a quarter of them registered a decline in their non-performing loans.

7.23 Recovery is better in poorer RCC areas. The data relating to the variation in performance of RCCs across townships, segregated by income, indicate that only 21% of the RCCs operating in the highest-income quartile townships recorded declines in overdue loan rates, compared to 46% of the RCCs operating in the lowest-income quartile townships (Table 13). The explanation is that the lending in the highest-income quartile RCC areas is skewed towards TVEs; moreover, a close link is found between lending to TVEs and high overdue rate. RCC lending in the poorer townships is mostly to households, and the repayment rate of loans to households is comparatively better.

Table 13. RCC recovery performance changes during 1994-1997 (%)

Township income quartile	Number of RCCs	Overdue Loan Rate		
		Decline	No Change	Increase
I (Highest)	19	21.05	0.00	78.95
II	18	38.89	5.56	55.56
III	20	45.00	0.00	55.00
IV (Lowest)	22	45.45	0.00	54.55
All	79	37.97	1.27	60.79

Source: Data from the Chinese Academy of Agricultural Sciences' survey.

7.24 Any assessment of the magnitude of non-performing loans in the financial system must also take into account the leniency of China's loan classification system compared with standard international practice. PBC began to introduce important reforms of the loan classification system in 1998. RCCs are reported to delay classifying loans as non-performing, primarily because classification was generally tied only to the repayment of principal and many loans were "bullet" loans on which no repayment of principal was required until the end of the loan term. In addition, the RCCs are also reported to roll over the non-performing loan so as to report them as performing.³⁹ The net effect of these shortcomings is that the published figures on non-performing loans are biased downwards, possibly by a large margin. In short, non-performing loans are maintained in the RCCs' books of accounts.

(8) Profitability

7.25 The profitability of RCCs has increased slightly, from 0.9% in 1988 to 1.2% in 1995. The profitability increased in Sichuan, Hubei and Shanxi, but fell in Zhejiang and Shandong. In 1995, 15 of the 54 RCCs for which profit data were available, reported negative before-tax profits, compared to 3 of 37 in 1988. The percentage of profit-making RCCs has declined. In Sichuan Province, 70% of the RCCs were reporting profit in 1994, as against 55% in 1998. The situation is worse in Shanxi province, where none of the RCCs reported profit in 1998 (Table 14).

Table 14. RCC profitability pattern (%)

Province	No. of RCCs	1994			1997			1998		
		-ve	0	+ve	-ve	0	+ve	-ve	0	+ve
Zhejiang	25	20.00	0.00	80.00	20.00	0.00	80.00	NA	NA	NA
Jiangsu	23	4.35	0.00	95.65	13.04	0.00	86.96	NA	NA	NA
Sichuan	20	15.00	15.00	70.00	20.00	10.00	70.00	45.00	0.00	55.00
Shanxi	23	56.52	30.43	13.04	47.83	30.43	21.74	69.57	30.43	0.00

Note: NA = not available

Source: Data from CAAS survey.

39. Rolling over means sanctioning a new loan to the borrower to close an old loan.

CHAPTER VIII

MACRO-CONSTRAINTS AFFECTING RCC PERFORMANCE

A. Governance

8.1 Governance is the process whereby a board of directors, through management, guides an institution in fulfilling its corporate mission and protects the institution's assets over time. A board of directors is established to provide oversight and give direction to the managers of an institution. The board carries out this function on behalf of a third party, referred to as the shareholders.

8.2 Fundamental to good governance is the ability of individual directors to work in partnership to accomplish an effective balance between strategic and operational responsibilities. Effective governance occurs when a board is able to give guidance to the management in strategic issues and is effective in overseeing management implementation of the agreed strategic plan. Management, in turn, assumes operational authority and ensures that the institution's programme of activities responds to the direction jointly agreed upon with the board.

8.3 The interplay between board and management centres on this relationship between strategy and operation, with the board focusing its discourse on strategy, while management ensures effectiveness of operations. Priorities are thus required for both elements to successfully navigate an institution through its short-term and long-term evolution. The challenge for governance, therefore, is to employ the perspectives and experiences of the board and management to maximize their overall contribution to the institution's performance.

8.4 The governance issue in RCCs is complex. Superficially, an RCC is a unit cooperative bank with its own elected board of directors under the regulatory framework of PBC. At the county level, RCCs are federated under a County RCC Union, with similar federations at each higher administrative level. Generally, the superstructure of RCCs above the township level has five tiers, similar to local government at each level. Official recognition by PBC of RCCs as cooperative banks implies that RCCs are unit cooperative banks or primary cooperative banks, with linkages to their respective unions and federations: each RCC is individually responsible for their financial losses and profits.

8.5 The emergence of the agricultural cooperative system and also the RCC system resulted from cooperative and collective campaigns and the rural and urban economic reforms of the Chinese government. Over the last 40 years, the RCCs have undergone a process of formalization. Though the RCCs initially started as cooperative banks, they were virtually co-opted by the government. Initially, the RCCs were regulated by PBC, but subsequently ABC managed them as a state-owned bank from 1980 to 1996. RCCs were de-coupled from ABC in 1996, and put under the regulatory framework of PBC, with the intention of transforming RCCs into real cooperatives.

8.6 Three issues need to be considered at this stage.

8.7 The first issue is that of ownership of RCCs. The RCC system developed as a part of the collectivization efforts of the government to form cooperatives in all spheres of economic activity. The government in the end realized the futility of this exercise. Most collectives were disbanded. However, RCCs continued their activity as they were brought under the umbrella of ABC. This clearly indicates that RCCs did not start as member-driven institutions. The RCCs are being treated as cooperative banks but in reality they are state-owned financial institutions. Cooperatives emerge organically from the share capital mobilized by the interest group for a specific activity, who mobilize share capital for growth. In the case of RCCs, the share capital contribution from households is nominal. The RCCs have already grown substantially with government patronage. Financial institutions are required to hold capital equivalent to 8% of their assets. The assets of the RCCs have grown very large due to government support, and at this point would require a substantial increase in capital to reach internationally accepted norm for capital adequacy ratio, which would be difficult to mobilize.

8.8 The second issue is related: the households that own shares have negligible influence in the management of the RCC. RCC shareholders do not elect the board of directors, as election to the board

follows a pattern that is intrinsically similar to the election of leaders to local government. Such a situation puts the RCC management on a weak footing. Typically, local government influence in the operations of the financial institution is harmful; effective financial management requires independence in lending operations and asset management. The negative effects are evident, reflected by the substantial loans by RCCs to TVEs, which have become non-performing assets. Under such circumstances, the RCCs cannot pursue a management policy that promotes maximization of profits to the shareholders.

8.9 The third issue relates to the management of RCCs. PBC is not only regulator and supervisor, but also manager of RCCs. RCCs, since their inception, have been managed by either the central bank or the state-owned bank, ABC. During the early years, PBC managed RCCs. Subsequently management of RCCs passed to ABC. Since the separation of RCCs from ABC in 1996, the RCC system has been managed by PBC. PBC, as a central bank, has had the dual role of being not only regulator and supervisor, but also manager of RCCs. As the RCCs are not adequately capitalized and run on the strength of savings mobilization, the government intentionally has tightly controlled the affairs of RCCs. The RCCs continue to function as public-sector enterprises or a state-owned bank.

8.10 It is widely recognized that the RCCs need their own hierarchical structure to effect national-level policy-making, management, provision of services and promotion. However, the government has decided to continue with the cooperative structure, even though the RCC system is steeped in the traditions of a public-sector set-up. In addition, the deposit mobilization capacity of the RCCs is linked to the perception of the people that RCCs are governmental organizations.

8.11 Following separation of RCCs from ABC, the staff of ABC handling RCC affairs were absorbed into the RCC system. This cadre provided the nuclei when forming the county RCC unions. The RCCs are required to obtain authority for major loan decisions from the union and to accept supervision and guidance from the union. The existence of the county union also makes it possible for effective funds management, allowing quick deployment of excess funds of one RCC to other RCCs within a county. RCC federations were subsequently created above the county level. The National Federation of RCCs was established in 1999, with the provincial and local federations created subsequently. Nevertheless, as RCCs are still controlled by PBC, the federations at different levels have been prevented from performing their proper managerial functions and provide service to RCCs.

8.12 Efforts are being made to turn the RCCs into real cooperative banks, but these efforts are so far unsuccessful. The same staff who managed the RCC while it was under ABC now manage the county RCC unions and federations. The names have changed but the management system and customs remain the same.

8.13 PBC is trying to increase RCCs' share capital, and data indicate that a substantial increase has been achieved. But in reality it is not share capital. In order to reach the targets set by PBC, RCCs have offered fixed-income on household share capital. They are nothing but 1-year savings deposits. The households interviewed by the mission clearly indicated their preference to keep their money as savings deposits rather than buying share capital.

8.14 In contrast to ABC, the RCCs are confronted by five issues that arise mainly from problems related to governance.⁴⁰

- (i) No one, including PBC, is accountable for RCC performance. PBC approves staff appointments and transfers, initiates penal action against errant staff, and provides lines of credit and monitors performance, but formally it is neither accountable nor responsible for RCC performance. For ABC, the managers at different levels are basically accountable for performance.
- (ii) RCCs do not have access to continuous and recognized qualified advice and professional support. ABC has such a framework, which speeds up the decision-making process; it has high quality staff at headquarters for advice and professional support to branches.

40. This does not mean that ABC is a better institution for delivery of rural credit and that it is devoid of any weakness.

- (iii) RCCs do not have a national system for the transfer of funds across regions. This presents problems in developing a loyal clientele due to inability to offer all banking services under one roof; this also presents problems for movement of funds from RCCs having surplus funds to other RCCs requiring funds. The current procedure allows RCCs to transfer funds only within the county. This problem is not experienced by ABC, which can transfer funds anywhere within the country, and hence able to obtain better interest income from excess liquidity by inter-branch transfers.
- (iv) Compared to ABC, the RCCs are exposed to less favourable policies and treatment from the central government – typically concerning compensation for inflation-indexed loans, and treatment of non-performing loans. The floating of the lending rate by up to 50% and small tax concessions for poor counties cannot compensate for higher transaction costs in these areas. ABC can itself float its lending rate by 30 to 40%.
- (v) RCCs are unable to cross-subsidize across regions as they are nominally single-unit banks and each RCC is responsible for its own profit and loss. ABC, being a bank with a network of branches, is able to cross-subsidize the poor performance of some branches.

8.15 Other issues related to governance are:

- (i) RCCs have difficulty in borrowing from MOF and Finance Bureaux. RCCs have no access to donor funding as PBC is unable or unwilling to guarantee repayments by RCCs.
- (ii) Inability of the RCCs to speed up the decision-making process. The ABC system has quickly adopted some of the micro-finance experiments, while RCCs have been only talking about it for a long time.

8.16 PBC is faced with major challenges in its need to shift RCCs toward a real cooperative governance structure. First, the financial situation of most RCCs does not enthrust the households to contribute to the capital of the RCC. Second, such a move would jeopardize the savings mobilization ability of the RCCs, which is closely linked to the common perception that RCCs are part of the government. Third, it is not easy to transform a government-owned structure into a cooperative-based one, especially when its financial performance is weak.

B. Historical Non-performing Loans of RCCs

8.17 The unsatisfactory financial performance of RCCs has been caused, *inter alia*, by a relatively high proportion of non-performing loans and interest receivables, high cost of funds, high transaction costs, PBC regulation of rates of interest, and poor staff efficiency. There are considerable variations in the performance of RCCs in different regions and counties, but the relatively high proportion of non-performing loans is a major contributor to the RCCs' poor financial performance.

8.18 The present practice of asset classification needs to be fully understood. It is far from international standards, or even the standards being followed in some developing countries. There are three categories of overdue loans, namely: (i) loans overdue from 1 day to less than 2 years; (ii) loans overdue for more than 2 years; and (iii) dead loans (enterprises bankrupt, borrowers dead, no repayment possibilities at all). Loan write-offs have to be approved by MOF.

8.19 The history of non-performing loans of RCCs needs to be understood. Most non-performing loans date from prior to the reforms in 1996-97. A high proportion of non-performing loans can be regarded as policy loans, i.e. loans provided in compliance with instructions given by county and township governments.

8.20 Moreover, the official statistics on non-performing loans do not represent a correct picture of reality. Two factors are at play. One factor is that some RCCs first roll over and re-schedule their loans; and the second factor is that they classify loans granted to poorly performing TVEs as "regular loans."

8.21 The loans provided to TVEs represent a high percentage of RCC non-performing loans. The statistics available indicate that the percentage of delinquent loans is generally higher for loans to TVEs

than for loans to rural households. In the western provinces of China, the repayment rates for loans to households ranged from 75 to 90%, which is much higher than the overall repayment rate for RCC loans (data from in Qinghai, Sichuan, Guangxi and Yunnan Provinces).

8.22 Local governments (in the case of RCCs, mainly the township governments) usually have two objectives in mind. First, to ensure that the RCCs invest more in local areas in order to raise local output, incomes and taxes, and, second, to induce RCCs to invest in some large projects, typically investment in TVEs. Although RCCs are not controlled directly by local governments, such intervention cannot be entirely avoided due to the special political, economic and social conditions in China.

8.23 RCCs have not yet been included in the efforts to re-structure bad debt. Debt and Asset Management companies have been established to re-structure non-performing assets of state-owned commercial banks, but similar measures have not been initiated for re-structuring the non-performing assets of RCCs.

C. Transaction Costs

8.24 The transaction costs (operational costs) of RCCs are generally higher than those of other financial institutions in China. Several factors have contributed to this state of affairs. First, RCCs are located in almost every township (*xiang*) of China, including the sparsely populated, remote mountain areas; in many locations, transport and communications involved in serving clients are costly and time consuming for the RCCs. Second, the higher transaction costs of RCCs are associated with financing of small-scale farmers; costs are high because of small loan size and use of credit agents to reach villagers. In recent years, with poor TVE performance, a higher percentage of loans has been disbursed to rural households. These changes should reduce loan arrears and increase outreach to poorer households, but simultaneously increase the cost of lending. Finally, there are large disparities across and within regions in operational costs. In general, the transaction costs are much higher in poor and more remote provinces and areas.

(1) Cost of Funds

8.25 RCCs have been exposed to higher cost of funds compared to other financial institutions in China, such as ABC. This can be attributed, first, to the historical inflation-indexed deposits of RCCs; second, to a higher proportion of fixed-term deposits for RCCs; and, third, to higher costs in mobilizing deposits from rural residents.

8.26 From 1988 to 1989, and again from 1993 to 1995, the government introduced inflation-indexed deposits to combat inflation. The interest rates on deposits were indexed to inflation, but the government did not permit the RCCs to compensate for their higher cost of funds by letting them also link lending rates to the inflation index. Because of this, RCCs lost around yuan 580 million for 1988-89. RCCs so far have received only partial compensation – yuan 100 million (ca 17% of the total losses) – from the government. The deflationary measures and inflation-indexed rates for deposits were reintroduced in July 1993, which resulted in a further loss of about yuan 2 400 million for RCCs. So far, no compensation has been provided to RCCs for these losses.⁴¹

8.27 Compared with the ABC, RCCs have a higher proportion of household deposits and a higher proportion of time deposits, and the cost of funds for RCCs becomes generally higher than that of ABC. For example, in 1995, the proportion of household deposits to total deposits in RCCs was 86%, compared with 70% for ABC. Moreover, the proportion of time deposits to demand deposits was around 70%, compared with 55% for ABC.⁴² In 1995, the rates of interest for demand deposits were 3.15% per annum, whilst the rate for time deposits was 9% for 6 months, around 11% for 1 year, 12.2% for 3 years and 13.9% for 5 years. About 80% of household time deposits at RCCs are of 1-year duration.

41 This information derives from discussions with RCCs and PBC.

42. Almanac of China's Rural Finance, 1996. Newsroom of Chinese Financial Almanac, 1996.

8.28 Finally, RCCs have received most of their deposits from individual households, hence their operational costs associated with deposit mobilization exceed those of commercial banks. Many RCCs use their village agents to attract deposits from villagers and pay the agent a commission for doing so. The interest spread between the cost of funds (including cost of deposit mobilization) and lending rate is inadequate to cover the credit risk and operational costs for lending. This situation represents a barrier to introduction of micro-finance products and lending to new agriculture enterprises.

(2) Interest Rate Structure and Macro-constraints

8.29 PBC regulates rates of interest in China, which are standard nationwide. After the separation of RCCs from ABC, many RCCs, particularly those RCCs in poor areas of China, found it difficult to cover their transaction costs. This has remained the case even though the RCCs, since 1996-97, have been allowed to float their rates by up to 50% over the base-lending rate set by PBC.⁴³ Following the Asian Financial Crisis and a more relaxed monetary policy in China, both lending and deposit rates continuously declined.

8.30 The state regulation of RCC rates of interest has its costs. It has contributed to: (i) the current financial difficulties of RCCs; (ii) reduced deposits from rural households, leading to a reduced credit supply to rural communities; (iii) lower spread and induced risk aversion by the RCCs, leading to higher transaction cost to borrowers due to RCC insistence on collateral and other security for obtaining a loan; and (iv) collateral-linked exclusion of resource-poor households.

8.31 In a normative setting, the interest rate spread for RCCs should be sufficient to cover their transaction costs and cost of funds, and leave enough reserves for growth, so that RCCs can serve the rural households and communities on a sustainable basis. The government, on equity grounds might subsidize RCCs in very poor and remote areas in order to improve their outreach mechanisms, but in the current situation, when both deposit and lending interest rates are highly regulated, when RCCs on the whole do not receive assistance to write off past bad debts, and when they have received only partial compensation for inflation-indexed deposits, the RCCs for the most part do not represent sustainable financial institutions.

8.32 PBC faces four constraints in permitting more flexibility in interest rates, that would in turn raise the margins and the performance of RCCs. First, the recent decline in farm prices and the low growth rate of rural household incomes makes it politically difficult for the government to liberalize RCC lending rates. There is a widespread perception among policy makers that the rural households, especially poor households, cannot afford to pay a higher lending rate. This perception has generated powerful political pressure and a lobby for low rates of interest for agriculture. Another related, but unjustified perception, is that household demand for credit is mainly for farm production purposes.

8.33 Second, the government's budgetary constraints contribute to a desire to use low-cost credit, rather than direct grants with which to support economic growth in rural areas. The third reason for the inability of the government to relax the interest rate regime is the poor economic performance of large numbers of county and township enterprises. There is pressure on the government to keep these ailing enterprises afloat by continued provision of low-cost credit. The fourth reason is that it is difficult for PBC to liberalize the rates for RCCs alone, without changes being made to the overall interest rate regime in the financial sector of China.⁴⁴

D. Reform Agenda – Progress to Date

8.34 A process of gradual reform has been started and announced in the *Decision on Rural Financial Systems Reform* of 1996. An inter-ministerial Coordination Group for Rural Financial Systems Reform, led by PBC, was then established. The 1998 National People's Congress took action. It singled out financial sector reform as one of five priority areas. With the allocation of

43. This compares with a 30-40% band for other state banks, such as ABC.

44. There is a move towards aligning government regulations with those of PBC.

USD 23 000 million for recapitalization of the four SOCBs in 1998, a visible commitment was made to supporting change in the financial sector.

(1) Separation of RCCs from ABC

8.35 The separation of the RCC network from ABC has been completed. PBC took on supervisory functions for RCCs, including management of statutory reserves, audit, inspection and management training and support. However, bad debts inherited from the ABC portfolio continue to be rolled over. With PBC entrusted with managing – not just supervising – the RCC network, the quantity of lending through RCCs has gone down, while the quality of new loans appears to have gradually improved.

(2) Nominal Share Capital Increases

8.36 As part of the reforms, RCCs are required to increase their share capital. The amount of loans to shareholding farmers should account for at least 50% of the loan portfolio of each RCC. While RCCs have complied with the stipulation for increased capital, this has been achieved at times through conversion of deposits and without addition of new and additional capital resources.

(3) Consolidation of RCC Network

8.37 RCCs with poor financial performance have been merged with other RCCs or closed altogether. This has happened above all in the poorer regions of China, and led to the beginning of a process of withdrawal of RCCs from some townships in economically disadvantaged regions.

(4) Legal Reform

8.38 The comprehensive new Chinese banking legislation enacted in 1995 introduced some key concepts, including capital adequacy, loan loss provisioning, and established standards for running and supervising commercial banks. ABC, as one of the four large SOCBs, is governed by that legislation, while RCCs are governed principally by specific regulations issued by PBC. Although the commercial banking sector has now been placed on a sounder footing, reform of relevant cooperative legislation has not kept pace. Chinese cooperative law foresees member-owned and member-managed cooperative institutions, including financial institutions, but without supporting institutions, such as cooperative auditors or specialized thrift-and-credit cooperative training centres. RCC affairs were managed by ABC up to 1996, and thereafter by PBC. Notably, reform of the cooperative legislation or introduction of specific laws governing cooperative banks are *not* currently viewed as a priority by Chinese policy-makers.

8.39 The German model offers some useful lessons in this regard. Legislation governing the German Volks-und-Raiffeisenbanken (thrift-and-credit cooperative banks) uses a two-way track system: the cooperative banks must not only conform to cooperative law, but also, and as cooperatives, conform to legislation governing the specific business area in which the cooperative operates, in this case banking. Cooperatives as enterprises without special privileges face the same conditions as their non-cooperative competitors.

8.40 Other factors in the 150-year-old success story of German cooperatives include freedom from governmental and public intervention into internal cooperative matters; a strict yearly audit by a specialized cooperative audit federation; efficient supervisory boards, whose members must be qualified and regularly trained to properly monitor management decisions; autonomy of cooperatives to design their own statutes within the legal framework of the Cooperative Act any relevant enterprise-specific legislation; and, finally, sufficient equity capital to have adequate reserve cushions at all times. Cooperative banks, in addition to having to comply with the regulations for banking supervision and with internal control procedures, also have to file monthly reports to the banking supervision department of the German Bundesbank.

8.41 Comparisons with other Asian and Pacific countries offer additional useful insights. The Philippine Cooperative Law of 1993 foresees the establishment of a Cooperative Development Authority (CDA), which is a parastatal authority external to the Cooperative Department. The newly

established CDA is mandated by law to register, supervise and liquidate thrift-and-credit cooperatives, but also applies to other cooperatives in the Philippines. In many countries of the Pacific, the central bank plays a crucial role similar to that in China in supervising the affairs of thrift-and-credit cooperatives. Country examples here include Papua New Guinea, the Solomon Islands and Vanuatu (the latter as a transitional measure). However, in none of these cases is the central bank charged with responsibilities beyond supervisory functions. National and regional federations handle management of the affairs of thrift-and-credit cooperatives.

8.42 As mentioned before, RCCs could also develop in a different manner, and be incorporated as shareholding companies, possibly initially with a mixed ownership of public (township government) and private investors. In this case, the current commercial banking legislation would need to be adjusted to account for the small RCCs. The case of the Philippines might be mentioned here as a precedent for small and decentralized, single-unit commercial banks. A single family or close relatives, however, in many cases *de facto* own the Rural Banks in the Philippines.

(5) Transforming RCCs into Commercially Viable Financial Institutions

8.43 The long-term reform objective for RCCs should be to transform these small, decentralized financial operators into a commercially viable financial institution. A move from a public-sector culture towards an effectively run financial institution has a number of implications for RCCs, and these need to be identified. First, ownership of RCCs needs to be clarified. What are the rights of shareholders and how do they participate in decisions affecting control, supervision and appointing managers? Second, a clear, simple and uniform application of systems and procedures is a key element in establishing workflow routines, and that in turn would form the basis of operational audits and controls.

8.44 The capability in China for effecting necessary reforms is huge, and institutional change and improvement of the RCC system is bound to come. The question is “When?” The corporate culture of RCCs requires a change away from a government-owned and -controlled service delivery point, to a simple, uniform and standardized workplace with clearly defined work descriptions and workflow. A standard credit manual plus sets of procedures for all office bearers is necessary. The current system, with its inadequately standardized procedures, militates against efficient control and auditing. Hence there is need for a fundamental change in attitude; in essence, any reform agenda for the RCCs implies a re-invention of the institution. Questions remain that are outside the scope of this Thematic Study. There is no clarity as yet on what kind of organizational structure RCCs would or should assume. PBC is convinced that a cooperative structure does not work. Nor is there interest in converting RCCs into a state-owned bank. The government at the moment does not have an explicit policy for addressing the issue of RCCs’ bad debts. PBC has enough issues to address with the existing state-owned banks.

CHAPTER IX

FACTORS AFFECTING INVOLVEMENT OF RCCs IN IFAD PROJECTS

A. Procedural Limitations Pertaining to Use of IFAD Loans

9.1 MOF has placed severe procedural limitations on the use of IFAD funds. IFAD funds are passed on as loans down to the township level, with township PMOs ultimately responsible for repayment of the loans. This makes it difficult to activate necessary interactions between PMOs and RCCs at township level. The *Measures for the Financial Management of the Projects Funded with IFAD Loans*, issued on 28 February 1995 (No. 16, 1995, Document of the Government of the People's Republic of China), states:

“The MOA, as the State-Council-designated external window on IFAD affairs, is responsible for project co-ordination and supervision. The MOF as external debt representative for the Chinese Government in accepting IFAD loan funds, assumes the responsibility as guarantor for paying IFAD all the principal and interest of its loans according to the date specified in the loan agreement. The financial departments at the various sub-national levels, as debt representatives designated by their lateral governments, are responsible for the assignment, allocation, recovery, debt-servicing of loan funds and management of supporting funds.”

9.2 The contents of this instruction are passed on to the county level. For example, in Taihu County of Anhui Province, the following major articles were set forth in the County Finance Bureau document.

- (i) the County Bureau, as the government designated borrower, is responsible for the assignment, allocation, recovery, debt-servicing of project funds;
- (ii) the County Government signs the loan assignment agreement with the township government, and the township finance offices sign the loan assignment agreement on behalf of the township government;
- (iii) the rate for loan assignment from the county to township is 6 per thousand per month, from the township to farmers, equal or below 7 per thousand per month. The interest spread shall be used mainly for loan loss provisions; and
- (iv) in the light of the loan assignment agreement, the township governments are required to repay the principals and interest of IFAD loans to the County government on time. Penalties apply to those townships which fail to do so.

9.3 With these regulations, IFAD projects face a double challenge. First, it would not be possible for MOF or Finance Departments at the Provincial level to assign IFAD loans to PBC or RCCs (or other financial institutions). Second, the township governments would not be able to use IFAD funds for activities other than credit, as these funds will have to be repaid. It does not appear to be a realistic proposition to expect governments of poor townships to repay funds taken for development of rural infrastructure, training and other activities.

9.4 The PMO model has been a convenient tool in the context of present procedures set by MOF, the borrower of IFAD loans. IFAD loans are passed on directly to the provinces as a loan repayable in 30 years, with a 10-year grace period, and with associated exchange risk. The provincial government bears the exchange risk and passes the loan on to the subsequent lower level, repayable in 15 years after a 10-year grace period. The township government, which ultimately receives IFAD loan funds, will have to repay to the higher levels of administration the amount borrowed.

9.5 One drawback with this procedure set by MOF needs to be further explored. IFAD credit funds are used as intended for lending to households, but the MOF procedure prevents the townships from

using the IFAD funds for infrastructure development and other activities. Instead, townships use them for providing credit to households, which can be recovered and repaid. This means that IFAD's intentions are thwarted: the projects provide funds for infrastructure development and other activities but these funds are not used as intended. Township governments use 100% government funds for rural infrastructure, training and other activities, excluding credit. This is in conflict with IFAD's intention, having made allocations for these components in the project documents. Instead, township governments claim reimbursement from IFAD *for all activities*. The reimbursement received from IFAD towards rural infrastructure and other activities are again deployed for giving credit to households. This is in addition to the funds specifically allocated for credit.

9.6 In reality, the mission's discussions and fact finding suggest that the entire IFAD loan is used for the credit component, whilst the township governments use counterpart funds to undertake other activities. The rationale behind this is that the IFAD funds are loan funds and will have to be returned or repaid. Hence, they need to be deployed as loans and not for infrastructure and other investment which cannot be recovered directly from private households as "repayment." So long as MOF uses the current procedure of passing on IFAD funds as loans, then local governments at the township level will find it difficult to absorb IFAD credit for infrastructure and other activities and repay the same at a later date.⁴⁵

9.7 The township, county and provincial governments are unwilling to place the funds – which they will have to ultimately repay – with the RCCs and thereby relinquish control over their use. They see no role for themselves in IFAD projects where the funds allocated for the credit component to be passed on to the RCCs. It would not be possible to integrate activities of PMOs and RCCs within the IFAD project framework if MOF continues with the current loan deployment procedure. Instead, a solution could emerge were the township governments to receive IFAD funds as a grant from MOF for rural infrastructure, training and other activities, plus funds for the credit component as a loan.

9.8 MOF is advancing the argument that the major constraint for a shift to the RCC model is the poor health of RCCs and the risk of non-repayment of funds to be provided to them. This argument is not valid. First, the poor performance of RCCs is not due to the above-mentioned problems of the institution alone. Second, macro-factors linked to government policy, such as governance issues, historic bad loans and the policy environment, are not sufficiently conducive to generating longer-term sustainable growth for RCCs. Third, to advance the reform and permit higher rural economic growth and employment, the Government will need to assist the RCCs to re-structure, and this will have to be supported by relevant regulatory framework and enabling policies.

B. Limited Incentive Structure for RCCs

9.9 RCCs have limited incentive to operate within the current framework of cooperation with PMOs. Four factors contribute, namely: (i) high cost of funds; (ii) perceived high credit risk; (iii) inconsistencies in lending policies and procedures; and (iv) perceived non-requirement of external funding. These are each considered further below.

(1) Cost of Funds

9.10 MOF passes IFAD funds to the Provinces at a very high cost. Under the current arrangements, the IFAD funds pass through five administrative layers before reaching the RCCs. MOF passes the funds with credit risk and exchange risk to the Province, but charges 4.5% to the Provincial Finance Department as against the 0.75% charged by IFAD. Yet MOF used to pass on World Bank project funds to the Provinces at 2%,⁴⁶ and recently it has even agreed to pass on funds at 0.75% to the Provinces.⁴⁷

45. This conclusion is arrived at after a set of probing questions and discussions with project management staff. The success of RCCs is predicated on a set of complex institutional issues that range far beyond the apparently simpler one of margin availability.

46. Qinba Mountain Poverty Reduction Project, funded by IDA.

47. Western Poverty Reduction Project, funded by IDA.

9.11 It could be argued that the cost structure for RCCs under IFAD projects unwittingly ensures failure of the RCC Model. The spread for RCCs is too low for them to be interested in seeking IFAD funding. The rate of interest on loans to households varies from project to project. In the Sichuan Project, in the areas where the RCC Model is being tried, the rate of interest charged to the households is 12.06%, whereas in areas with the PMO Model, the rate of interest is 8% (Table 15). The spread available to RCCs varies from 1.1 to 1.3% in Anhui Project. The RCCs have been promised an additional spread of 1.5% by the PMOs. In practice, this would mean that the PMOs would have first to receive 1.5% spread refund from MOF prior to passing this refund on to RCCs.

Table 15. Cost of Funds under IFAD Projects (%)

Fund Flow Channel	Sichuan Project		Anhui Project (RCC Model)		Jianxi Project (PMO Model)
	PMO Model	RCC Model	Taihu County	Jinzai County	
MOF to Province	4.5	4.5	4.5	4.5	4.5
Province to Prefecture	6.5	6.5	5.0	5.0	4.5
Prefecture to County	6.5	6.5	5.0	5.0	5.1
County to Township	7.0	7.0	6.0	6.5	6.5
County/Township to RCC	NA	8.0	6.0	6.5	NA
Lending rate to households	8	12.06	7.1	7.8	7.5 to 7.8

Note: NA = not applicable

Source: Provided by the PMOs to the Study Team

9.12 The average cost of funds for RCCs, as calculated by interest expenditure to outstanding deposits, has been declining steadily over recent years with PBC's downward revision of interest rates. The overall cost of funds declined from a high of about 6% in 1997, to about 4% in 1999

9.13 The weighted average rate of interest for new deposit mobilization is much less than the RCCs' current average cost of funds. The latter ranges from 1.75% to 2.21% and is headed downwards with the declining proportion of time deposits of longer maturity (Table 16).

9.14 It is definitely not a viable business proposition for RCCs to accept project funds at 6-7% when additional funds could be mobilized at a rate not exceeding 2.26% (excluding cost of mobilization). In addition, the cost of deposit mobilization of RCCs is approximately 1.35% of the total deposit outstanding. The upper limit of total cost of funds is estimated at about 3.6%, as PBC provides funds to RCCs at 2.9% interest. The high cost of funds has acted as a disincentive for RCCs, not only for participating fully in IFAD projects, but also to take full credit risk. It can be safely assumed that RCCs would not be able to accept project funds at a cost exceeding 3% to 3.6%.

9.15 The design of IFAD projects has assumed that a spread of 4 to 4.5% should suffice to cover all costs of credit delivery, recovery and credit risk, and make a reasonable amount of profit. This hypothesis is also invalid. Based on the survey of RCCs in five provinces, it was found that the RCCs could employ a spread of 7% in 1995.⁴⁸ The performance of RCCs has not improved since 1995. The need for a larger margin has not reduced. This clearly indicates that the current incentive structure for RCCs does not encourage them to participate in IFAD projects.

Table 16. Weighted Average Cost of Deposits for RCCs in 1999

RCC	Percentage
Da Feng Township	1.79
Feng Yi Township	1.82
Erlong Township	2.21
Dong Xing Township	1.86
Tai Hu County RCC Union	1.99
Liu Fan Township	2.11
Mi Tou Township	2.21
You Fang Dian Township	1.82
Gao Xing Township	1.75
Jibu Township	1.98

Source: Data provided by the RCCs

(2) Perceived Credit Risk

48. Albert Park, Loren Brandt and John Giles. *Giving Credit where Credit is Due: The Changing Role of Rural Financial Institutions in China*. Unpublished manuscript, Univ. of Michigan, 1997.

9.16 Even if a sufficient margin is provided to the RCCs, in order to bear the full credit risk they require complete independence in selecting the borrowers. Were complete independence given, the mission estimates that the RCCs would reject about 40-50% of the loan applications forwarded by the PMOs. This follows since the RCCs rightly place emphasis on the credit history and the repayment capacity of the clients. This means a completely changed credit delivery scenario: the credit uptake will be far less than the current projections.

(3) Inconsistencies in Lending Policies and Procedures

9.17 There are three inconsistencies between the project propagated and RCCs' own credit delivery systems, pertaining to: (i) loan size; (ii) loan duration; and (iii) requirement of no-due certificate. The size of the loans provided to the households under the project varies from yuan 500 to yuan 3 000. Most loans for economic tree plantation, irrigation and land development are about yuan 3 000, and the loans for pig raising, pig breeding, duck raising, etc., are about yuan 500. In comparison, the RCCs' own loans to the households are smaller.

9.18 The RCCs provide short-duration loans, not exceeding 1 year. This helps RCCs to recycle funds at a faster rate and achieve a higher effective rate of interest on loans. The loans provided under the project are medium to long term in nature. Even the loans provided for duck raising and pig raising, which yield required returns within one year, are supported through loans with a 2- to 3-year repayment period.

9.19 The RCCs insist on a no-due certificate from the prospective borrowers. This means that the households with outstanding loans from ABC or a PMO cannot get a loan from an RCC. This procedure does not apply in PMOs, so this is an important issue, as it potentially lowers the quality of lending through PMOs.

(4) Perceived Non-requirement of External Funding

9.20 The mission visited some RCCs that felt that external funding was not required for their operations. This was more evident in Jiangxi province, where the RCCs considered that adequate deposits could be mobilized to fund their lending programme. RCCs, at the current lending rate, find it risky to provide loans to poor households. In contrast, empirical evidence confirms unmet credit demand and willingness to borrow at higher interest.⁴⁹ New credit products with flexible interest rates and incentive for on-time repayment could sufficiently enhance credit demand, as well as the incentives for RCCs to expand lending.

C. Current Scenario

9.21 IFAD is the first IFI to start mainstreaming financial services into the financial system of the country. Even the most recent World Bank projects use ABC as the agent for delivery of credit. Efforts for complete integration of project credit delivery into ABC are yet to begin. Within the IFAD project framework, attempts are being made to integrate RCCs for delivering financial services, but such integration has been difficult to achieve.

9.22 Given the constraints in implementing the RCC model as prescribed in IFAD project documents, the RCCs and PMOs have reached a tactical arrangement in Anhui province to facilitate implementation. The PMOs continue to bear the credit risk and the RCCs deliver loans to all the borrowers identified by the PMOs. This contrasts with the subsidiary loan agreements signed between RCCs and PMOs, where the PMOs stipulate that the full credit risk remains with RCCs and that the RCCs will have complete autonomy to select borrowers. In the words of PBC, this arrangement is an Agent Arrangement between the PMOs and the RCCs.

49. Refer to Annex 2: Assessment of demand for and supply of financial services in the rural areas of China.

CHAPTER X THE FUTURE

A. Shift Towards Sustainable Financial Service Delivery

10.1 A local-level perspective is needed to fight poverty. Such a perspective imposes a special approach towards institutional issues of banking and financial sectors. Non-financial institutions play an important role that is not always well recognized in the literature.⁵⁰ The PMO model of credit delivery through Finance Offices does not form part of the local financial infrastructure. The credit transactions of the PMO Model may attain transactional sustainability and the borrowers may not be concerned about the institutional sustainability in the short run, as long as they are able to access credit. In the absence of financial institutions willing to cater to the demand of households, the PMO model occupied the vacuum. It has been an effective tool for disbursement of credit, and in the short run this model infused much-needed capital into the rural economy.

10.2 An institution is sustainable if it is able to operate on its own. When the emphasis is placed on the sustainability of the institution, little attention is paid to the immediate needs of the borrowers. Borrowers are made to underwrite the costs of making the institution sustainable: credit is sold at a higher price to achieve institutional sustainability. However, this should not discourage development of financial infrastructure at the local level.

10.3 In China, RCCs are the necessary entry point into the local financial infrastructure. Overall, financial activity in the rural areas originates from RCCs and returns to them. Apart from the ABC Township Offices in some areas, RCCs are the only institutions that can issue guaranteed and exchangeable liabilities against cash deposited on their books by depositors and savers. In short, they are also the only institutions that create money when extending credit.

10.4 A shift to the RCC model – apart from helping integration within the local financial infrastructure – has two distinct advantages. First, given the evidence of the huge unmet demand for credit in the rural areas of China, no donor will be able to satisfy the demand for credit in the rural areas by adopting solutions that are institutionally unsustainable. Donors need instead to consider using their funding to leverage local resources to develop local financial infrastructure capable of shifting from traditional lending to poverty-focused lending. The efficiency gains from leveraging local resources or unshackling part of the local resources for poverty alleviation are immense. For example, the Jiangxi/Ganzhou Integrated Agricultural Development Project covers 47 townships and has an allocation of yuan 193 million for five years, and used the PMO model of credit delivery. The annual credit disbursement is estimated at about yuan 39 million. In contrast, each RCC in the project area has an outstanding savings balance of approximately yuan 8 million, totalling yuan 376 million. Were IFAD projects able to leverage only 10% of these funds for micro-finance, the allocation for credit would double! Second, the management information system of the local financial infrastructure is generally well developed compared to those of non-financial institutions. The former is transparent with regard to utilization of the funds and is under the supervision of the Central Bank.

10.5 These reasons have rightly prompted IFAD to move towards use of RCCs. In addition, the government has also realized the importance of integrating credit services with those of the local financial infrastructure. It has issued guidelines for stopping all credit-related activities through government departments. IFAD has been the first IFI to begin experimentation with integration of project-funded credit operation within RCCs. As with any first effort, this has not been without some difficulties.

10.6 The study findings were presented in a Technical Review Workshop, in Beijing, July 2000, to (i) disseminate study findings; (ii) arrive at a common understanding of issues confronting the

50. See the Conceptual Framework for the study (§1.12 *et ff.*), based on the McKinnon-Shaw analysis of financial intermediation.

implementation of credit components under IFAD projects; and (iii) reach a broad agreement on the future course of action. The details of the workshop are provided in Annex 6. The recommendations set out below are broadly in line with the workshop deliberations.

B. Overall RCC Reform

(1) Developing Management Capabilities

10.7 To begin with, a review is warranted of the management structure of the RCC network at its different levels as an input to ensuring improved future operations. There is a consensus that PBC should regulate but not manage the RCC network. Depending on the direction that the RCC network will take in the future, two broad recommendations emerge. Either (i) RCCs could be transformed into small, joint-stock single-unit banks, probably with a much reduced minimum capital and other licensing requirements, and the related governance issues need to be addressed in the framework of the existing commercial banking law, or, if the RCCs develop as genuine cooperative banks, (ii) an internal management structure with apex organizations at different levels will need to be developed for management support, training, and audit and supervision.

10.8 For the second course of action, it is recommended that genuine demand for superstructures needs to be mobilized from the primary-level RCCs in order to avoid a supply-driven institution-building approach with expensive recurrent cost implications for the RCC network. Apex structures are easy to create, but more difficult to maintain (preferably from RCC member fees) and, once established, hard to streamline or remove.

(2) Specialized Legal Framework?

10.9 The ultimate legal footing of the RCC network will depend on the pace and direction of the ongoing reform efforts. In this transition phase, it is uncertain whether RCCs will emerge as thrift-and-credit cooperatives, cooperative banks, or single-unit joint-stock banks. For the last-named option, no specialized legislation would be required, as joint-stock banks are fully and entirely covered by national banking legislation. For the first two – cooperative – options, those carrying out reforms should draw upon the expertise of leading modern cooperative associations with extensive experience in legal matters, such as the German Raiffeisen Foundation.

(3) Savings-Based Development Approach

10.10 Deposit instruments need to maintain their current range of term diversification and pricing. Households have a higher proportion of current and time deposits in RCCs compared to other categories of investor. In addition, the share of time deposits in RCCs is also higher compared to current deposits. In 1995, the proportion of household deposits to total deposits was about 86%, compared to 70% for ABC. Moreover, the proportion of time deposit to household deposits was around 70%, compared to 55% for ABC.⁵¹ The current term structure therefore appears adequately diversified within RCCs, but savings could be linked in special schemes, such as for house purchase or similar. Self-finance from internally mobilized deposits remains a more flexible and less costly strategy for investment than taking loans. Compulsory deposit insurance available to rural depositors in RCCs and ABC instead of a *de facto* state guarantee for state-owned financial institutions would diversify risks and increase robustness within the financial system.

(4) Transparency of Loan Re-scheduling

10.11 Tracking down re-scheduled loans in a bank's portfolio is neither an impossible nor mysterious undertaking. However, the statement of accounts on which the accounting frame is based needs to be updated. In the "Loan Assets" heading of the accounts, a separate line for re-scheduled loans needs to be added.

51. Almanac of China's Rural Finance, 1996. Newsroom of Chinese Financial Almanac, 1996.

10.12 If loans are re-scheduled with different maturities, sub-accounts should be inserted based on classification of repayment period.⁵² With a view to achieving consistency, development projects should avoid putting re-scheduling routines in their credit manuals; instead, they should promote adequate loan loss provisions for treating re-scheduled past due loans.

(5) Loan Write-offs Based on an Adequately Classified Loan Portfolio

10.13 Procedures for asset classification need to be revised. PBC would be wise to address this task promptly with adequate regulations. External capital infusions similar to the inflows into SOCBs could be considered after RCCs have been classified into four categories: insolvent; potentially recoverable; operating with problems; and operating satisfactorily. Also, owners and managers need to express their commitment to institutional re-structuring. A clear strategy and specific objective needs to be formulated for performance improvement before any external capital injection could have its potentially useful effects.

10.14 Similarly, the distortions resulting from fictitious income from outstanding loans that have no chance of being recovered can be ameliorated in part by a shift to cash accounting procedures. It is the understanding of the mission that most RCCs already employ cash accounting procedures.

10.15 For this and the other specific recommendations, it will be necessary to complement their introduction with a review of the criteria used by PBC in assessing RCC staff performance. Inadequately trained and supervised RCC staff may contribute to practices that are not warranted, such as inflating the loan portfolio size and net incomes. In the final analysis, implementing reform elements must not result in a process of self-inflicted negative positioning on the part of progressive RCC staff vis-à-vis other RCCs that do not introduce new procedures.

(6) Strengthen Commercial Lending Capacities

10.16 In the past, credit rationing in favour of SOEs – irrespective of their competitive status in the market place – has affected the financial health of the four large SOCBs. Similarly, the RCCs were burdened with non-performing loans of TVEs after separation from ABC, or have carried such loans over in their own portfolio. With a view to ensuring successful continuation of the current consolidation of the RCC network of PBC, the banking skills of RCC staff need to be upgraded. They need to be at a level that permits sound financial and elementary technical screening of loan applications. The recent trend of separating policy-based from commercial lending is a welcome step in this regard. In the longer term, however, the rural finance system requires a level playing field between the different institutions, with a phasing out of preferential and subsidized lending to priority target groups.

52. In the absence of dedicated accounts for re-scheduled loans, the extent of loans re-scheduled needs to be assessed indirectly through Loan Officers or the Lending Manager of a Financial Institution. As a result of this type of loan tracking, the portfolio re-scheduled would then need to be separated into irrecoverable and potentially recoverable loans, consistent with international accounting standards.

(7) Promote Complementary
between Non-financial and Financial Services

10.17 The traditional focus in projects – namely providing only credit – has inherent limitations. Complementarities at the client level need to be pursued to avoid an imbalance between loans and technical services through state extension and support services, or through innovative ways of promoting small-enterprise development.

10.18 As far as non-credit financial services are concerned, insurance schemes – together with loan and deposit services – have been introduced and are on offer for livestock insurance through the Animal Husbandry Bureau. Voluntary, individual insurance schemes have the scope of reducing climatic and other external risk pressures; they would broaden the scope of financial services and permit a shift from a credit-based to a broader service approach.

(8) Improved Mechanisms to Facilitate Learning

10.19 There is no harm in not having it right the first time an activity is undertaken, but there is a need for a structured process to be in place for deriving the relevant lessons from past experience, and for incorporating the lessons learnt into future activities. Repeating mistakes and applying failed financial technologies represents an unnecessary wastage of scarce resources. The current micro-finance promotion in China presents an example in this regard. Where systems have failed because of substandard performance of the two key variables of rural financial intermediation, namely management of service costs and management of lending risks, conclusions need to be drawn. The onus is on donors to put in place more objective and transparent monitoring and evaluation systems, and to make results available to other agencies planning to replicate a service delivery approach. Once this is in place, the debate would be greatly facilitated concerning the pros and cons of (i) government-staffed versus parallel financial intermediation structures put in place by a number of micro-finance projects; and (ii) operating within the existing framework of rural financial institutions so as to improve performance. Such a broader comparative analysis is beyond the scope of this study. It is, however, recommended that the donor community follows up with a broader, possibly jointly launched, evaluation of rural finance and micro-finance approaches in China. Involvement of the different government ministries and agencies would be imperative. Such an objective performance assessment could then guide future decisions regarding support to financial systems.

CHAPTER XI

DESIGN CONSIDERATIONS FOR FUTURE IFAD PROJECTS

11.1 Despite its imperfections, micro-finance is still a key element in poverty eradication policies. Micro-finance is a difficult, labour intensive “product” that requires interdisciplinary teams, strong backstopping capabilities and ceaseless mainstreaming efforts. No one approach can be applied uniformly across all regions of China. In some areas, where no local financial infrastructure exists in the form of RCCs, the PMO model may still be a valid option.

11.2 In the Chinese context, the limitation of IFAD’s instrument becomes apparent in mainstreaming IFAD project funds into the local financial infrastructure. It uses only its loan instrument, and volume is small compared to other major IFIs. Using its own resources and instruments, IFAD may not be able to negotiate reform of RCCs, which would be part of the overall financial sector reforms, as well as public sector reform. The RCCs are definitely in difficulty and need to be reformed, but reforming them will be a long, drawn-out battle. But the problems posed by those RCCs in difficulty cannot be addressed by excluding them from the micro-finance and poverty alleviation lending, or, for that matter, by basing the decision to include or exclude them solely on the strength of an analysis of their financial statements. Issues instead can be addressed by encouraging RCCs to experiment and by creating a system of rewards and punishments. The pilot experiments assisted by IFAD ought to be jointly evaluated for replication. This would serve and assist all Chinese partner institutions in learning and re-assessing policy.

A. IFAD Loan Use Procedures

11.3 In China, the system of resource transfer from central government to local governments is unique. It has two features that distinguish it from other developing countries. First, IFAD funds are transferred as loans to the township level, and the township local government is responsible for repayment. In most other countries, IFAD loans either flow as a grant from the central government, or as a loan only to the level of provincial government. The township level receives IFAD loan funds as grants. Second, the provincial, prefectural, county and township governments are responsible for mobilizing the required counterpart funds. In most other countries, counterpart funds are provided either by central or provincial government.

11.4 The present system in China needs to be changed. If funds reach the county and townships level as loans, it is too optimistic to assume that the local governments will hand over funds for the credit component to RCCs, and then undertake support activities using loan funds that they have to ultimately repay. Under the project, funding for rural infrastructure, training and extension services needs to reach the township government as “grants.” Credit component funds would have to be made available to the RCCs as loans. Funding for capacity building and infrastructure to improve access required by RCCs will have to be provided as a grant. Following the theory of “seeing is believing,” it would be appropriate to organize a study to permit policy-makers in China to study and understand the procedures of IFAD loan use in other countries. It would also provide them with an opportunity to study various rural poverty alleviation and micro-finance models pursued in other countries.

B. The Case for Changed MOF Regulations for Transfer of Funds

11.5 It is not easy to understand why MOF uses one set of regulations with regard to IFAD funds and another set for other IFIs. IFAD funds are transferred to provinces at 4.5%, who bear all the risks. In contrast, World Bank funds are transferred to provinces at 0.75% (in the case of the Western Poverty Reduction Project). Such disparities need to be minimized. If arrangements can be established similar to those for World Bank funds, provinces would be able to lend to RCCs at an acceptable rate of interest. RCCs, in the IFAD project framework, borrow from the county or township. It would be appropriate for RCCs to borrow directly from the provinces so as to avoid co-ownership of funds at the local level. The participants in the Technical Review Workshop also recommended the transfer of credit funds direct from provinces to RCCs.

C. Getting RCCs interested

11.6 The main reason for including RCCs in all efforts to improve a region's financial infrastructure is to encourage them to take an active interest in micro-finance. This is not an easy task. RCCs may not readily use any of their sources of re-financing (deposits from clients, re-financing from PBC, and loans from other banks) to re-finance micro-credit operations. RCCs assess their re-financing needs (i.e. need for funds) in relation to their projected uses of funds. RCCs also determine their level of deposit mobilization and level of borrowing and lending in the money market according to their current pattern of activity. Strong, credible incentives are required to convince RCCs to change the way in which they operate. To leave room for new operations, such as micro-credit, banks must understand the benefits they can derive from their involvement in this activity.

11.7 Getting RCCs interested is particularly difficult given the situation with regard to their performance. Crises in the financial sector have induced PBC to tighten the controls under which RCCs and other financial institutions operate. Stricter asset classification and provisioning norms make it much more difficult to RCCs and other financial institutions to enter into what could be considered experimental lending. In fact, bankers feel more comfortable today investing excess liquidity in money market instruments than risking it in credit, let alone micro-credit. Considering RCCs in the design of credit projects and seeking to consolidate the development of rural financial services under the RCC umbrella would be an essential first step in integrating project-led credit.

11.8 However, the issue related to the cost at which the RCCs would receive funding within the IFAD project framework would have to be settled. It has been assumed that the cost of funds for RCCs should cover operational cost and credit risk, but RCCs need to be provided with funds that are simultaneously attractive compared to other sources of refinancing, and yet not potentially a disincentive for mobilizing deposits, through creating a dependency syndrome vis-à-vis donor funding. RCCs should receive funding at a rate not exceeding the rate at which PBC lends to RCCs.

11.9 Financial intermediation at the local level improves once complementarity among the interlinked elements of the local financial infrastructure can be strengthened. In the Chinese context, this calls for the various civil society organizations and actors to collaborate with RCCs in providing credit in the rural areas, with RCCs remaining the main stakeholders in the rural financial infrastructure. Efforts should be made to develop the comparative advantages of institutions at the local level. The organizations need to be strengthened to develop complementarities across organizations. However, the present financial situation of the RCCs does not allow them to invest in enhancing outreach capability and capacity building. It would be necessary for the RCCs to be provided with grant funding for enhancing outreach capability and capacity building.

D. Product Development

11.10 There exists a clear mismatch between the current range of products offered by RCCs, the credit instruments designed in IFAD projects, and the products required by the resource-poor households. RCC credit instruments have four basic features. They are (i) short term in nature, repayable within 1 year; (ii) repayment to be in one instalment at the end of the repayment period; (iii) interest rates are stipulated by PBC; and (iv) they rely on the credit history and collateral of the applicants. The IFAD project loans are mostly for agriculture and livestock development. Client selection and provision of technical services rest with the PMO, and credit delivery with the RCC. No collateral is insisted upon and the credit history normally is not reviewed. Such shared responsibility has been responsible for the RCCs insisting on shifting credit risk to PMOs. In contrast, most resource-poor households require small loans initially for consumption. Over time, their credit absorption capacity should increase and they will be able to develop the requisite credit history to qualify for larger loans.

11.11 It is necessary that RCCs are permitted to design products that meet the requirements of resource-poor households and yet at the same time yield the spread required by RCCs to cover cost of funds, transaction costs, credit risk and provide a reasonable profit. The essential features of the micro-finance instruments to be built into the IFAD project framework are:

- (i) *Flexibility in activities for providing loan.* Currently IFAD project design stipulates the activities for which funding is available. There needs to be complete flexibility concerning activities for which a loan can be made available. Households should be able to borrow for a broad range of activities, including consumption.
- (ii) *A ladder approach to develop credit history.* RCCs need to focus on developing a credit history for clients by initially providing small loans, and then allow them to graduate to obtain larger loan amounts.
- (iii) *Pro-poor lending policies.* Lending policies such as requirements for collateral and guarantee requirement need to be modified, adopting instead joint liability concepts, and credit-history-based lending. RCCs need to move away from “bullet” repayment practices that lump all payments at the end on the loan period, to more structured weekly or monthly repayment plans.
- (iv) *Incentive for prompt repayment.* The clients need to understand the importance of prompt repayment and the advantages linked to it. The client who has promptly repaid the loan should be able to easily access a larger loan amount. Persons with a better credit history could even be given a discounted interest rate.
- (v) *Flexibility in lending rates.* RCCs need to be permitted to adjust the lending rates to reflect their perception of credit risk, transaction cost and cost of funds.

E. Improve Outreach

11.12 Access to financial services is vital to the resource-poor household. RCCs need to improve outreach capability by developing village-level mechanisms to reduce transaction costs for the borrowers. The capability of RCCs to appoint village agents would have to be strengthened by providing grant funding during the initial years.

F. RCC-PMO Collaboration

11.13 The IFAD projects have been trying to foster collaboration between PMOs and RCCs. The PMO is responsible for tasks related to identification of clients and selection of activities, while the RCCs are responsible for credit delivery and recovery. However, the project design gives the RCCs “imaginary” powers to appraise the loan and accept or reject them. Two factors contribute to the inability of RCCs to resist pressures from PMOs and local government. First, the RCCs have limited technical competence to appraise agriculture development activities. Second, the funds are provided by the PMO and the RCC is obliged to toe the PMO’s line.

11.14 The most successful credit projects have been those handled directly by one agency without interference from local government. Such an agency needs to be a financial institution or an institution with a clear vision of establishing itself as a sustainable financial institution. Unless the funding is routed to the RCCs through their supervisory bodies directly from MOF, it is unlikely that RCCs would be able to act independently and shoulder credit risk.

11.15 Any meaningful financial-service-based rural development effort to reach the resource poor in China requires a two-pronged approach in IFAD projects. First, the funding track for RCCs needs to be completely delineated, and complete independence from local government structures maintained. Grant funding will have to be provided to RCCs for (i) capacity building; (ii) incorporating the micro-finance strategies evolving in China into their regular lending strategies; and (iii) to increase outreach by employing village agents. RCCs will have to be given complete independence to select and fund clients using newly developed micro-finance strategies. RCCs will have to be encouraged to use funds from their own savings mobilization by providing incentives for micro-finance lending rather than providing funds for lending operations. In the case of RCCs facing liquidity constraints, their access to PBC re-finance window could be enhanced.

11.16 Second, the size of the credit component in IFAD projects needs to be substantially reduced. The capacity of PMOs to provide medium- and long-term loans will have to be enhanced. This recommendation is made because the current financial situation of many RCCs may not permit their

active involvement in medium- and long-term credit. Systems need to be built to ensure that the PMO does not offer unhealthy competition to RCCs. The rate of interest on loans should be equal to the rate of interest charged by RCCs on an annualized basis. The PMO would be permitted to provide only one loan to a client to ensure that the client, after successfully repaying the loan, then moves to RCCs to obtain subsequent loans. Record keeping, loan account monitoring and maintenance of revolving funds will have to be substantially improved to improve transparency.

G. Technical Backstopping

11.17 Provision of technical services to households continues to be the core competence of various line departments under the umbrella of PMOs set up under IFAD projects. WFP collaboration in provision of training has helped in efficient credit utilization. This arrangement needs to be strengthened with grant funding for PMOs to undertake these activities.

H. Reaching Those not Reached by Financial Institutions

11.18 For poverty alleviation lending, complete dependence on formal financial institutions such as RCCs is a double-edged sword. On the one hand, it improves efficiency, and institutional sustainability is a distinct possibility. On the other, it may exclude a set of people who do not possess the necessary credit history and demonstrated ability to effectively use credit. Even with well-intentioned micro-finance product design and delivery systems, it would take a long time to develop RCCs as poverty-focused institutions. In addition, there exist areas without local financial infrastructure. In such circumstances, a different strategy needs to be adopted. A PMO-led strategy for reaching such areas and households remains a valid proposition.

11.19 A Self-Help Group (SHG) strategy, with groups as the elements of local financial infrastructure, is a better option compared to the direct-lending strategy adopted by previous IFAD projects. Although groups engaged in savings and credit activities have a long informal history, their formal history is generally considered to have started 150 years ago in Germany. These efforts spread to other parts of Europe and Canada. The first groups were formed on the basis of full solidarity of the members among themselves. They followed the rules of the cooperative movement. The groups started specializing in either savings-and-credit or guarantees. The former led to formation of banks (Volksbanken and Raiffeisen Kassen) and the latter led to formation of mutual-guarantee associations. A different initiative to create financial services groups came from Asia after the Second World War. Constituted by banks to group together small borrowers, as in the German example, the Asian groups also intended to collect savings and distribute credit amongst themselves.

11.20 Financial groups are now well established aspects of the financial infrastructure in many developing countries. In most parts of Asia, SHGs have become channels of micro-lending operations through systematic linkages with financial institutions. In Africa, groups have been used in monetization actions, and also as a channel for micro-lending operations. Comparisons between the attitudes of borrowers involved in group lending and formal lending in the case of Madagascar showed that borrowers felt more compelled to repay loans borrowed through a group mechanism than loans extended by formal lenders.

11.21 The groups perform the core function of risk absorption that is essential for the development of financial infrastructure. To perform this function more efficiently, they need to build equity with member contributions and, when possible, with donor money. The main issue is the need for institutions to take the initiative to create groups.

11.22 PMOs, with their network extending to the village level, should be, with requisite capacity building, best suited to take over the responsibility of group mobilization. Group mobilization, capacity building, provision of a small revolving fund and subsequent linkage with the RCCs need to be the essential features of SHG mobilization in China. Collaboration with WFP can be effectively used to help in building capacity of the groups, improve uptake of credit by the resource-poor households and develop a set of new clientele for RCCs, with requisite credit history.

