



Special Topic II

Reform and Development of the Rural Financial System

Reforming and developing the rural financial system is an important part in the efforts to build a socialist new countryside, and is a long-term task in the endeavor to promote balanced development of rural and urban China. For seven years in a row, the CPC Central Committee has stressed the importance of rural financial reform in the first document that it issued in the year since 2004. The 3rd National Financial Work Conference held in 2007 has made the decisions to establish and improve a multi-tiered, extensive and sustainable rural financial system tailored to the need of the development of agriculture, rural areas and farmers. In 2008, the 3rd Plenary Session of the 17th CPC Central Committee called for further efforts to build a modern rural financial system to support reform and development in rural China under the new circumstances.

An Update of the Rural Financial Reform and Rural Financial Services

In recent years, under the leadership of the State Council, PBC, CBRC and other government agencies have worked hard to promote financial reform and improve financial services in rural areas. As a result, progress has been made in restructuring and reforming financial institutions, innovation of financial institutions and products, financial infrastructure building and policy support.

A Multi-tiered, Extensive and Sustainable Rural Financial System Is in Place

The county-level financial system composed of banking financial institutions including rural cooperative financial institutions (i.e. rural credit cooperatives, rural cooperative banks, and rural commercial banks), ABC, ADBC, PSBC, and village and township banks, insurance companies, securities companies, futures companies, loan companies, rural mutual credit cooperatives works fairly well to satisfy the diversified demands of farmers and rural membership cooperative businesses for financial services. In addition, pilot micro-credit company projects are advancing.

The extensive outlets of financial institutions have provided large amount of lending to rural lenders. At end-2009, the agriculture-related loan outstanding grew 32.3 percent y-o-y to RMB 9.14 trillion yuan and accounted for 21.5 percent in total loan outstanding. Rural cooperative financial institutions provided credit services to around 82.42 million rural households, or 33.5 percent of total rural households.

While expanding lending to rural areas, various types of financial institutions have kept their agriculture-related NPL ratio relatively low and developed their business in a sustainable manner. At end-2009, average agriculture-related NPL ratio of all financial institutions declined by 2.23 percentage points y-o-y to 5.94 percent. Specifically, this ratio of state-owned commercial banks, ADBC, and joint-stock commercial banks was 2.75 per-

cent, 3.72 percent, and 1.44 percent respectively; this ratio of rural cooperative financial institutions decreased by 4.32 percentage points y-o-y to 12.6 percent.

Agricultural insurance has developed further. Its business volume has been expanding. In 2009, total agricultural premium income grew 21 percent y-o-y to RMB 13.39 billion yuan; risk protection amounted to RMB 381.2 billion yuan, an increase of 59 percent. With more than 160 products, agricultural insurance covers planting, animal farming, rural housing, farmer household property, agricultural equipment, pension, and new cooperative medical care. The pilot geographical coverage has expanded continuously. The rural insurance network includes the two national insurance companies of PICC and China United Property Insurance Co., Ltd. and the three regional companies specialized in agricultural insurance of Sunlight Mutual Insurance Co., Ltd., Anhua Insurance Company and Shanghai Anxin Agricultural Insurance Co., Ltd. and covers every province (autonomous region and municipality) on the mainland. Agricultural insurance service has improved with clearly defined timeframe of claim settlement and simplified claim procedures.

Reform of Rural Financial Institutions Progressed Smoothly

Reform of RCCs made important progress. According to the overall arrangement of the State Council on deepening RCC reform and the general principle of having the local government in charge of the reform process with central government support, and the spe-

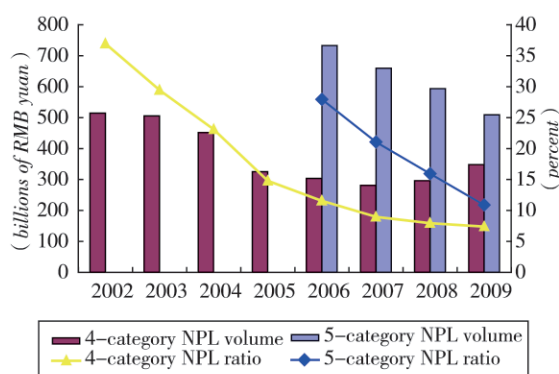
cific requirements of defining property relationship, strengthening discipline, and enhancing service functions, the RCC reform started in Zhejiang and other 7 provinces in August 2003, expanded to 29 provinces (autonomous regions and municipalities) a year later, and further expanded to the entire country except Tibet Autonomous Region. At end-2009, 2 054 institutions with legal person status at the county level, 43 rural commercial banks and 196 rural cooperative banks have been established nationwide.

Reform has helped enhance the lending ability of rural cooperative financial institutions and their support to agricultural and rural development. Owner's equity increased from negative RMB 27.418 billion yuan at end-2002 to RMB 430.5 billion yuan at end-2009, meanwhile their loan outstanding grew by 251 percent from RMB 1.4 trillion yuan to RMB 4.7 trillion yuan, and deposit outstanding by 237 percent from RMB 2 trillion yuan to RMB 6.97 trillion yuan. At end-2009, agricultural loan outstanding of these institutions posted RMB 2.1 trillion yuan, accounting for 44 percent of their loan outstanding (as against 40 percent at end-2002) and for 95 percent of agricultural lending of all financial institutions (as against 81 percent at end-2002).

At the same time, their NPL ratio kept declining with NPL volume dwindling. Based on four-category loan classification, the volume and ratio of NPL decreased from RMB 514.714 billion yuan and 36.93 percent respectively at end-2002 to RMB 349 billion yuan and 7.4 percent at end-2009; and based

on five-category loan classification, the volume and ratio of NPL decreased from RMB 732.729 billion yuan and 27.93 percent respectively at end-2006 to RMB 507.7 billion yuan and 10.89 percent at end-2009 (Figure A2.1).

Figure A2.1 NPL Ratio and Volume of Rural Cooperative Financial Institutions



Source: CBRC.

Progress was made in the reform of ABC. Over the years, ABC has been an important player in providing financial services to agriculture, rural areas and farmers. Since 2006, in accordance with the principle decided by the State Council of reforming ABC as a whole based on market operations, aiming to get listed at a proper timing and serving the agriculture, rural areas and farmers, the relevant authorities have advanced the shareholding reform prudently and steadily. In January 2009, ABC became a shareholding company. Since then, governance structure has been es-

tablished, risk control system improved, internal reform and mechanism transformation continued, and its business grown continuously. ABC has actively explored an effective approach to combine serving rural and agricultural customers and developing market-based operations, continued to increase agriculture-related lending, improve and strengthen agriculture-related products by focusing on service innovation and pilot multi-divisional reform. Since March 2008, ABC started pilot Agriculture-related Multidivisional Reform in the branches and sub-branches in Sichuan, Chongqing, Guangxi, Gansu and other three provinces (autonomous regions and municipalities) to establish a set of mechanisms and business models that are different from urban businesses, to delegate decision making powers on financial services to agriculture, rural areas and farmers, and to make the county-level sub-branches more active and competitive. These measures have enhanced the services provided by ABC to support agricultural and rural development and farmers.

Reform of ADBC continued. Since its establishment in 1994, the business of ADBC evolved in three stages. Between its establishment in 1994 and March 1998, it mainly conducted purchase and reserve of grain, cotton and edible oil and lending services, provided ear-marked loans for agricultural development, poverty reduction, and cotton and grain processing enterprises; between March 1998 and July 2004, it specialized in lending for the purchase of grain, cotton and edible oil; since the 57th State Council Regular Meeting in July 2004, ADBC's business expanded gradually,

conducting commercial businesses including offering loans to dragonhead enterprises in agricultural industry and agricultural product processing industry, to small enterprises, to agricultural technology, to agricultural infrastructure building and to comprehensive development of the agricultural sector. ADBC made concrete efforts to protect farmers' interests in issuing no IOUs to farmers in purchasing grain, cotton and edible oil, to support the improvement of agricultural production environment and enhance its own ability to serve the farmers. At present, according to the "one bank one policy" principle decided by the 2007 National Financial Work Conference, PBC is working with relevant authorities on the reform of ADBC to prepare for deliberation of the draft reform plan.

Reform of PSBC deepened. Since 2003, the postal savings system became independent in using their deposit fund, and channeled the fund to rural areas by providing financial support to RCC association and other local financial institutions. Since 2006, the postal savings system took part in consortium loans and allocated large amount of fund to key projects in developing agriculture, rural areas and supporting farmers, rural infrastructure development and comprehensive development. In the beginning of 2007, PSBC was established, and thus has started the search for an effective approach to provide market-based services to rural customers. With the nationwide introduction of small loans pledged on deposit certificate, PSBC conducted micro-credit pilots in seven provinces including Henan by providing co-guarantee loans and guarantee loans to

farmers and businesses, and introduced these businesses to the rest of the country at the beginning of 2008.

New Types of Rural Financial Institutions Have Been Created

Since December 2006, in order to build a relatively competitive rural financial system, CBRC granted green light to the creation of three types of new rural financial institutions based on the principle of low threshold and strict supervision, i. e. village and township banks, loan companies, and rural mutual credit cooperatives. The pilot started in early 2007 in six provinces (and autonomous regions) including Sichuan, Qinghai, Gansu, Inner Mongolia, Jilin and Hubei, and was expanded to all the 31 provinces (autonomous regions and municipalities) in October 2007. At end-2009, a total of 172 new-type rural financial institutions were established and 58 more were in the pipeline. These newly opened financial institutions had a total equity of RMB 7 billion yuan, and took a total of RMB 26.9 billion yuan in deposit; their loan outstanding reached RMB 18.1 billion yuan. They played an important role in covering rural areas with financial institutions outlets and increasing the competitiveness of the rural market.

Rural Financial Product Innovation Has Been Fruitful

In August 2003, with the pilot RCCs reform underway, the piloting RCCs were given a lending rate ceiling of two times of the benchmark lending rate. In October 2004, the ceil-

ing was further increased to 2.3 times of the benchmark rate. The gradual lifting of interest rate ceiling has encouraged rural financial institutions to price their product so that returns can cover the risks, thus become financially viable, and created the necessary environment for rural product innovation.

Based on the RCCs' experience in offering rural household micro-credit loans and co-guarantee loans, PBC and CBRC jointly released in October 2008 *Opinions on Speeding up Innovation in Rural Financial Products and Service Delivery* and decided to start pilot innovation in selected counties and cities, major regions for grain production or with great county-level economic development, in six central China provinces and the three provinces in northeast China. The content of pilot-ing project included introducing micro-credit loans and co-guarantee loans to farmers to increase loan coverage in rural households, loan guarantee innovation to increase the range of eligible collaterals, exploration in financial instruments based on orders and insurance policies to allocate rural credit resources more effectively and diversify the rural credit risks, exploration of issuing collective bonds by agriculture-related SMEs on the inter-bank market to offer more financing channels to these enterprises, improvement in the delivery of rural financial services with the introduction of electronic network, information technology and standards. The pilot project helped increase credit input of financial institutions into the agricultural sector, rural areas, and farmer households, encourage them to improve mechanism for rural financial services to satisfy the

diversified needs for financial services in rural China.

Rural Financial Infrastructure Has Been Improving

More measures were taken to build a rural credit system. In recent years, PBC actively promoted the building of a nationwide credit information system. A nationwide enterprise and individual credit information data system has been established, and the credit information system now covers rural China in addition to urban areas. Meanwhile, the building of a rural credit system was underway based on credit households, credit villages and credit townships. PBC collected and assessed in 2007 rural household credit information in selected regions on a pilot basis and released in 2009 *Guidelines on Promoting Rural Credit System Building*. Local governments, commercial banks and relevant government agencies worked together in this endeavor. At end-2009, out of the 2 682 counties in the country, 2 372 counties built their own household credit filing system, opened credit files for 110 million rural households, and assessed credit of 73.18 million of these households. A total of 66.92 million households who established credit files received RMB 2.2 trillion yuan of loans, 958.2 billion of which was outstanding.

Building of a rural payment system was strengthened. In recent years, PBC took various measures to improve rural payment system in order to improve rural financial services. With the designing of flexible and multiple access methods, the accessing of payment

system and CIES by rural financial institutions including RCCs and rural commercial banks was made easy and fund transfer among rural financial institutions became smooth. At end-2009, a total of 20 587 RCCs connected their outlets with the PBC payment system. Furthermore, PBC provided guidance on RCCs' efforts of building an electronic network, encouraged the RCCs to move faster to connect their network with the RCC associations, gradually established an internal payment and settlement network and improved channels of payment and settlement.

The service of bankcard tailored for rural migrant workers was expanded. In December 2005, Guizhou conducted a pilot in bankcard services tailored for rural migrant workers to enable rural migrant workers to deposit cash in the bankcard in the cities they work and withdraw the cash in the RCC outlets in their hometowns at a favorable rate. At end-2009, about 52 000 rural cooperative financial institution outlets in 23 provinces (autonomous regions and municipalities) including Guizhou and Hunan, and 15 000 outlets of PSBC in every province, autonomous region and municipality provided tailored bankcard services to migrant rural workers. In 2009, transaction volume of tailored rural migrant worker bankcards grew 177 percent y-o-y to RMB 22.102 billion yuan. These tailored bankcard services satisfied the need of migrant workers for safe and quick cash remittance and deposit and helped them avoid the trouble of cashing large amount of cash back home.

A System of Rural Financial Support Policies Has Been Adopted

Monetary policy instruments were used flexibly to promote reform and development of financial institutions and guide them to support agriculture, rural areas and farmers. First, differentiated reserve requirement ratios were adopted. At present, the reserve requirement ratio of most RCCs is 11 percent, 5.5 percentage points lower than that of the large commercial banks; those RCCs (and rural cooperative banks) with small asset volume and a high proportion of agricultural lending in the loan portfolio follow a reserve requirement ratio of 10 percent, 6.5 percentage points lower than the large commercial banks; and village and township banks follow the same reserve requirement ratio as the local RCCs. Second, central bank lending earmarked for supporting agriculture and rural areas was increased. Starting from 1999, PBC increased central bank lending to increase the funds available for financial institution to provide lending to agricultural sector and farmers. At end-2009, the quota of agriculture-supporting central bank lending reached RMB 149.7 billion yuan, including 139.3 billion for the west and grain producing regions. PBC provided RMB 1.3 trillion yuan in central bank lending on a cumulative basis, over 90 percent of which were used for lending to farmer households. Third, special bills and designated lending was issued to support the reform of RCCs. Such measures have been taken by PBC since 2003. At end-2009, PBC issued a total of RMB 169.5 billion yuan of special

bills to RCCs in 2 407 counties, redeemed RMB 164.1 billion yuan of such bills from RCCs in 2 340 counties, and provided RMB 2.1 billion yuan of designated lending.

Various tax preferential policies were adopted. Between 2003 and 2009, MOF provided tax preferential policies for RCCs, i. e. business tax rate of 3% for all RCCs, income tax exemption for RCCs in the middle and western regions, and reducing income tax for those in the eastern regions by half. As a result, a total of RMB 76 billion yuan of business tax and income tax was exempted, and RMB 8.8 billion yuan of subsidies were delivered to cover interest payments. In 2009, MOF released the *Provisional Administrative Measures on Fiscal Subsidy to New-Type Rural Financial Institutions* to provide fiscal subsidies to village and township banks, loan companies and rural mutual credit cooperatives nationwide. Meanwhile, MOF released *Provisional Administrative Measures on Appropriations for Rewarding the Increment of Agriculture-Related Lending by County-Level Financial Institutions* to provide incentives to financial institutions in counties in Heilongjiang, Henan, Hunan, Yunnan and Xinjiang for increasing agriculture-related lending, and expanded the program to Inner Mongolia, Jiangsu and Anhui at end-2009.

Other favorable policies are being considered. Those commercial banks that have opened new outlets in rural areas will receive favorable treatment in terms of urban outlets and urban business access. The supervision fee of rural mutual credit cooperatives will be

waived, and the supervision fee will be cut by half for other rural institutions. Third, favorable monetary policy and supervisory policy are being considered for financial institutions with county-level legal person status with local lending reaching a certain percentage in their new loans.

An Analysis of the Problems in the Current Rural Financial System

As a result of many years of reform and development, rural financial system has been improved. Yet, as rural economy and finance are of high risk and offer low returns and as the Chinese economy is in transition, rural financial system remains the weak point in the financial system and has various drawbacks.

Rural Financial Services cannot Satisfy the Diversified Demand

For many years, due to lack of diversity in financial products and in the delivery of financial services, rural financial institutions have failed to meet the diversified rural demand for financial services. First, financial institutions offer only basic services in rural areas such as deposit and lending to rural households, and have no products or services in the fields of agricultural technology, developments of agricultural products, irrigation facility, and direct sales of agricultural products. Second, underdeveloped agricultural insurance featured by small size, limited coverage and low compensation standards is not effective in diversifying

and reducing agricultural risks and cannot meet the demand of the developing agricultural sector. Third, fluctuation in the price of agricultural products and the ensuing market risks are the major risks in the production and sale of agricultural products and need to be managed with effective futures products. But with limited variety in products and limited scale, the futures market cannot play an effective role in hedging risks.

Corporate Governance of Some Rural Financial Institutions Needs to Be Further Improved with Clear Definition of Rights and Obligations

The problems in corporate governance structure and definition of rights and obligations are pronounced in some rural financial institutions. First, the rights and obligations relationship between provincial RCCs association, their local offices and county-level association is not clearly defined. Some provincial associations and their local offices have become the administrative superiors of the county-level RCC associations with legal personal status. The autonomy of county-level associations as a legal person is limited and their shareholder meetings and supervisory board exist only in name. Second, the share of some RCCs is scattered, and qualification shares take up a large share in total shares. These qualification shares are principal guaranteed and receive dividend and can be withdrawn. Their holders are looking for easy access to lending and better interest rates and have low incentives in exercising their rights. Third, ADB has to further explore its definition on the market and an

effective business model and its governance needs improvement too.

NPL Ratio of Rural Financial Institutions Is Relatively High

In recent years, despite declines in NPL ratio of the rural financial institutions, the ratio in some financial institutions, RCCs in particular, remains high. There are various reasons. First of all, there are more systemic risks in the financial business in rural areas than that in urban business operation. Second, there are flaws in business operation, management mechanism and governance structure. Third, development of agricultural insurance, secured loan and guarantee loan has been slow. Fourth, the process of absorbing rural debt loss has been slow.

Supporting Policies Need to Be Improved

Development of rural finance needs policy support. However, the financial eco-environment in rural area is under-developed. First of all, there is not sufficient legislation to support rural financial innovation. After the promulgation of *Real Rights Law*, the relevant implementation rules were not released promptly. The eligibility of forest rights and account receivable as pledges and its enforcement have not been established. Second, the support of fiscal and taxation measures does not match the development need of rural finance and external incentive and a long-term risk compensation mechanism are not available to encourage development of agricultural and rural financial business. Third, land reform and reform of investment environment, credit envi-

ronment, and public service infrastructure related to rural financial development have not been completed and hindered the process of rural financial reform to a certain extent.

Further Steps in Rural Financial Reform

The *CPC Central Committee's Decision on Several Major Issues in Promoting Rural Reform and Development* adopted at the 3rd Plenary Session of 17th CPC Central Committee provided guidance in the establishment of a rural financial system. Going forward, the focus of improving rural financial services will be on institutional innovation, easier access to rural market, the development of a fully capitalized rural financial system combining commercial, cooperative and policy finance that operates safely and provides various functions and services, intensifying policy support for rural finance, and expanding financing sources to channel more credit fund and private capital into rural development.

Promote Further Restructuring of Rural Financial Institutions

Deepen RCCs reform. It is necessary to strengthen market discipline and improve market exit arrangements. Based on the risk profiles of RCCs, corrective measures will be imposed with gradually increasing intensity on the RCCs until their market exit. Soundly operating financial institutions will be allowed to restructure, merge or acquire those insolvent

RCCs which did not conduct prudential operation. RCCs will be encouraged to provide retail financial services in counties, townships and villages. In light of the local circumstances and based on category guidance, the property rights system, organizational structure and internal control system of RCCs will be improved. The status of county (and city) RCCs associations as legal persons will be safeguarded, and the provincial associations will provide industry management, guidance, coordination and service for RCCs. Efforts will be made to prevent administrative measures being taken for the purpose of restructuring, merger and acquisition or alliance of RCCs to pursue RCC's scale expansion or legal person status at a higher level.

Continue to promote ABC's reform.

ABC's reform will be continued in accordance with the program approved by the State Council and with reference to the practices of other large state-owned banks, in terms of corporate governance, transformation of operation mechanism, strengthening internal control and risk management mechanism. The various reform measures will be implemented to realize the reform goals. ABC will sum up and assess the pilot program of multi-divisional arrangement for rural financial services, promote management regime reform, establish institutional arrangement and organization structures that are supportive of rural business, improve the multi-divisional structure for rural business and the financial services for agriculture, rural areas and farmers. Building on progress in the above-mentioned fields, the introduction of strategic investors and IPO will proceed to en-

hance ABC's market competitiveness.

Continue the research on the reform of ADBC. PBC will work together with other relevant agencies to promote further internal reform of ADBC, including improvement of credit risk management system and internal control mechanism, and building of information system, to prepare for comprehensive reform.

Improve the function of PSBC in providing rural financial services. The traditional role of PSBC in taking rural deposit, providing rural remittance, payment and settlement services will be enhanced so that PSBC can channel rural deposits including money sent home by migrant rural workers into rural and agricultural development. The extensive outlet network of PSBC shall be tapped to establish a retail business operation system that can satisfy the demand for financial services in rural areas and in the agricultural sector.

Improve the Rural Financial Market System and Enhance Innovation in Rural Financial Products

Measures will be taken to further improve the credit, insurance, futures markets in rural areas, and establish a rural financial market system with full functions and coordination and cooperation. The financial product innovation will be enhanced. In addition, efforts will be made to promote development of order-based farming, and encourage rural credit product innovation related to order-based farming, especially financial products and services to support agricultural technology, produce and irri-

gation facility development. Commercial insurance companies will be encouraged to explore rural market, and encourage insurance based on orders. A banking-insurance cooperation mechanism will be explored to combine rural credit with insurance. The agricultural product futures market will be developed through various measures including introducing new products, improving product diversity, introducing futures and options products at a proper time, establishing pilot futures investment fund, studying the QFII arrangements for futures market, and encouraging companies involved with agricultural products to hedge in the futures market.

Continue the Institutional Building of the Insurance Deposit System and Allow Easier Access to the Rural Financial Market

The deposit insurance system, as a fundamental institutional arrangement in the banking sector in the market economy, once introduced, will help enhance the resilience of rural small and medium-sized financial institutions, solve the problem of risk resolution of small and medium sized deposit-taking financial institutions and make it possible to close failed financial institutions, prevent the loss of depositors' confidence and run on banks triggered by failure of rural financial institutions. The system is expected to play an important role in promoting reform and restructuring of small and medium-sized rural financial institutions, and improve the system of rural financial institutions. Therefore, an early introduction of the system at an opportune moment is necessary.

While establishment of the deposit insurance system should be accelerated and the market exit mechanism should be improved, it is necessary to relax the rural financial market access policy. In the principle of clearly defined property relationship and multiple forms of organizations, development of new-type rural financial institutions such as micro-credit organizations, village and township banks, loan companies, rural mutual credit cooperatives and community small and medium-sized banks providing services in rural areas should be advanced. The sound development of micro-credit companies will be promoted, informal finance will be regulated, and conditions will be created to guide informal finance to become an important player in the rural financial market.

Improve Supportive Policies of Rural Finance

A system of well-coordinated policies that provides effective incentive and has controllable risks will be established to support development of rural finance. First of all, fiscal policies will be used, including fiscal subsidy, guarantee or tax exemption, to encourage fi-

nancial institutions to increase credit input to agriculture, rural areas and farmers. Second, monetary policy instruments such as required reserve ratio, agriculture-supporting central bank lending and interest rates will continue to play a role in promoting rural economic development. Third, supervision over rural financial institutions will be improved in accordance with the characteristics of rural institutions and different types of regulatory policy will be applied to different types of institutions. Fourth, measures will be taken to encourage the establishment of share-holding guarantee funds or guaranty companies based on modern enterprise system funded by local governments with farmers and rural enterprises holding shares where conditions are ready and encourage the development of various types of guarantee institutions. Fifth, the range of eligible collaterals will be expanded to include goods in inventory, account receivable, and rights can serve as pledges. Explorations can be made to use land as collaterals. Sixth, local governments can play a role in supporting the creation of a good rural financial eco-environment and in maintaining financial stability.