



Report on
Best Practices for Sustainable Models
of Pro-Poor Rural Financial Services
in **CHINA**



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Best Practices for Sustainable Models of
Pro-Poor Rural Financial Services in CHINA

Enjiang Cheng and Dan Wang

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Foreword

Promoting pro-poor growth is a pattern of growth that is inclusive and enhances the ability of impoverished people to participate, benefit in, and contribute to the growth process. This is a critical factor for developing countries to achieve a sustainable way out of poverty and to enable achievement of the Sustainable Development Goals.

The causes of poverty are complex and multi-dimensional. They involve, among other things, climate, gender, markets, access to finance and public policy. Likewise, the poor are quite diverse in both the problems they face and the possible solutions to these problems. Poverty remains a predominantly rural problem with a majority of the poor in developing countries living in rural areas. It is estimated that 76 percent of the developing world's poor live in rural areas whereas only about 58 percent of the overall global population lives in rural areas. Because of the complexity of rural poverty, each country needs to evolve its own strategy for addressing the concerns of rural poor that is in tune with its socioeconomic ethos.

APRACA has been in the forefront to lead access to finance in the rural areas through its member institutions in the Asia-Pacific region by providing technical assistance in capacity building, research and knowledge management. We are fortunate enough to receive generous funding from International Fund for Agricultural Development (IFAD), the global leader in development finance for documenting the pro-poor rural finance best practices (RuFBEP project). The knowledge gathered will help APRACA in disseminating the information that promotes innovations, productivity, inclusive growth, self-reliance, and welfare of the rural poor in the region and benefit the member institutions in 21 countries across the region. We are confident that documenting the best practices on sustainable practices of pro-poor financial services in the countries like China, India, Indonesia, Philippines, and Thailand will be extremely useful to the countries in the Asia-Pacific region to draw lessons in evolving suitable strategies for the benefit of their people and will add value to global knowledge resources.

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Enjiang Cheng
Dan Wang

Abbreviations

ABC	Agricultural Bank of China
ADBC	Agricultural Development Bank of China
CBRC	China Banking Regulatory Commission
CFPA	China Foundation for Poverty Alleviation
CFPA MF	CFPA Microfinance Pty. Ltd.
CRCB	Chongqing Rural Commercial Bank
FI	Financial Institutions
LDCs	Less Developed Countries
LGOP	Leading Group Office of Poverty Reduction (State Council)
MCC	Microcredit company
MFI	Microfinance institution
MoF	Ministry of Finance
MSEs	Micro and Small Enterprises
mn	million
NGO	Non Government Organization
NPL	Non-Performing Loan
PBOC	People's Bank of China
PSBC	Postal Savings Bank of China
RCC	Rural credit cooperative
RCCU	Rural credit cooperative union
RCOB	Rural cooperative bank
RCB	Rural Commercial bank
RFC	Rural Fund cooperatives
RFI	Rural Financial institution
RFM	Rural financial market
RMB	Renminbi yuan
SMEs	Small and Medium Enterprises
SOCB	State-owned commercial bank
SOE	State-owned enterprises
VCFs	Village Community Funds
VTB	Village and Township Bank

US\$ 1 = ¥ 6.4 RMB (yuan) as on 27 August 2015

Executive Summary

Continuous income growth and urbanization in the last decade have resulted in dramatic changes in the demand for loans and other financial products and services in rural China. On the whole, the demand for loans for small-scale mixed farm production has been on the decline whereas the demand for loans for larger-scale farm production and family consumption has risen. The development of farmers' cooperatives and agricultural value chains they are involved with has raised the demand for the storage, processing, and transportation of farm goods by agricultural cooperatives and farmers' cooperatives. The demand for off-farm activities undertaken by migrant workers in China's small cities and large townships has also been on the rise.

As a developing economy under the process of economic transformation, China's rural financial system is highly regulated and dominated by state-owned banks, mainly the rural credit cooperative (RCC) system, the Agricultural Bank of China (ABC), and Postal Savings Bank of China (PSBC). China's formal banking system has coped relatively well with the provision of savings, money transfers, and payment services to agriculture and to rural communities and households. Significant progress has been achieved by the regulated rural financial institutions (RFIs) in rural lending though more efforts are needed to outreach their loan services to small rural households, especially the poor ones, to farmers' cooperatives, and to agro-businesses for larger-scale farm production and marketing.

The Chinese government has used several policy instruments to promote rural finance and microfinance, including the provision of agricultural on-lending to the RCCs, tax concessions and subsidies extended to regulated RFIs for rural and micro-lending, and partial liberalization of the lending rate of interest for rural and micro-lending. The government also permitted the entry of new types of RFIs to strengthen competition in China's rural financial markets.

Obstacles to sustainable rural financial services for meeting the changing demand remain in China. Despite the great efforts made by the financial regulators and the progress achieved after the reforms in 2005 and 2006, China's RFIs remain slow in penetrating the rural financial markets (RFMs). Overall, the loanable funds have been channeled from rural to urban areas and from the poor western regions to the richer coastal regions by the formal financial system in China. On the whole, the financial markets in China are dual: large- and medium-size enterprises, especially state-owned enterprises (SOEs), have access to cheap credit from formal banks while the privately owned small and micro-enterprises and farmers either have very limited access to formal credit or have access to formal credit at a much higher cost. Many MSEs and small farmers are dependent on finance from informal sources to meet their demand.

Based on the inclusion criteria involving mass outreach to rural communities and households, operational sustainability, and innovations in financial products and services, we selected three best cases for rural and microfinance in China: the mobile phone product by Chongqing Rural Commercial Bank (CRCB), the case of CFPA Microfinance Pty. Ltd. (CFPA MF), which is a semi-formal RFI unregulated by CBRC, and the microfinance downscaling by city and rural commercial banks in China.

The mobile banking is a pilot undertaken by CRCB, one of the largest RCBs in China. The mobile phone product developed by CRCB has had a mass outreach to rural people, including migrant workers, and provided good impact on bank clients. CRCB itself has also benefited from the development of such a technological and product innovation, and the product is sustainable and replicable. By appropriate

pricing and marketing policies, rural low-income people can easily move to mobile phone-based services. The very successfully implemented case of introducing mobile services to low-income clients and its impact on the growth of the bank's clientele and profitability are relevant for many institutions in the region, which are at the moment considering similar mobile strategies to widen their clientele in a sustainable manner.

Unlike its peers in China, CFPA MF, as a semi-formal RFI, has enjoyed significant growth in its assets, loans, and geographic coverage. This has been driven by the organizational reforms, and improvement in its governance structure and promotion of new products and services. A key lesson behind the success of CFPA MF is its commercial operations while sticking to its key rural market. The successful large NGO MFI in the complicated and demanding environment of China is an interesting case, especially as the means of success are so closely related to the generally accepted standard management and financing practices, strongly supported by institutions such as APRACA and IFAD. Another important success factor of the CFPA MF case is the support provided by the government agencies and commercial banks in China. As an unregulated microfinance institution, CFPA has a semi-legal status to undertake microfinance operations in China and CFPA Microfinance has access to the credit bureau service of the PBC and to on-lending from the development and commercial banks in China. A well-managed MFI in China can access wholesale on-lending capital also from private markets (not only government banks). This should be seen as a key way to transfer liquidity from the banks to the micro-borrowers. This is of great interest to many APRACA countries. A key conclusion is that, in China and most other countries of the region, there is room in the rural market for these institutions, if they follow the "best practices" of microfinance management. Critically, if this is the case and the MFI's indicators show financial strength, the liquid commercial banks in Asia are happy to advance large wholesale loans to these institutions for on-lending, and in most cases on reasonable terms.

Microfinance downscaling by city and rural commercial banks in China provides a good case for the success factors behind the replication of the IPC micro-lending model in China. The IPC model is centered on evaluating the capacity and willingness of clients to repay loans. The procedure for assessing loan repayment capacity includes field visits by a credit officer to understand the client's production, marketing, and fund flows, and to prepare financial statements for the client to harden soft data. During the field visits, the loan officer collects information on the purposes of the loan and on the client's assets and liabilities, income, profit and loss, cash flows, and sources of funds for loan repayments, according to IPC procedures. As far as willingness to repay loans is concerned, the IPC model uses soft data, such as personal reputation and credit history, to make judgments. For instance, the banks collect non-financial information about the client, pertaining to honesty, family relations, and reputation, and cross-check the information. The key conclusions follow: (a) a key to success is the change in understanding of the overall nature of modern SME lending by middle-level managers and loan officers, (b) high-class capacity building is required to make this change happen, and (c) these two things are much more important than the provision of credit lines by the state or donors, as most city and rural commercial banks have adequate low-cost funds of their own.

At the national level, the project impact can be understood from the following two perspectives. *First*, the implementation of the project among the 12 PFIs strongly indicates that microloans to urban and semi-rural micro-entrepreneurs and small enterprises in China can be provided in a commercially sustainable way. In other words, commercial financial institutions, especially the local banks, can benefit in terms of profit, local market share, and a diversified loan portfolio by providing MSEs with microloans ranging from RMB 10,000 to RMB 500,000, without subsidies from the government. On the other hand, urban and semi-rural micro-entrepreneurs and small enterprises can benefit from the institutional microloans, which provide them with increased working capital and funds for business expansion. *Second*, the universally accepted lending methodologies, such as the micro-lending methodologies based on cash flow analysis that were introduced by IPC into China, can be applied elsewhere in the country, with certain modification. This shows the importance of international cooperation and mutual learning in China's banking and rural finance reforms.

The innovations in China's rural financial markets and services have been driven by several factors since the beginning of this century, chief among them a change in the demand for rural financial products and services following income growth and the process of urbanization, increased market competition for the provision of financial services in China's urban and rural areas, relaxation in rural financial regulations, and mainly the liberalization of lending rates of interest and technological progress in Internet and mobile phone use. We believe that many of these changes will continue to drive China's rural financial innovations.

It is recommended that the pilot on mobile banking undertaken by CRCB should be replicated by RCCs and other RFIs in other parts of China and in the region, especially for the institutions that serve remote rural communities and households. Replication of the pilot is expected to benefit rural communities and households as well as the relevant RFIs. The enlarged rural clientele through the use of mobile banking serves as an excellent base for expanding bank services from money transfers and deposits to more advanced operations, which in China could immediately include IT-solution-supported rural loans and village agent-/shop-based cash services in remote rural areas.

More support should be provided to NGO MFIs in China. Well-performing MFIs should be granted access to credit bureau services and to on-lending support from policy and commercial banks. So far, the cash flow-based lending practiced under microfinance downscaling has been undertaken mainly in China's eastern and central regions. The lending technologies should be replicated by those RCCs and city commercial banks in China's poor areas such as those of Qinghai, Ningxia, and Guizhou to support SMEs in off-farm activities. The downscaling to the SME sector by very liquid commercial banks is of major importance for many countries, including large ones such as the Philippines and Vietnam, particularly as the emphasis in successful SME lending in the case study is on modern lending technology and the related TA and capacity building, not on the provision of subsidized credit lines by state banks and donors.

More efforts should be given to promoting agricultural chain finance, which involves financing within the chain and from outside the value chain but fit to the nature of the value chain and actors involved. For financing outside the value chain, processing machines, inventory, and receivables, the important assets of agro-processing plants, should be accepted as collateral for loans, and purchase orders provided by the agro-processors or farmers could also be accepted as collateral for loans under certain conditions. For financing inside a value chain, first, RFIs can use value chains to reduce credit diversion by farmers so as to improve loan repayment rates. For example, a farmer's cooperative may purchase bulk farm input for its members with the bank loans so the loans will not be diverted for other uses. Second, RFIs could accept the guarantee and collaterals pledged by inter-linked enterprises for loans provided to individual farm households.

Competition is the most important driving force for the downscaling of rural financial services to MSEs and small farmers in China. More small-size bank permits for rural financial institutions should be issued to private capital and others for operation in rural counties and in China's western regions where formal rural financial services have been dominated by RCCs. Well-performing non-deposit-taking institutions such as MCCs and NGO MFIs that have provided substantial support to MSEs and to agriculture could be granted licenses for banking operations at the county level and below to enhance competition and to demonstrate the effects for others. Poorly performing formal RFIs should be pushed to exit the market through merger with stronger ones.

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CHAPTER 1

Introduction

1.1 Background

China's financial market is a highly regulated one. Under financial regulation, China's rural financial services, including rural deposit savings, money transfer, lending, and insurance services, are dominated by the regulated banks. Of the regulated banks, rural credit cooperatives (RCCs) have been the major providers of rural financial services, especially rural lending services in China, while the Postal Savings Bank of China has led rural remittance services.

China's regulated banks have done well in the provision of deposit and domestic money transfer services. RCCs in many areas of China have also achieved good outreach in their lending services under guidance from CBRC. NGO MFIs and the community-based village funds have been more active in China's poor areas, where it is difficult for the formal banks to penetrate.

Rural finance, as defined in this report, includes the financial markets, institutions, and policies related to rural and agricultural development in China, as well as microfinance policies, institutions, and services. In many cases, because of small landholding, rural finance overlaps with microfinance in China. Most loans for rural households are micro loans. Also, rural areas cover not only the villages but also the county seat and other large townships in a county. As well, many micro-entrepreneurs and small business owners operating in urban areas come from rural areas and still hold rural residence such that financial services to them can be regarded as part of rural finance. Thus, the boundary between urban and rural becomes blurry because of integrated urban and rural development today.

In a country like China where the financial system is heavily regulated and the formal financial institutions (FIs) have been dominated by state-owned FIs, the national government plays an important role in the formation of an efficient rural financial market and in the downscaling of financial services to farmers and other low-income communities. However, the measures undertaken by the national government in promoting rural and micro-enterprise financial services have varied from one country to another, and many of them have not been successful. There has also been disagreement as to whether the government should use market or administrative means, or use indirect or direct means, to outreach financial services to low-income farmers and small and micro-enterprises.

Some national governments have used more direct means to downscale financial services. The tools used include but are not limited to interest rate interventions, regulations on the minimum ratio of lending to agriculture or small-scale enterprises, licensing restrictions or requirements for banks and others to engage in rural areas as a mandatory condition of their license, subsidies to specific FIs for rural lending, or the creation of specialized agricultural development banks by the government for rural lending. The interest rate interventions include interest rate ceilings, subsidized rates of interest, and a low rediscount rate from the central bank for priority-sector lending. Government direct control on rural financial markets (RFMs) has given rise to a high proportion of non-performing loans of RFIs, an ever-increasing amount of subsidies, and rural financial market distortions. On the other hand, the means for a market approach or indirect control range from interest rate liberalization, the entry of more rural financial institutions (RFIs), including microfinance Institutions (MFIs), and promotion of market competition to improvement in the efficiency of RFIs. The government can also encourage financial downscaling by improving rural infrastructure, offering tax concessions, and using other indirect means.

From the early 1990s until 2005, the financial sustainability of China's RFIs and their outreach to rural households and other low-income groups were influenced mainly by the reforms of state-owned commercial banks (SOCBs) and pilots on NGO microfinance.

First, the reforms of SOCBs initiated in the mid-1990s reduced the access of rural households and micro- and small enterprises to institutional credit, which had contributed to the monopolistic operation of rural credit cooperatives in rural lending. Following the bank commercialization, SOCBs, particularly the Agricultural Bank of China (ABC), withdrew their services from rural areas by merging and closing down their rural branches and service points on a large scale. More funds were channeled from rural to urban areas and from small clients to large clients and large projects. Second, the NGO microfinance pilots initiated in the early and mid-1990s, though with limited progress and insignificant coverage, introduced the Grameen Bank microfinance model into China and this affected government agencies, the central bank, and financial regulators as well as the public. The pilots in NGO microfinance indicate that poor farmers in China are bankable and the major microfinance mechanisms, such as group guarantee, dynamic incentives, and female targeting, are applicable in China.

Against the background of bank commercialization and rising income gaps between rural and urban households, the Chinese government adopted several measures to increase the credit access of rural households from the supply side. First, the government put off the reforms of RCCs when SOCBs were commercialized. Second, with strict restrictions on the entry of new FIs, territorial restrictions were applied to individual RCCs: RCCs were not allowed to operate beyond a county, which reduced the flow of funds from rural to urban areas and the flow of funds among different counties through the RCC system. At the same time, RCCs were encouraged to pilot on non-collateral micro loans based on group or third-party guarantees so as to maintain reasonable rural household coverage in a county. Third, when the interest rate ceilings for commercial banks were lifted a number of times, the interest rate ceilings for RCC lending to rural households were maintained. RCCs could lend at a rate up to 5-5.5 times the base lending rate set by PBOC. Fourth, the government compensated RCCs for their rural lending programs by providing RCCs with implicit deposit insurance (no exit mechanism) and agricultural support for on-lending at a lower rate of interest from the PBOC. As a consequence, those RCCs with a high proportion of non-performing loans (NPLs) and negative equity were not allowed to go bankrupt and neither could the good-performing RCCs expand their operations.

Following the deterioration in RCC performance, the central government initiated a pilot in RCC reforms in Jiangsu Province in 2000 and replicated the reform across the country from 2003 to 2005. The major reform outcomes included a shift in RCC management from CBRC to the provincial governments and an increase in RCC equity capital. However, until 2005, little progress was achieved in terms of the corporate governance and operational model of RCCs. Owing to the problems with ownership structure, governance, and management, monopolistic operation did not generate monopolistic profit. Continuous subsidies from the central and local governments were still required.

Territorial restriction on RCCs did not stop the overall fund flow from rural to urban areas and to large clients and projects through the formal financial system, as a large amount of funds were channeled through SOCBs and the Postal Savings Bank.

Apparently, the pre-2005 reforms emphasized institutional reforms, especially institutional and management reforms of RCCs. Little effort was made to increase rural and microfinance outreach and improve services through increased market competition by allowing new RFIs and by liberalizing interest rates. There was a supply vacuum for urban microfinance. During the process of SOCB reforms, RCCs were made the principal supplier of rural credit services involuntarily due to the lending rate ceiling, territorial restrictions, and government subsidies. This approach to RCCs is contradictory to the market approach for financial liberalization; the monopolistic operation of RCCs and no exit mechanism led to low efficiency and poor service quality provided by RCCs.

By 2004-05, similar to other countries, RFIs in China confronted two major challenges: (a) higher credit risks derived from natural disasters and changing market conditions. In agriculture, risk is exogenous and unpredictable; (b) higher transaction costs associated with low population density and remoteness. An important transaction cost for RFIs is staffing cost as it is usually difficult for RFIs to recruit and retain qualified credit officers and management staff. Chinese farmers and micro-entrepreneurs had additional challenges as follows:

- A lack of physical collateral as China's farmland is owned by collectives and farm families are not allowed to use contracted farmland as collateral.
- Chinese farmers are also not allowed to use their farm house as collateral for loans, as farm houses are built on the collectively owned land, and the banks are not allowed to take over and sell the last house resided in by the household borrowers.
- Banks in urban areas usually do not lend to micro-entrepreneurs who do not have local residence; many micro-entrepreneurs operating in China's urban areas were migrant workers with rural residence.
- Agricultural insurance subsidized by the government is new and available only for a few cropping and animal products.

1.2 The Reforms to China's Rural Finance Since 2005-06

Since 2004 and 2005, the Chinese government and bank regulators, mainly PBOC and CBRC, have adopted concrete steps and launched several policy initiatives to support RFIs and improve rural financial services to meet the changing demand for the services. The policy initiatives so far have focused on strengthening market competition, providing subsidies and other policy support for rural lending, widening the scope for loan collateral, and improving the outreach of financial services to rural households and enterprises engaged in agricultural value chain development.

The policies and reforms for promoting agricultural development and MSE finance can be categorized into the following three areas: (1) general policies on financial market liberalization, including changes in interest rates and market opening for new entrants in financial services; (2) specific policies to support agricultural and rural development, including direct fiscal subsidies and agricultural on-lending; and (3) policies targeting increasing the access of farmers and MSEs to credit, such as policies on collateral and guarantee. We are not reviewing the institutional reforms of financial institutions in this report.

The rural financial policy reforms since the beginning of the new century started with the relaxation on market entry and the entry of new rural financial institutions. In December 2005, seven microcredit companies (MCCs) with investment from the private sector were created in five pilot provinces of China. In May 2008, the CBRC and the PBC jointly issued guidelines for the MCC pilot, which was later replicated throughout China. MCCs are lending-only institutions subject to non-prudential regulation by provincial government agencies. One year after the launch of the MCC pilot, the CBRC started its own pilot program involving village and township banks (VTBs), loan companies, and rural fund cooperatives, the so-called new types of RFIs. VTBs are county-level deposit-taking banks subject to CRBC regulation, and they are allowed to engage in full banking operations. However, VTBs can be set up only by an existing commercial bank with at least a 20 percent share in the total equity investment. By the end of 2015, there were 800 VTBs, 14 loan companies, and 49 rural fund cooperatives under the supervision of the CBRC. The number of VTBs increased to 987 by the end of 2013.¹ In March 2007, the Postal Savings Bank of China (PSBC) was created on the base of China Postal Savings and immediately started its micro-lending operations. It is important to note that the new types of RFIs discussed above are commercially oriented with small or no subsidies. The State Council's Leading Group Office of Poverty Reduction (LGOP) and the Ministry of Finance (MoF) started their pilot village community development

¹ The data are from CBRC.

funds (CDFs) in more than 100 villages in six provinces in 2006, and expanded coverage to 57 provinces in 2007. By the end of 2013, there were more than 17,000 VCFs across 57 provinces of China.² These village funds are financed by government poverty funds.

The government has generally liberalized China's lending rates of interest to encourage financial institutions to provide loans to rural households and MSEs. RFIs in China can lend to their customers at up to 4 times the base lending rate set by the PBOC. However, while lending to rural households, RCCs can float their lending rates upward up to 5.3 times the base lending rate only to protect the interest of small farmers. Considering the higher risks and higher transaction costs for small household lending, a cap on the lending rate might have encouraged RCCs and VTBs to lend to rural smallholders. Further institutional reforms have been undertaken with RCCs in China. Most RCCs have been converted to rural commercial banks (RCBs) and rural cooperative banks (RCOBs) with more operational autonomy. The PBOC and CBRC have actively supported the microfinance downscaling project conducted by China Development Bank with support from the World Bank and KfW. The microfinance downscaling so far has been followed by many city and rural commercial banks in China. The microfinance downscaling project conducted by China Development Bank with support from the World Bank and KfW is also commercially oriented with small subsidies to the participating institutions.

1.3 Government Support and Enabling Environment

Government Regulations and Recent Relaxation

China's financial industry has been highly regulated to ensure China's macro-economic stability while the economy is under the process of reform and opening up to the outside world. There are severe restrictions on the entry of FIs, including RFIs, in addition to the regulations on territories and scope of operations. As far as RFIs are concerned, the county RCCUs, including RCBs and RCOBs, are allowed to perform their banking functions usually within a county, and special permits from the CBRC are required for them to operate in other regions. So far, there have not been clear regulations and rules for RFIs to exit the market.

Market entry was relaxed since the beginning of the new century, starting with the relaxation of the entry of new rural financial institutions. In 2005, PBC enabled the creation of microcredit companies (MCCs) to compete with RCCs for credit provision. In May 2008, the CBRC and the PBC jointly issued guidelines for the MCC pilot, which was later replicated throughout China. MCCs are lending-only institutions subject to non-prudential regulation by provincial government agencies. In 2006, the government through the CBRC established a legal and regulatory framework for three new types of rural financial service providers: VTBs, VFCs, and loan companies. VTBs are county-level deposit-taking banks subject to CBRC regulation, and they are allowed to engage in full banking operations. However, VTBs can be set up only by an existing commercial bank with at least a 20 percent share in the total equity investment. In March 2007, the Postal Savings Bank of China (PSBC) was formed out of China Postal Savings and immediately started its micro-lending operations. LGOP and the Ministry of Finance (MoF) started their pilot CDFs in more than 100 villages in six provinces in 2006 and expanded coverage to 27 provinces in 2007. By the end of 2013, there were more than 17,000 VCFs across 27 provinces of China.³

Government Support to Rural Finance

The government has strengthened its support to China's rural economy and rural finance through the provision of fiscal subsidies and agricultural support for on-lending, tax concessions, and other policy measures. Some of the subsidies, such as tax concessions for the newly created village banks and direct

² The Monitoring Report for VCFs by the Foreign Capital and Project Management Centre under LGOP.

³ The Monitoring Report for VCFs by the Foreign Capital and Project Management Centre under LGOP.

grants provided for micro loans, are expected to increase lending to rural smallholders. Other interventions, such as the lending rate caps applied to rural household lending by RCCs, may have distorted rural financial markets by discouraging RCCs from lending to the household sector. The government and financial regulators have provided the following assistance to RFIs and borrowers engaged in agriculture and rural areas:

- Subsidized interest rates for poverty loans: The subsidized lending rates apply mainly for loans provided to poor households (a subsidy at 5 percent of the loan portfolio) and agriculture-related enterprises in poor areas (a subsidy at 3 percent of the loan portfolio). The local LGOP has been responsible for selecting targeting enterprises and households, with the grants provided by the MoF and the relevant local governments (Cheng and He 2011).
- Subsidies provided to new types of RFIs, from 2008 to March 2014: A subsidy equivalent to 2 percent of the average loan portfolio in the previous year was provided to new types of RFIs meeting the following criteria: (a) an increase in the average loan portfolio in the previous year; (b) the ratio of total loans to total deposits exceeded 50 percent at the end of the previous year⁴; and (c) other regulatory requirements were met.⁵ This subsidy aims at new types of RFIs under the supervision of the CBRC because they are new and supposed to have higher operation costs.
- Subsidies for loans to agriculture: In 2009, MoF introduced a direct fiscal subsidy to RFIs linked to growth in agricultural lending. Any county-level RFIs whose average loan portfolio increased by more than 15 percent in the previous year will be eligible to receive a fiscal grant, which is equivalent to 2 percent of the increase in the average loan portfolio over 15 percent (MoF 2009). The subsidies apply to all formal financial institutions at the county level (i.e., the RFIs supervised by CBRC).
- Tax concessions to RFIs: Since 2010, sales tax for interest income from loans below the size of RMB 50,000 by formal FIs has been exempted (taxed at 5 percent for general interest income). The interest income for RFIs operated at the county level and below, including RCCs, VTBs, loan companies, and rural fund cooperatives, is taxed at 3 percent instead of 5 percent; the profit of rural commercial banks and VTBs is taxed at 15 percent⁶ (MoF 2010).
- Agricultural support for on-lending to RFIs.⁷
- Differential RRR for RFIs: Since 2010, the Chinese government has tightened its monetary policies several times by raising reserve rate requirements for deposit-taking institutions to curb lending. Currently, the reserve ratio for RCCs and VTBs is about 6-7 percentage points lower than that for other deposit-taking institutions in China.

Moreover, the government has liberalized China's lending rates of interest further to encourage financial institutions to provide more loans to rural households and MSEs. RFIs in China can lend to their customers at up to 4 times the base lending rate set by PBOC. However, when lending to rural households, RCCs can float their lending rates upward up to 2.3 times the base lending rate only to protect the interest of small farmers. Considering the higher risks and higher transaction costs for small household lending, a cap on the lending rate might have encouraged RCCs and VTBs to lend to rural smallholders. In April 2014, PBOC reduced the minimum reserve requirements for rural banks and rural credit cooperatives to facilitate the growth of rural finance and microfinance.

⁴ This clause does not apply to loan companies and rural fund cooperatives.

⁵ Minor changes were introduced in April 2014. To be eligible for the subsidies, the new types of RFIs need to lend 70% of their total portfolios for agricultural uses (mainly loans to rural households) and for uses by MSEs.

⁶ The usual corporate tax rate is 27%.

⁷ To encourage RFIs to provide more loans for rural development, China's Central Bank PBOC has provided RFIs with agricultural support for on-lending at a low rate of interest (about 2% p.a.).

The government has encouraged RFIs to widen the scope of loan collateral so as to increase access to loans for rural households and MSEs. The CCP in its official documents has called a number of times for pilots on the use of contracted land rights, rural household residential plots, and farm houses as loan collateral (CCP 2014). China's local governments are very active in setting up credit guarantee funds and guarantee companies for scaling up lending in rural areas.

Innovations have also been introduced for rural financial products and services. Against a background of a few rural and micro-lending products, PBOC, together with CBRC, initiated rural financial innovation pilots in six provinces in Central China and three provinces in the northeast part of China in 2008. The pilot program has experimented on promoting rural micro loans without collateral and group guarantee rural micro loans, advocating new means for credit guarantee and collateral, such as using an agricultural product procurement contract and insurance cover as a guarantee for loans, and promoting electronic finance and the use of bank cards in rural areas.

Finally, the government has prioritized the development of agricultural insurance with rising incidents of natural disasters. In 2007, the MoF launched a pilot on subsidized agricultural insurance by releasing management rules on subsidies for agricultural insurance fee payment (MoF 2007). The insurance fee payments for five crops in six provinces of China were subsidized by both the central and local governments, and the share of the fee payment between the central government, local government, and farmers is 25 percent, 25 percent, and 50 percent. Since then, the pilot has been replicated to other regions of China, resulting in increases in the crop produced, and subsequent increases in the government subsidies on agricultural insurance. The total central government subsidies on agricultural insurance reached RMB 2.133 billion in 2007, 4.869 billion in 2008, 5.965 billion in 2009, and 6.777 billion in 2010.

1.4 Objectives and Scope of the Study

This report aims to study the best practices in China's rural finance that have a wide outreach to rural communities, especially poor rural communities, while operating sustainably. Following close consultations with the CBRC (China Banking Regulation Commission), a mobile phone product developed by Chongqing Rural Commercial Bank (CRCB) has been selected as a best case in rural financial innovations in China. The mobile phone product has targeted rural households and migrant workers against a background of rapid development of mobile and Internet banking in China.

The mobile phone product developed by the CRCB, an innovation in both technology and financial delivery channels, has a wide outreach and a profound impact on the welfare of rural communities, including migrant workers and the rural poor in Chongqing. Using the results from a fieldwork study in Chongqing as well as data provided by the CRCB, the rapid growth in both the volume and value of transactions with the mobile phone product, the savings incurred by bank clients, and the benefits to the bank are analyzed. It was found that the mobile phone product is replicable in other parts of rural China and possibly in other parts of the Asia-Pacific region.

The other two cases selected for study are CFPA MF, the largest poverty-oriented microfinance institution (MFI) in China, and microfinance downscaling by China's city and rural commercial banks. While the study on the mobile phone product of the CRCB has focused on the innovations in savings and money transfer services for the rural community and households, the study on CFPA MF has focused on its effort for the provision of micro loan services. In this report, we examine the loan products and services provided by CFPA, as well as the institutional changes and management behind the provision of the services. The process of microfinance downscaling for micro and small enterprises (MSEs) in China, a process of replication of the IPC model of microfinance by city and rural commercial banks in China, provides valuable lessons for the replication of best practices for our APRACA project.

In this report, we also study the development and capacities of different rural financial institutions (RFIs) in China and the major challenges with China's rural financial markets (RFMs) and institutions. This report touches on the methodologies for the design, implementation, and evaluation of rural financial innovations with their possible applications to China. Policy recommendations are made at the end of the report.

CHAPTER 2

Methodologies

2.1 Inclusion criteria

We have applied the following inclusion criteria for the selection of best cases in China:

- A great outreach to rural communities and households, especially the rural poor communities and households on a large scale.
- Sustainability of the operations, including financial and institutional sustainability.
- Important innovations in financial products and services, in service delivery channels, and in institutional and/or technological innovations.
- The pilots selected can be replicated in China and in other parts of the Asia-Pacific region.

This research covers both regulated banks and non-regulated financial institutions, as described below in “Sampling Methodology.”

2.2 Geographical Area Coverage

The best cases we selected cover all of China, focusing on China’s poor western regions. Chongqing RCB has operated basically in China’s southwest. CFPA MF extends its operations to 141 counties in 16 provinces throughout China, mainly in China’s state-designated poor counties. The 12 banks under the CDB microfinance downscaling pilot have also conducted their MSE financing operations throughout China.

2.3 Sampling Methodology

In selecting rural financial best cases, we have applied the following sample methodology:

1. We divided China’s rural financial institutions into regulated and non-regulated institutions, with best cases selected from both.
2. For regulated RFIs, we focused on the RFIs that have provided good deposit, money transfer, and payment services as China’s formal RFIs have been good in providing such services.
3. Of all the regulated RFIs that have provided good deposit, money transfer, and payment services, we selected the ones that have undertaken important innovations in mass outreach to rural communities and households, especially the poor ones.
4. Of non-regulated RFIs, we focused on those institutions that have targeted their lending on poor rural communities and households and have achieved sustainable operations.

CHAPTER 3

Review of Literature

3.1 Rural Financial Regulations and Supervision

Sustained economic growth and integrated development in the urban and rural areas of China have led to significant changes in the objectives of rural finance policy, in market demand, and in types of institutions. Against such changes, China's central government launched a round of rural financial reforms in 2002 and 2003, aimed at building a multi-layered, inclusive, and sustainable rural financial system. As far as changes in market demand are concerned, demand for microcredit from rural households for farm production, particularly for seeds and fertilizers in traditional agriculture, has been on the decline. In contrast, demand for larger loans for rural structural adjustment, such as loans for large scale livestock production, cash crops, and agricultural processing, is on the rise (PBC Zhangjiajie Branch 2005), and so is demand for loans from large-scale agricultural producers and from new economic entities, such as agricultural cooperatives and agricultural companies. With regard to changes in types of financial institutions, the most noticeable has been the entry into the market of new RFIs, such as VTBs. In addition, some existing RFIs have been permitted to engage in cross-regional operations. All these changes call for innovations in financial regulation and supervision.

3.1.1 Regulation Challenges for China

High risk, high transaction costs, and low returns, common features of RFMs in developing countries, have driven many commercial financial institutions away from the rural market in China (Yaron et al. 2002). The huge development gaps between regions and regional variations in animal and crop varieties, production seasons, and level of government support for farm production and marketing are complicating factors. These differences must be kept in mind when designing an appropriate financial supervision system (Tang, 2010). Automatically applying urban commercial banking standards to agricultural financial supervision would be both illogical and unsustainable (Song and Tang 2009).

At the end of 2006, the CBRC issued Document No. 90 (2007) titled "Policies about Economic Adjustment and Flexible Implementation of Permits for the Entry of Financial Institutions into the Rural Banking Market and Certain Opinions on Improving Support for the Construction of the New Socialist Countryside." According to the principle of "low-entry threshold and strict supervision," it encouraged the setting up of three kinds of RFIs: VTBs, finance companies, and agricultural mutual fund cooperatives. These new types of institutions would stimulate the growth of rural financial services, but their creation would also raise new issues in rural financial supervision (Gao 2010). Striking an appropriate balance between financial market dynamism and more efficient and secure operations will be difficult (Tang 2010).

Informal finance has been active in China's vast country areas. After the government shut down rural credit foundations in 1997 in an effort to maintain financial security, many unregulated rural financial institutions went underground. Informal finance has an important role in the economy and is very active across the country, including the southern, eastern (Zhejiang province), and southeastern (Fujian province) regions of China (Zhang et al. 2002; He 2002; Guo and Liu 2002). For farmers and SMEs that are disadvantaged by restrictions on formal lending, informal finance is an alternative. Informal financial institutions can screen and supervise clients and ensure the implementation of loan contracts with the help of their own sources of "soft" information.

Views of informal finance in China differ significantly. Informal finance helps meet the demand for financial services in rural areas, especially among the under-banked, and is therefore beneficial to economic growth. At the same time, the potential harm it poses should be considered and dealt with properly. Liu (2006) asserts that the supervision and monitoring of rural informal finance requires a better understanding of the characteristics and operations of informal financial markets.

3.1.2 Major Constraints to Effective Financial Supervision in China

Innovations in rural financial supervision must adapt to these changes, motivated by pressure to improve supervision. The research department in PBC Zhangjiagang branch identified three main constraints on the effectiveness of supervision: (i) information asymmetry between supervision authorities and the entities they supervise; (ii) inefficient information gathering and exchange caused by limitations in institutional systems and in supervisory approach, thus raising supervision costs; and (iii) staffing and technical constraints.

First, information asymmetry and internal controls, among their other functions, ensure that data produced by an institution are accurate and reliable. However, internal controls in most RFIs are unsound. Deficiencies in coordination and corporate governance structure within supervised institutions, such as state-owned commercial banks and quasi-collective RCCs, stand in the way of effective internal controls (Yin 2003). Some institutions do not comply strictly with accounting standards or with the required data accuracy in financial statements. Others set up controls but these are discrete and not mutually supportive. Supervision authorities cannot base their on-site and off-site supervision on financial statements provided by RFIs with serious internal control problems (Xu 1999). Moreover, irregular and opaque disclosure of information within RFIs, which does not allow the supervising officers to obtain correct and timely information about the RFIs' operations and risks, would also result in wrong supervisory decisions.

Second, inefficient information gathering and exchange within financial institutions, because of institutional limitations and a rudimentary and inflexible approach to supervision, increase the transaction costs of supervision and diminish its effectiveness.

To supervise effectively, supervisors should have fairly complete information at their disposal and be able to implement regulatory measures. The financial supervision of RFIs, however, rests on a weak institutional base. Poor coordination among the PBC, the CBRC, the China Securities Regulatory Commission, and the China Insurance Regulatory Commission in financial supervision hampers information sharing and, hence, supervisory performance. The three commissions, despite their relative independence, have overlaps and conflicts in responsibilities. The supervision performance of the CBRC, in particular, would be significantly affected by inadequate information from the PBC about rural finance.

Rudimentary approaches and a lack of technical means of financial supervision lead to inefficiencies in financial regulation and supervision. In China, where it is difficult for financial regulators and supervisors to shed the inertia of administrative regulation, the criteria for measuring the performance of financial institutions and the systems of reward and punishment are ill defined and ambiguous. Supervision depends mainly on on-site supervision, especially surprise inspections. Off-site supervision through continuous monitoring is deficient. Emphasis is placed on determining operational compliance with laws, rules, and regulations through administrative methods. Overall operational safety, profitability, and risk control are often overlooked. Supervision of this type, although aimed at safeguarding national laws and policies, cannot effectively track the risks faced by financial institutions, much less meet the demand for effective supervision in China's changing rural financial markets. Advanced supervision techniques for risk management that have been tested in other countries have not yet been introduced into China.

Finally, a limited number of supervisors and their low level of capacity are also partly responsible for the inefficient use of information resources and supervision instruments. On-site and off-site supervision demands the services of capable supervisory professionals. However, CBRC supervisory institutions at the primary level are in poor condition.⁸ The supervision unit of primary-level branches of the CBRC is understaffed, with about three supervisors being responsible for supervising all the formal banks (branches) in a county (Zhao 2007). Moreover, information on all the primary-level branches for horizontal and vertical analysis and comparison is difficult to obtain, for lack of proper technical equipment and software. For the same reason, monthly, quarterly, and annual financial reports and other analytical data needed to determine the condition of RFIs and their risk management cannot be delivered on time. Coping with the rapid growth of RFIs presents an additional challenge.

3.1.3 Efforts to Introduce Innovations in Rural Financial Regulation and Supervision

As RCCs dominate the agricultural financial markets, they have attracted much attention by the supervisory authorities. At the start of 2006, the CBRC stated that commercial banking standards were to be regarded as benchmarks in the financial supervision of RCCs. This ruling marked a significant change in the supervision of RCCs. Previously, RCCs classified delinquent loans into loans that were up to 1 year overdue, loans that were more than 1 year overdue, and bad loans. Supervision and management procedures were applied later, according to loan maturity. Consequently, loan risks were concealed and assets were not accurately classified.

The CBRC subsequently issued certain institutional measures. These included the “Comprehensive Carrying out of Organizational Implementation Plan for Rural Cooperative Financial Institutions to Classify Loans into Five Categories”⁹ and the “Classification Guidance for Rural Cooperative Financial Institutions’ Credit Assets.” The improvements in the credit risk management system placed the risk assessment criteria and process, limits of authority, and loan classification mostly under regulation. RFIs now had rules to follow when implementing the five-category risk classification. Using modern technology, the CBRC also developed specialized software, the “Rural Credit Cooperatives’ Risk Classification on Deviated On-Site Inspection and Statistical Analysis.” Thus, rural financial cooperatives could be inspected to determine their degree of loan delinquency.

In 2007, the CBRC introduced “The Guidance for the Supervision and Rating of Rural Cooperative Financial Institutions.” This guidance took a step further to strengthen the supervision of rural financial institutions following the implementation of the five-category loan classification.

Compared with their urban counterparts, many rural financial institutions have lower ratings because of their higher ratios of non-performing loans and lower operational efficiency. With six grades for the rating of financial institutions in China, the CBRC created three sub-grades for each of the three low-section grades (Grades 4-6) in an effort to distinguish rural financial institutions.

Differential supervision applies different measures according to the type of RFI, the type of financial service, and the type and population of the rural financial market. In particular, the supervision requirements for RCBs, RCOBs, RCCs, VTBs, finance corporations, rural mutual funds, and MCCs are significantly different in several respects. *First*, the standards of commercial bank supervision are quite strict for RCBs and RCOBs, given their rural context. *Second*, for the RCCs, the supervision standards involve adhering to the bottom line, exercising appropriate tolerance, and achieving the standards gradually. *Third*, as far as provincial RCC federations are concerned, their performance is evaluated yearly. *Fourth*, a transitional space is provided for the newly created VTBs to meet the major regulatory requirements, including the loan deposit ratio set by the CBRC. *Fifth*, the supervision of the lending-only micro-loan companies focuses on the loan uses and quality. *Sixth*, supervision for small-scale rural cooperative funds is mainly on compliance.

⁸ It refers to the county level.

⁹ The five loan categories are normal, attention, sub-standard, doubtful, and loan losses.

In December 2006, the CBRC issued the document “Certain Opinions about Adjustment to Lift the Control over Banking Financial Institutional Permits for Entry in Rural Areas to Effectively Support New Agricultural Construction.” Significant changes in the entry permits eased the entry of VTBs, finance corporations, and rural mutual funds. This striking shift in policy will help improve the rural finance organization and service system of China.

The registered capital requirements for new rural financial institutions, which are supervised by the CBRC, are relatively low. For example, the minimum registered capital for VTBs is RMB 3 million in counties and RMB 1 million in villages and towns. For cooperative institutions, it is RMB 0.3 million in villages and towns, and RMB 0.1 million in administrative villages. For commercial banks setting up wholly owned subsidiaries, the minimum registered capital is RMB 0.5 million. Rural cooperative banks need at least RMB 10 million in registered capital.

In addition, the State Council’s “Several Opinions on Encouraging and Guiding the Healthy Development of Investments from the Private Sector” encouraged private investors to launch or participate in establishing VTBs, financial corporations, rural mutual funds, and other financial institutions. It also relaxed the restrictions on the minimum capital contribution for VTBs and community banks.¹⁰

In May 2008, the CBRC and the PBC published the paper “Guidance for Pilots on Microfinance Lending,” which presented new developments in rural financial supervision and introduced the concept of stratified supervision. Provincial institutions, including financial offices and financial service authorities, are now allowed to supervise microcredit companies. The stated premise is that the institutions are willing to assume the risk management responsibilities of the microcredit companies. This is a significant change in China’s financial supervision system. Stratified supervision aims to encourage supervision innovation and diversification, and will benefit competitive supervision and financial innovation (Lin 2009).

Microfinance companies are allowed to lend to and borrow money from no more than two commercial banks. On the one hand, this benefits commercial banks by increasing their wholesale credit business while a platform is built for bank participation in rural development. On the other hand, financial institutions in the wholesale credit business could also take responsibility for supervising microfinance corporations. These institutions will work with provincial supervision departments to regulate the behaviour of microfinance companies. Multi-channel supervision could harden the budget constraints of microfinance companies – an important form of market power to supervise financial institutions.

3.1.4 Issues for Further Study

Since RCC reform started in 2003, a multi-channel management system has been formed by the CBRC in coordination with the local governments and provincial RCC federations. However, the authority and responsibilities of these RCC federations need to be defined more clearly, and the related legal standards and guidelines still have to be developed. China also has no laws specifically for financial cooperatives.

Financial supervisors in China are inadequately supervised. In countries with strict rules, the behaviour of supervisors is closely regulated. In China, the interests of the supervisors and those supervised are extraordinarily complicated because of regulatory insufficiency, culture, weak implementing mechanisms, and other factors. This situation is not conducive to efficient financial supervision and financial risk protection. In fact, it may increase financial rent seeking and corruption. Because of the absence of the Cooperative Finance Act and the Cooperative Finance Supervision Act, the boundary between bank supervisors and managers has been blurring (Zhao 2007).

¹⁰ See the State Council Document No. 13, 2010, issued in 2010.

Grass-roots supervision is weak and needs to be strengthened immediately. Investments must be made in supervision facilities and in the construction of modern communication networks. The approach to and capacity for timely supervision and off-site supervision should likewise be improved.

The external economic environment is a key element of effective rural financial supervision, and fiscal and monetary policies have a unique role (Meng 2009). The main challenges for rural credit are high costs, high risks, and low profits. Fair compensation, such as finance discounts and insurance subsidies, can therefore be provided to RFIs and to the users of financial services. This may be a feasible way of promoting the sustainable development of RFIs. The support system of monetary policies consists of differential reserve requirements, refinancing policy for agricultural support, and market-oriented interest rate reform in rural areas. A significant issue in rural financial supervision is how to support differential supervision with reasonable fiscal and monetary policies. The coordination between fiscal and monetary policies is another major topic that needs to be investigated.

3.2 Agricultural Value Chain Financing

3.2.1 Introduction

The transformation of agricultural operations and the emergence of many new economic entities in China (e.g., large-scale plantations, dragon-head enterprises, and rural cooperatives) have significantly changed the demand for rural financial services. The demand for small amounts of farm inputs (seeds, fertilizer, etc.) and for short-term credit has decreased, while the demand for larger amounts of longer-term credit associated with rural industrial adjustment, specialized farm production, specialized cash cropping, and agricultural processing has increased (Task Force of PBC Zhangjiajie Branch 2005). Dragon-head enterprises need loans for both working capital and long-term capital investment (Chou 2008). Farmers' cooperative members have more homogeneous, and often also more concentrated, demand for credit (Strategic Management Task Force of ABC 2009). These changes in demand for credit require new approaches to rural finance and better loan products and services.

The financial institutions in rural China have difficulties in meeting the changing demand for rural financial services for various reasons. RCCs, the main providers of financial services in rural areas, provide mostly micro loans to rural households, household group guarantee loans, and collateralized loans. Household microcredit is high in risk because of the low profits from small-scale agriculture, the high market risk, and the lack of agricultural insurance, and entails high transaction costs because of the difficulties involved in gathering information and in disbursing small loans, monitoring them, and collecting them from thousands of households. Loans to farming household groups pose different problems: such groups are not easy to form and their group lending mechanism has little effective control over loan defaults. Collateralized lending, for its part, has a limited range of eligible collateral. Land-use rights and farmhouses, the two major properties owned by farmers, cannot be used as collateral under existing laws and regulations.

From the point of view of banks, on the other hand, agricultural loans cost more because lending is geographically dispersed and the loans are small in size and large in number. According to a study of the Penghu Agricultural Cooperative Bank in Zhejiang Province by Chen (2011),¹¹ in 2006, the bank had 39 credit officers and nine vice presidents in charge of agricultural credit, with 18,842 rural household borrowers, and a household loan portfolio of RMB 419 million. For rural household loans, the total interest income was RMB 29.5 million and the total costs were RMB 29.9 million; so, each agricultural credit officer created a financial loss on average of RMB 9,100 in comparison with a profit of RMB 139,600 per bank employee in the bank.

¹¹ It is important to note the rapid industrialization in the county. The agricultural cooperative bank in the county provided loans mainly for non-agricultural uses, including manufacturing, transportation, construction, and housing. Loans to rural households, regarded as agricultural loans in China, constituted a relatively small share of total bank lending.

A significant issue for researchers and policymakers, therefore, is how to meet the demand for rural finance and thereby promote innovations in financial products, techniques, organization, and loan supply mode, tailored to the new needs of farmers, rural cooperatives, and dragon-head enterprises. A question that should be addressed is whether the dispersed demand for credit in rural areas can be integrated through *chanyehua* and farmers' specialized cooperatives to improve access to credit and the quality of rural financial services.

3.2.2 Definitions, Characteristics, and Models of *Chanyehua*

Chanyehua can be defined differently (Chou 2008), but, according to the Soft Science Committee of the Ministry of Agriculture (2005), *chanyehua* involves (i) market-oriented, efficient farm production using the latest farm technology; (ii) more specialized farm production based on family farming, with dragon-head enterprises and agricultural cooperatives taking the lead in marketing and other services; and (iii) the development of agricultural value chains with close links between farm production, processing, and marketing. Yu (2002) states that *chanyehua* enhances rural organization building, promotes vertical integration, and emphasizes agricultural specialization. Dragon-head enterprises or cooperatives organize individual farmers into agricultural value chains according to the principles of mutual benefit and common interest. Agricultural production, processing, and marketing are vertically integrated. Vertical integration in general can be either complete (the same agent performs all the activities in the value chain) or incomplete (different agents perform the various activities through contracting). In *chanyehua*, vertical integration is mainly incomplete.

Agricultural specialization can take one of the following three forms: (i) agricultural institutions, including agricultural enterprises and households, specialize in the production of certain farm goods for the market; (ii) different agents specialize in different stages of farm production according to their comparative advantage, to improve production efficiency; or (iii) regions specialize to achieve a regional comparative advantage in farm production. By definition, *chanyehua* goes beyond farm production and integrates the processes of input supply, grading, processing, and marketing of farm goods.

The "enterprise + farming households" model is arguably the most common model of *chanyehua* in China (Guo 2007). In this model, an agricultural enterprise is often the leader, or 'dragon head', and farm production, processing, and marketing are integrated and coordinated. According to organizational structure, the various *chanyehua* models can be categorized as follows:

- **"Dragon-head enterprise + households" model**, with integrated farm production, processing, and marketing, but still involving rural households in production (Yu 2002).
- **"Intermediary organization + farming households" model**. Intermediary organizations, such as agricultural cooperatives and professional associations, take the lead in promoting agricultural production by offering services related to information, capital, processing, technology, and marketing.

3.2.3 Financial Demand of *Chanyehua*

Chanyehua production has changed significantly, from small-scale and generalized to specialized operations, and from decentralized to centralized management. Meanwhile, the value chain has become more market oriented. Large-scale farming households, dragon-head enterprises, and rural cooperatives are now the most dynamic and promising entities in rural economic development, and they have created new requirements for rural financial services.

The financial demand of cooperatives has several key characteristics. The majority of cooperatives in the initial stages of growth lack capital to purchase large or new machinery and equipment, and therefore require more credit for such purchases. Cooperatives have a greater and more urgent need for liquidity than individual farming households, to procure and purchase agricultural inputs, and to process,

produce, transport, and market agricultural products. Their demand for credit is also more sustained and frequent than the credit demand of individual farming households since many cooperatives expanded their scope of farm production through diversification.

Together with structural adjustment in agriculture and the development of *chanyehua*, changes have occurred in the agricultural credit requirements of farming households. Specifically, the demand for small-scale credit for traditional agriculture (to pay for seeds, fertilizer, etc.) has decreased, while the demand for large-scale credit (for structural adjustment, specialized breeding, and the processing of agricultural and auxiliary products) continues to increase (Task Force of PBC Zhangjiajie Branch 2005). Moreover, because these cooperatives have integrated the supply of agricultural inputs, such as seed and feed, to farming households, the demand for microcredit has decreased greatly (Chou 2008).

The transformation of agriculture and the construction of the new socialist countryside have considerably changed the credit needs of farmers of different types. Jiang and Wu (2006) classify farmers into three income categories: wealthy, average, and poor. According to their survey on the credit required by farmers in Jingshan County of Hubei Province, wealthy farmers engage in large-scale cultivation, plantation, agro-processing, marketing, and social services, and have long-term and large demand for credit. Farmers of average income are mainly involved in small-scale cultivation and breeding, and therefore have less demand for credit. The majority of poor farmers also need credit, but in small amounts.

3.2.4 Main Problems with Financial Support for *Chanyehua*

The formal financial system so far has provided inadequate support for *chanyehua* and can hardly sustain the extension of the agricultural value chain. Insufficient funding has weakened ABC support for *chanyehua* in the past few years. RCCs are primarily in the rural microcredit business, with credit lines generally below RMB 3,000 in remote areas and maximum loan amounts of only RMB 20,000-30,000 even in the developed suburbs, not enough to meet the needs of *chanyehua* (Zeng and Zhou 2008). Furthermore, the various channels of agricultural value chain financing are not connected. In the “Enterprises and farming households” model, for example, agricultural dragon-head enterprises obtain credit mainly from large and medium-sized financial institutions, including CCBs, whereas rural households obtain credit from the RCCs, even informal financial organizations. Because banks and RCCs cannot reach a consensus on cooperation and investment, separate financing channels serve the needs of enterprises and individual farmers, thereby reducing the efficiency of the value chain and complicating system management and risk control. Despite their importance in *chanyehua*, cooperatives cannot obtain loans from financial institutions under current lending policies, which encourages dispersed lending, contrary to cooperative principles.

Current financial products and procedures are not suitable for *chanyehua*. The maturity structure of loans does not match the demand for credit for *chanyehua*. Agricultural enterprises have seasonal demand for large amounts of long-term credit, but rural financial institutions, intent on controlling risk, are more willing to disburse short-term loans.¹² Financial institutions also have difficulty providing credit rating, acceptance, discounting, foreign exchange, and other financial services required by modern agricultural enterprises and farmers who practice specialized farming.

The inability of formal financial institutions to meet the credit demand of specialized farming households has three aspects. One is the line of credit. Formal financial institutions use microcredit models that restrict the development of businesses needing large amounts of capital. Another aspect is mortgage. When effective real estate mortgages or third-party guarantees are not available, some leading agricultural enterprises have attempted to use their farm products as collateral for loans. But,

¹² Some agricultural enterprises have a high demand for loans in the spring season for the purchase of farm inputs, while others have a high demand for loans in the autumn for agricultural marketing and processing.

the banks in China usually do not accept farm products as loan collateral (Weng and Lv 2008). The third aspect relates to the reuse of lines of credit by farmers (Li 2008).

3.3 Cooperative Financing

In recent years, various types of rural cooperative organizations have mushroomed across the country. Relevant laws and regulations such as the Law of the People's Republic of China on Farmers' Cooperatives (2006), the Demonstration Constitution for Farmers' Cooperatives in China (2007), and the Accounting System (Trial) for Farmers' Cooperatives (2008) drive rural cooperative organizations to specialize and standardize. The specialized cooperatives are responsible for bringing about specialized, modern, and large-scale agriculture to increase farmers' income.

Most cooperatives face a capital shortage during setup and early expansion. The Law of the People's Republic of China on Farmers' Cooperatives (2006) provides legal protection for credit services for cooperatives. However, banks, as the main financing channel of cooperatives, cannot meet their demand with the present banking products, procedures, and technology. The cooperatives themselves are partly responsible for this.

3.3.1 Farmers' Cooperatives

As defined in the Law of the People's Republic of China on Farmers' Cooperatives, farmers' cooperatives are voluntary organizations of agricultural producers or service providers of the same type. Their production and management occur at two levels: rural cooperatives produce and operate at the unified level, while farming households engage in dispersed production. The credit demand of these organizations also has two levels: centralized (in the case of the cooperatives themselves) and dispersed (in the case of their farmer members).

There are four main types of farmers' cooperatives. Cooperatives of the first type are formed by farmers who specialize in an industry or product and are drawn by the technology, management, capital, and commercial network advantages that membership offers. A considerable number of cooperatives organized by specialized farmers can be found in Zhejiang and Jiangyu provinces and other eastern coastal areas of China (Zhang 2009).

The second type of cooperative is formed by enterprises, which use the advantages of enterprises to link production bases, farming households, and markets into integrated supply, production, and marketing systems. After the passage of the Law of the People's Republic of China on Farmers' Cooperatives, many dragon-head enterprises, especially the larger ones, began showing great interest in joining or leading cooperatives (Zhang 2009).

The third type of cooperative is established or led mainly by the Rural Buying and Sales Cooperatives (RBSCs) in China or by agricultural technical extension staff.¹³ The farmers' cooperatives led by RBSCs are expected to inherit the market experience and links of RBSCs while the cooperatives led by agricultural extension staff have advantages in the application of agricultural technologies.

The fourth type is led by village-level organizations, which link farmers' production with government by making full use of the advantages of economic collectives and the intermediary role of village cadres to promote production and marketing. This type of cooperative is prevalent in central and western PRC.

¹³ China's Rural Buying and Sales Cooperatives (RBSCs) were created in the 1950s during China's agricultural cooperative campaigns then. The system has lost its cooperative nature for a long time and become an officially operated agricultural marketing service provider. Many grass-roots RBSCs ceased their operations after the rural economic reforms in the 1980s because of the competition from private traders.

3.3.2 Financial Demand of Farmers' Cooperatives and the Risks They Face

The financial demand of farmers' cooperatives can be divided into three types, according to the entity involved: financial demand of the cooperatives themselves, financial demand of enterprises owned by cooperatives, and financial demand of cooperative members. Cooperative members mostly need productive capital to purchase seeds, fertilizer, and pesticides, among other things. In general, the demand is strongly homogeneous and often centralized.

In China, many cooperatives would like to have access to longer-term loans with relatively low lending rates for capital investment.¹⁴ Farmers' cooperatives that are just starting out need long-term, large-scale capital to build storage facilities and other infrastructure and to purchase transportation and processing equipment. According to Ma and Yang (2011), many cooperatives have a business plan to expand their operation scale well beyond their registered capital and need a large amount of longer-term loans. Mainly short-term loans (maturing within a year) from formal sources obviously do not meet such needs.

3.3.3 Financing Channels of Farmers' Cooperatives

Farmers' cooperatives have internal and external sources of finance. Cooperatives should not rely solely on external sources of finance, including credit from financial institutions to meet their capital demand. The investment from members and support from the government and others are equally important.

Farmers' cooperatives can be classified, according to legal entity, into commercial entities (commercial firms), juridical associations, and mutual aid societies. Under the Company Law (rev. 2005) and the Farmers' Cooperative Law, only farmers' cooperatives registered as a commercial firm legal person can apply for loans from formal financial institutions (Zeng 2009).

Because of their organizational characteristics, farmers' cooperatives can provide their members with credit guarantee services based on internal credit mechanisms. Mutual cooperation between members can increase credit to farmers, and minimize or at least reduce natural and market risks and moral hazard problems in repayment. Internal funds flow and logistics relationships between members and the cooperatives, involving the unified purchase and marketing of production materials, technology dissemination, return of surplus, and capital settlement, among others, can also help in avoiding default risk. In the field survey, some financial institutions chose to have credit guarantees from farmers' cooperatives that were well organized and managed, thereby expanding the agribusiness operations of the financial institutions, besides solving the problem of fund shortage (Zheng 2008).¹⁵

3.3.4 Difficulties in Financing Cooperatives

According to several studies, the financing of cooperatives is constrained by factors related to the characteristics and operations of the cooperatives themselves, to the operations of financial institutions, and to the credit insurance mechanism.

Cooperatives have difficulty borrowing from banks because of their own inadequacies in the following aspects:

- **Legal inadequacies.** Farmers' cooperatives register with the State Administration for Industry and Commerce without having their registered capital verified by a third party. They therefore lack credibility with financial institutions. Moreover, the Law of China on Farmers' Cooperatives

¹⁴ Many farmers' cooperatives in China have little registered capital investment, due mainly to the problems with their governance structure. Cooperatives in other countries with sufficient capital investment may not need a large amount of long-term loans.

¹⁵ In other countries, savings from members are an important source of finance within a cooperative. The existing laws and regulations in China, however, provide no support for savings from cooperative members.

withholds from the presidents of cooperatives the right to dispose of cooperative proceeds, which must be divided among the members, and requires all members to sign loan guarantees to obtain financial support.

- **Organizational and management problems.** Farmers' cooperatives are usually loosely managed. The Task Force of PBC Jingzhou Branch (2009) noted that, though 87 percent of the cooperatives in Jingzhou had councils and supervisory boards and held membership meetings, their performance depended mainly on their leaders, most of whom had limited capacity to coordinate, guide, and manage operations in a democratic way.
- **Lack of credit rating.** A survey made by the Task Force of PBC Nanping Branch (2008) revealed that the property of farmers' cooperatives in Jian'ou City consisted of the collective property of villages (such as factories, offices, and equipment); property donated by governments and their various departments (such as computers, registered trademarks, and office decor); office equipment purchased; and property borrowed or rented from individuals (such as offices and sales outlets located in members' houses). These assets generally did not meet banks' requirements for loan collateral.
- **Financial reporting inadequacies.** In a survey of 100 farmers' cooperatives in Jingzhou City, Hubei Province, the Task Force of PBC Jingzhou Branch (2009) found that 42 cooperatives in the sample had full-time accountants, 34 had part-time accountants, and 24 had no accountants who could provide complete financial statements. Without the financial statements, financial institutions would not understand the operations of the cooperatives and their need for financing.

CHAPTER 4

Findings on Rural Financial Services

4.1 Key players in Rural Finance Space

The providers of financial services in China can be categorized into the following: (i) regulated financial institutions, mainly deposit-taking banking institutions regulated by CBRC¹⁶; (ii) semi-regulated financial institutions, such as the lending-only microcredit companies (MCCs) and financial guarantee companies, supervised by the local government or government departments; and (iii) informal institutions such as P2P and some credit cooperatives that are not supervised by any government departments in any formal arrangements. NGO microfinance institutions could be categorized as semi-formal institutions as they are usually supervised by the county level of government or the agencies of the county government.

As far as rural finance is concerned, the regulated rural banks can be separated further into the following categories:

1. *Policy banks*: the Agricultural Development Bank of China (ADBC).
2. *Commercial banks*: the Agricultural Bank of China (ABC) and Postal Savings Bank of China (PSBC) (Table 1).
3. *Cooperative banks*: the rural credit cooperative (RCC) system, including rural credit cooperative unions (RCCUs), rural commercial banks (RCBs), and rural cooperative banks (RCOBs).
4. *New types of RFI*s, which refer to those institutions permitted entry by CRBC in 2008: including village and township banks, loan companies, and rural fund cooperatives.
5. Insurance companies doing agricultural and rural insurance.

Table 1. The Agricultural Policy and Commercial Banks in China (RMB)

	Unit	ABC	PSBC
Inception year ¹		1951	2007
Ownership structure		SOCB ²	SOCB
Listed company		Shanghai & Hong Kong ⁵	Not listed
Total assets at end of 2013 ³	Trillion ¥	14.56	4.7
Total loan portfolio at end of 2013	Trillion ¥	7.22	
Total deposits at end of 2013 ³	Trillion	11.81	4.5
Agri-related loan portfolio ⁴	Billion	2,200	446
Number of branches & offices		23,547	39,000
No. of staff			

Sources: The website of ABC, ADBC, and PSBC, Zhu Xiujie and Li Yucui (2014).

Notes: ¹ ABC was created first in 1951; it was restored in 1979 when the Cultural Revolution ended.

² State-owned commercial banks, SOEs = state-owned enterprises.

³ The figure of PSBC is for Oct. 2012.

⁴ March 2014 for ABC and Oct. 2012 for PSBC.

⁵ Listed on Shanghai and Hong Kong Stock Exchange.

¹⁶ The regulated non-banking financial institutions in China include the insurance companies (regulated by the China Insurance Regulation Commission), financial leasing companies (regulated by the Ministry of Commerce), and financial institutions regulated by the China Security Regulation Commission.

The two banks in Table 1 are state-owned large banks with their operations all over China. ADBC is a policy bank on agriculture, being responsible mainly for agricultural procurement and storage. It also disburses loans for agricultural development. From 2004 to 2014, the bank disbursed a total of RMB 3.7 trillion for agricultural procurement and storage. ABC is one of the big-four SCMBs in China. Its operations have moved far beyond agriculture though the government and the bank regulators often instruct the bank to provide more loans to agriculture and rural households. PSBC was converted from the Postal Savings Services under China Post in March 2007, so the bank has a massive branch network across the country, including the remote rural areas. PSBC has been the major provider of remittance services for millions of migrant workers in China. Recently, PSBC has been very active in promoting micro loans to urban micro and small enterprises (MSEs).

The development of cooperative finance and new types of RFIs in China's rural areas is shown in Table 2. The rural credit cooperative system in China currently consists of rural commercial banks (RCBs), rural cooperative banks (RCOBs), and rural credit cooperative unions (RCCUs). Each province has a provincial-level RCC Federation (RCCF), except for Beijing, Shanghai, Tianjin, Chongqing, and Ningxia, where a provincial-level RCB has been set up. The paid-in equity capital of the RCC system soared from RMB 62.5 billion in 2003, when the latest round of the RCC reform was launched, to RMB 578.1 billion by the end of 2013, which allowed RCCs to lend an additional RMB 6.4 trillion at a leverage of 12.5 times (Zhu Xiujuan and Li Yucui 2014).

Table 2. Regulated Rural and Microfinance Institutions in China, as of the end of 2013

	Numbers ²	No. of branches	No. of employees
RCCs	1,957	49,034	505,859
Rural commercial banks (RCBs)	337	19,910	550,045
Rural cooperative banks (RCOBs)	147	5,463	55,855
New types of RFIs ¹			
VTBs	1,105	1,456	30,508
Loan companies	16	14	111
Rural fund cooperatives	47	49	451
Total	3,574	75,896	809,733

Sources: CBRC, Zhu Xiuji and Li Yucui (2014).

Notes: ¹ The new types of rural financial institutions refer to the RCFs permitted in 2006, with the license issued by CBRC. MCCs are not included in the new types of RFIs here.

² The number of VTBs, loan companies, and rural fund cooperatives are for March 2014. (Please note that totals do not agree with the numbers in the columns.)

The non-performing loan ratios for the banks in China have been low and in case of foreign banks it is exceptionally low which same for the joint stock banks also. All commercial banks improved their NPL ratio and it is below 1 percent whereas the Rural Commercial banks have little higher NPL ratio (1.76%) which shows that the recovery ratios are below the standards in the country (Table 3).

Table 3. The Total Loan Portfolio and Non-performing Loans for Commercial Banks in China (2010-12)

	2010		2011		2012	
	Total L ¹	NPL% ²	Total L ¹	NPL% ²	Total L ¹	NPL% ²
All commercial banks	394,185	1.1	457,900	1.0	518,845	0.95
Large commercial banks	540,385	1.3	575,364	1.1	315,656	0.99
Joint-stock banks	80,857	0.7	93,833	0.6	110,694	0.75
City commercial banks	36,555	0.9	45,375	0.8	51,758	0.81
Rural commercial banks	14,563	1.9	51,313	1.6	35,045	1.76
Foreign banks	9,800	0.5	10,000	0.4	10,385	0.55

Source: Calculated from the data from CBRC website, www.cbrc.gov.cn.

Notes: ¹ The total loan portfolio in RMB 100 million.

² The ratio of non-performing loans.

The pilot on village community funds (VCFs) or village development self-help funds was launched by the Poverty Alleviation and Development Office under the State Council (LGOP), with support from the Ministry of Finance (MoF) in 2006. VCFs are basically revolving funds consisting of the grant from MoF and the contributions from villagers for revolving loans within a village. The grant from the MoF for each village is in the range of RMB 150,000-250,000. From 2001 to 2010, the grant funds from the central government for VCFs reached RMB 5.415 billion. The rules and decisions for lending for RCFs are supposed to be determined by the villagers themselves.¹⁷

The semi-regulated financial institutions in China presented in Table 4 include MCCs, pawnshops, leasing companies, and NGO MFIs. Of these, MCCs and NGO MFIs, especially the latter, have more lending in rural areas. The pilot on MCCs was launched by the PBOC and some local governments in 2005. MCCs are privately owned companies and, as a lending-only institution, MCCs are allowed to borrow up to 50 percent of their equity capital from Chinese banks and the limit for their single largest loan is 5 percent of their equity capital. As private enterprises, most MCCs in China have targeted SMEs in China's urban areas, though the intention of the government was for the MCCs to provide micro loans to MSEs in China's rural areas.

The pilot on NGO microfinance started in China in 1993 and 1994, introduced by the group with the Chinese Academy of Social Sciences. Registered with the county-level government departments of civil affairs and with funds mainly from donors, NGO MFIs in China usually provide micro loans (from RMB 3,000 to 20,000) to rural households and migrants in China's poor counties. There are 10 to 30 active NGO MFIs in China today though in the heydays the number of NGO MFIs exceeded 200. The largest NGO MFI in China is CFPA MF. After an institutional reform in 2008, CFPA MF entered a track of rapid growth. By the end of 2014, CFPA had more than 200,000 active clients in 141 counties of 16 provinces of China. About 93 percent of its clients are women, with a loan portfolio of RMB 1,879 million. In 2014 alone, it disbursed RMB 2,867 million micro loans to rural households and micro-entrepreneurs in China's poor areas.¹⁸

Table 4. Development of Non-banking Micro loan Institutions in China, 2012 and 2013

	MCCs	Pawnshops	Leasing companies ¹	NGO MFIs
Number ²	7,839	6,084	540	About 100
Total portfolio (RMB billion)	819.1	70.61	890	
Supervisors	Local governments ³	Ministry of Commerce	Ministry of Commerce	Unclear
Main clients	MSEs, micro-entrepreneurs, farmers	MSEs, micro-entrepreneurs, individuals	Enterprises	Mainly rural households

Source: Hanhua Co. unpublished report, 2014.

Notes: ¹ Refers to financial leasing companies.

² The number of MCCs in the table is for 2013, and 2012 for all the other institutions

³ In most cases, local government financial offices.

4.2 Challenges Related to Rural Finance in China

Compared with that in other less developed countries (LDCs), the formal rural financial system in China has provided good savings and remittance services to rural communities and households, including migrant workers, because of well-developed financial infrastructure, the development of transportation and communications, and the emphasis of the government and financial regulators for the RFIs and others on supporting farmers and rural economic development (Cheng and Xu 2007).

¹⁷ See www.China.com.cn/law/flfg/txt/2006-08/08/content_7056240.htm.

¹⁸ See www.cfpamf.org.cn/static/upfile/201501121121366615.pdf.

Progress has been achieved for the RFIs in China to outreach their lending services to rural communities and households, especially after the reforms of RCCs initiated in 2000 and replicated nation-wide from 2003. The entry of new types of RFIs and MCCs since 2005 has improved China's lending services further.

Despite the great efforts made by the financial regulators and the progress achieved after the reforms in 2005 and 2006, China's RFIs remain slow in penetrating rural financial markets (RFMs). Overall, the loanable funds have been channeled from rural to urban areas and from the poor western regions to the richer coastal regions by the formal financial system in China. On the whole, the financial markets in China are dual: large and medium-size enterprises, especially SOE enterprises, have access to cheap credit from formal banks whereas the privately owned small and micro-enterprises and farmers either have very limited access to formal credit or have access to formal credit at a much higher cost.

The slow progress in outreach to rural households and micro-enterprises by the traditional and new institutions can be attributed to a number of factors. First, micro-lending to average rural households and micro-enterprises still suffers from higher risks and high transaction costs because of the slow progress with social protection and social welfare in rural areas. Agricultural insurance is available for only a few products in selected areas with subsidies from the state from time to time. Farmers need different tools to mitigate their risks and smooth their consumption, including savings, insurance, and credit. The absence of insurance services in many places of rural China has increased risks for farmers as well as RFIs. In addition, mobile banking and branchless banking in China have been used by some RFIs though more progress has been achieved in recent years.

Second, in recent years, the credit from SOCBs and other shareholding banks has been concentrated on large-size enterprises and projects, especially the large projects undertaken by SOEs and local governments following the outbreak of the Global Financial Crisis. Accordingly, there is a chronic shortage of supply of formal credit to SMEs in China. With this shortage in credit supply, new market entrants in the financial sector tend to enter the market for SME lending first, considering that most new entrants with private equity investment have a strong profit motive and are short-term profit maximizers. As a matter of fact, the main function of newly created MCCs has been as a supplement to commercial banks in SME financing, lending to those SMEs that have difficulties in borrowing from commercial banks because of their problems with collateral, or they are unhappy with the loans from commercial banks because of the timeliness in loan application and approval, loan size, and loan duration. MCCs are also able to provide loans to SMEs when the regulated banks suffer from the restrictions on lending by the regulators for the purpose of macro-economic adjustment.

Third, limited progress in downscaling has been achieved by the entry of new types of RFIs since 2005 and 2006. As shown in Table 4, few loan companies and RFCs have been created. The operation of some newly created VTBs is not very different from that of other commercial banks even when they operate at the county level. Most MCCs established since 2005 have targeted SMEs rather than micro-enterprises and farmers, the proportion of their portfolio to micro-enterprises is low, and their rural household loans are rare. Although a number of city commercial banks (CCBs) and RCBs have been active in conducting microfinance downscaling, many of them have not reached economies of scale for their micro-lending operations except for a few. On the whole, except for a few markets, the competition in rural household and micro-enterprise lending in China remains limited and most rural households and micro-enterprises face serious credit constraints.

Finally, China's MFIs, including MCCs, NGO MFIs, and VCFs, can hardly achieve operational and financial sustainability if their operational scale is small. MCCs as lending institutions are allowed to borrow only up to 50 percent of their equity fund, which is very low compared with the international standard. With these constraints in place, it is difficult for these institutions to increase their scale of operation and enhance micro loan services to low-income rural households and micro-enterprises.

4.3 Typology for Providing Rural Finance

As discussed before, we can divide China's rural financial institutions into the following categories:

1. Regulated banks (see 4.1).
2. Semi-formal RFIs, RFIs under the supervision of government departments (rather than CBRC and PBOC), including NGO microfinance, MCCs, village community funds, financial leasing companies (those under the Ministry of Commerce), and credit guarantee companies (under financial offices).
3. Unregulated institutions and individuals undertaking rural financial services, including P2P companies, some township or village credit cooperatives unlicensed for doing financial businesses, and moneylenders.

China's agricultural policy bank, ADBC, is mainly responsible for providing financial support, including loans for agricultural procurement, especially the procurement of grain and other key agricultural products, to ensure China's food security. ADBC also provides loans for agricultural development, usually in a large size.

Commercial banks in China can be divided into the following five categories: (i) large state-owned banks (the Big Four and the Postal Savings Bank of China); (ii) joint-stock banks with branches across the country; (iii) CCBs; (iv) RCCs, many of which have been converted into rural commercial banks (RCBs) and RCOBs after a number of reforms; and (v) new VTBs. In terms of regulation and management structure, RCBs and RCOBs remain part of the RCC system. The major difference between an RCC and a VTB lies in each VTB's sponsorship by a qualified commercial bank with not less than 20 percent (more recently, 15 percent) of the shares.

Category I banks in China usually have a national headquarters with provincial divisions and branches at the prefecture (*shi*) and county levels. Compared with the Big Four, PSBC is a new bank whose lending license was granted only in 2007. So, PSBC has neither a client base of borrowers nor a base of experienced credit officials. But, with its postal savings network, PSBC has branches all over China and has more branches at the rural county and township level than any other big bank in the country. Category II (second-tier) banks have a similar organizational structure, but the distribution of their branches is heavily biased toward more developed urban areas: most branches are in metropolitan areas and provincial capitals, and there are few branches at the county level.

Compared with Category I and II banks, Category III–V banks have a much smaller scale, in terms of their capital base, total deposits, and loan portfolios. Moreover, these banks have a simpler organizational structure, with a head office and branches concentrated in a city or a county, allowing them to make quick decisions. Finally, these banks have more connections with local enterprises while the bigger banks have lent more to large SOEs. The CCBs, as their name suggests, are located mainly in urban areas, mostly in provincial capitals and prefecture-level cities. Geographic restrictions are applied to RCCs and VTBs to ensure that these banks serve the rural areas and farmers. Most RCCs and almost all VTBs can operate only within a county. But, some RCBs have been granted licenses to operate across regions. RCCs have been the major supplier of rural financial services in China.

Unregulated RFIs in China are not allowed to provide deposit and money transfer services, so these institutions have mainly focused on the provision of rural credit services. NGO MFIs have focused their lending mainly on poor rural areas while microcredit companies have targeted mainly small and medium enterprises in China's urban areas. Village community funds are revolving funds at the village level.

As far as rural financial innovations are concerned, China's regulated RFIs have been innovative in the use of new technologies, especially the mobile phone and Internet, to develop new financial products

and services, with a focus on deposits, money transfer, and payment services. Small and medium-size banks have also been active in developing new lending products to serve SMEs under the competition from large banks. Unregulated RFIs have developed lending products tailored to the demand from rural communities and households.

4.4 Capacity of the Rural Financial Institutions in China

Overall, regulated RFIs in China have a strong capacity in delivering domestic remittance and deposit services to rural enterprises, communities, and households compared with FIs in many other LDCs. PSBC has been in a leading position for the provision of rural remittance services, including services to the migrant workers across China, given its vast branch network and the impressive banking infrastructure for providing such services. Other regulated RFIs, including ABC and RCCs, have also done well in providing rural savings and remittance services. The new types of RFIs, such as VTBs, have been weaker in providing savings and remittance services given their scale and a lack of the branch network for providing such services. Unregulated financial institutions in China are not allowed to provide deposit and remittance services.

Among all regulated banks, RCCs have been a leader in providing rural lending services, especially services to rural enterprises and individual households. RCCs in many areas of China, especially China's remote and poor areas, however, still have difficulties in accessing small rural households because of the high transaction costs and high risks associated with micro loans for farm production and consumption by rural households. Moreover, there has been a shortage of loanable funds for MSEs in off-farm activities in China's rural areas, including the large county-level township, though more and more RCBs in China's eastern and central areas have applied microfinance techniques to improve such services.

Agricultural chain finance has become more and more important as the government is actively promoting agricultural industrialization (enlarging farm size and promoting specialized farm production and marketing to achieve economies of scale). Many regulated and unregulated financial institutions in China have difficulties in assessing the risks and returns associated with loans for large-scale farm production, processing, and marketing.

The provision of agricultural insurance services has been a weak link in China's rural financial system. Up to now, agricultural insurance in China has been heavily dependent on subsidies from both the central and local government. More seriously, the demand for agricultural insurance services has been weakened by low compensation from service providers, even with the increased subsidies from the government. In general, regulated RFIs in China do not provide agricultural insurance services.

MCCs at the current stage should not be regarded as RFIs as most of them target mainly the SMEs in urban areas. With the investment from private capital, most MCCs have neither incentives nor techniques to do real micro- or agricultural lending.

NGO MFIs have been active in doing rural micro-lending for poverty reduction. The capacity of most of these institutions in providing sustainable rural lending services has been paralyzed, however, by their institutional weaknesses (such as problems with their governance structure, interference from local governments), high operational costs associated with the small scale of operation, shrinking external fund support, and uncertainties about the future for NGOs for operating loan programs in China. The social enterprise model advocated by CFPA MF and the Yiming MCC in Yanchi of Ningxia Hui Autonomous Region, which combines a clear objective market with corporate management and finance as well as a focus on operational scale, has shed some light on the development of NGO microfinance for poverty reduction in China.

Considering that RCCs have been converted into RCOBs and RCBs, the development of real savings and credit cooperatives in China remains at an early and pilot stage. To the authors' knowledge, CFPA MC

has conducted a cooperative finance pilot in IMAR and another pilot has been conducted by a group of practitioners in Jilin, Shandong, and Henan provinces. VCFs sponsored by LGOP and MoF on the whole should not be regarded as credit cooperatives. Most VCFs (revolving poverty funds) are managed by village officials. However, some VCFs could be converted into credit and savings cooperatives operating at the village level.

With reference to agricultural development and poverty alleviation, technical support and capacity building could be provided to RCCs (including RCBs and RCOBs), NGO MFIs, and VCFs and others to strengthen their capacity for agricultural support and poverty reduction. The capacity building could focus on agricultural lending, including agricultural chain finance, rural consumption loans, and cooperative finance at the township and village levels.

CHAPTER 5

Detailed Study of Rural Finance Best Practices

Case 1. Small and Thin Membranes, Huge Impact – The Case of CRCB

1. An Introduction to Chongqing and Chongqing RCB

As a provincial-level municipality directly under the central government, Chongqing has 38 districts and counties, of which nine districts are located in the metropolitan area. Different from other large municipalities of Beijing, Shanghai, and Tianjin, Chongqing has a higher percentage of rural and poor population. The municipality has more than 8,400 rural villages and more than 10 million rural people out of a total population of 34 million. The municipality also has 14 poverty-stricken counties.

In a field visit to CRCB by the mission in December 2014, the staff from the IT, individual banking, and rural and agricultural banking departments and a division chief from Chongqing CBRC in Chongqing were interviewed. The mission also visited Hechuan, a rural district under Chongqing. A brief note on the visit is presented in Annexure 1.

As the largest RCB in China, Chongqing Rural Commercial Bank (CRCB) was created in 2008 by merging all the RCC county unions in Chongqing, a provincial-level mega-city in China. CRCB went public on the Hong Kong Stock Exchange in 2010 and became the first listed RCB on the market. In the same year (2010), the bank also set up three village banks in Jiangsu, Sichuan, and Yunnan provinces. In 2015, the bank opened up a branch in Qujing District of Yunnan, and set up more village banks outside Chongqing. At the end of 2014, CRCB had one division bank, 15 branches, and 1,775 sub-branches, with a workforce of more than 16,000. By the end of September 2014, the bank's total assets exceeded RMB 600 billion, with its total deposits standing at more than RMB 400 billion and loans outstanding at RMB 530 billion. The non-performing loan ratio was maintained at within 1 percent. The bank was awarded "China's best rural financial institution" by the U.S. Global Finance Magazine in 2013.¹⁹ CRCB has made efforts to support agriculture and the rural economy in Chongqing.²⁰ According to Chongqing CBRC, CRCB has 1,775 branches and offices, more than all the big five added together in Chongqing.²¹ Chongqing is a mountainous region, and the transaction costs are high for both the banks and their rural clients.

2. The Innovations in Mobile Banking

CRCB launched its mobile banking product "Jiangsu Mobile bank card" in June 2011. The mobile phone product of CRCB is mainly a technological innovation focusing on product delivery. It aims at reaching out to a large number of clients, especially rural clients. As shown in Annexure 1, the bank provides clients with a membrane, which sticks to an existing mobile SIM card.²² The back of the card shows that Fangfutong, an IT support company, provides technical support. The mobile product as a SIM application

¹⁹ See CRCB website, <http://www.cqrcb.com/1894789617550846/index.htm>, For CRCB's English website, see <http://www.cqrcb.com:85/5303883415897488/1507171159097908/index.htm>

²⁰ For the details on the bank's operation in rural areas and agriculture, please see: <http://www.cqrcb.com/1894789617550846/5117586635553535/5085745408553548/2014/1196341536465114.htm>

²¹ According to the introduction by Mr. Tang, the division Chief of Chongqing CBRC.???

²² Here, the membrane is a thin, pliable sheet.

can be found under Phone in Settings. After the membrane is installed in her mobile phone, a client is able to perform the following bank functions through her phone: account balance inquiry, account transfers, remittance (inter-bank to all banks in China), account payments, and credit card repayments.

The mobile phone product has the following merits:

- *Easy access and cheap to use; thus, deep outreach to rural communities:* Using the communication system of mobile phone messages, the product can operate without an Internet connection, so it can reach a vast region and cover a large rural population, especially in the remote and mountainous regions of Chongqing. It is also cheap: even the very basic mobiles in China have message functions and mobile service providers usually do not charge, or charge very little, for mobile messages.
- *Safety:* The product is physically separated from the mobile phone parts and the Internet, so it is immune to cyber-attack and virus infections.
- *User-friendly:* A farmer with an advanced primary school or middle school education (6-9 years of school) generally has no difficulties in using the product. A client can select the menu, similar to the messages, and can learn to use the product quickly.
- *Quick instalment:* A bank staff member can install the membrane into a mobile phone in 1-5 minutes over the bank counter.

CRCB has actively promoted mobile phone products since 2011. Bank staff traveled to Guangdong and Guangxi in southern China and Inner Mongolia Autonomous Region in northern China to promote the new product to the migrant workers from Chongqing. The bank has also actively promoted it in Chongqing, using festival times when migrant workers visit their families and relatives. There was a clear shift of the promotion emphasis into rural areas in 2013.

The product was developed jointly by CRCB and Shanghai Fangfutong Service Company, an IT company based in Shanghai. More than 40 city and rural commercial banks in China have developed similar mobile banking products with IT support from Shanghai Fangfutong, including more than 10 provincial-level RCC federations in Hubei, Hunan, Jiangxi, Anhui, and Shandong. Some of these banks started to develop their own products following their study tours to CRCB. The IT company in Shanghai is able to tailor its membrane products to different requirements.

3. An Analysis of the Innovations

We use the general framework of the triangle of outreach, sustainability, and impacts applied by Myers and others to analyze the effects of the innovations on mobile banking by CRCB.

C1. Meet the ever-growing demand for banking services

The growth in overall bank transactions and in mobile phone transactions in terms of both volume and value from 2010 to 2014 is presented in Table 5.²³ Table 5 also has information on the share of mobile transactions in total CRCB transactions. The composition of the CRCB transactions is presented in Table 6, Figures 1 and 2. Of all the CRCB transactions, by value, more than half of the bank transactions have been money transfers, followed by cross-bank remittances. However, by volume, fee payments have accounted for about a quarter of the bank transactions. Apparently, from 2010 to 2014, the share of cross-bank money transfers grew from 18 percent to 33.8 percent by volume and from 55.1 percent to 46.8 percent by value, mainly at the expense of money transfers within the CRCB.

²³ In Table 5, the volume of transactions does not include balance inquiries. According to CRCB, the volume of balance inquiries through mobile banking was 1,163,514 in 2011, 10,990,408 in 2012, 53,660,809 in 2013, and 36,954,659 in 2014.

Table 5. The Volume and Value of Bank Transactions at CRCB, 2010-14¹

	Money transfers	Inter-bank transfers	Time to demand deposits	Fee payment	Repay credit card	Total
2010						
Total transactions (000) ²	3,970	951	0	0	0	4,890
Total value of transactions (¥ 000) ³	78,879	56,395	0	0	0	105,575
Value per transaction (¥)	198,714	586,735	0	0	0	515,583
Mobile/total transactions (%) ⁴	0	0	0	0	0	0
Mobile/total value of transactions (%) ⁴	0	0	0	0	0	0
Value/mobile transactions (¥)						
2011						
Total transactions (000) ²	7,535	1,356	8	1,555	50	10,141
Total value of transactions (¥ 000) ³	110,978	36,108	13	73	17	147,188
Value per transaction (¥)	153,458	566,594	15,930	478	8,497	145,148
Mobile/total transactions (%) ⁴	9.84	9.49	63.87	13.99	50.57	10.48
Mobile/total value of transactions (%) ⁴	0.80	0.98	61.93	1.50	8.54	0.85
Value/mobile transactions (¥)	15,508	57,653	15,446	51	3,404	11,818
2012						
Total transactions (000) ²	15,539	5,805	64	6,085	98	51,588
Total value of transactions (¥ 000) ³	115,383	45,815	146	83	515	161,638
Value per transaction (¥)	95,051	163,317	55,975	137	51,857	74,874
Mobile/total transactions (%) ⁴	49.51	50.39	94.59	60.76	55.54	55.80
Mobile/total value of transactions (%) ⁴	8.31	7.59	84.09	53.93	8.16	8.18
Value/mobile transactions (¥)	15,445	54,609	50,455	54	7,906	11,605
2013						
Total transactions (000) ²	51,511	11,059	195	11,098	195	44,055
Total value of transactions (¥ 000) ³	156,709	78,684	407	106	535	536,441
Value per transaction (¥)	75,851	71,343	50,865	96	57,894	53,706
Mobile/total transactions (%) ⁴	65.36	84.75	89.51	86.74	16.87	75.50
Mobile/total value of transactions (%) ⁴	16.40	19.95	91.43	56.39	9.60	17.70
Value/mobile transactions (¥)	18,579	16,770	51,313	65.14	15,869	15,593
By the end of Nov. 2014						
Total transactions (000) ²	56,680	50,950	589	13,465	304	61,655
Total value of transactions (¥ 000) ³	150,111	106,931	567	98	697	558,404
Value per transaction (¥)	45,019	51,114	19,653	75	55,938	37,046
Mobile/total transactions (%) ⁴	74	93	88	91	16	84
Mobile/total value of transactions (%) ⁴	31.57	56.59	87.95	93.35	8.96	59.04
Value/mobile transactions (¥)	18,983	14,379	19,557	74	13,508	15,769

Source: CRCB.

Notes: ¹ Transactions in this table do not include balance inquiries.

² Abbreviations: no. = number; tran. = transactions.

³ ¥: Chinese RMB, US\$ 1 = 6.4 RMB.

⁴ The share of mobile banking in total bank transactions.

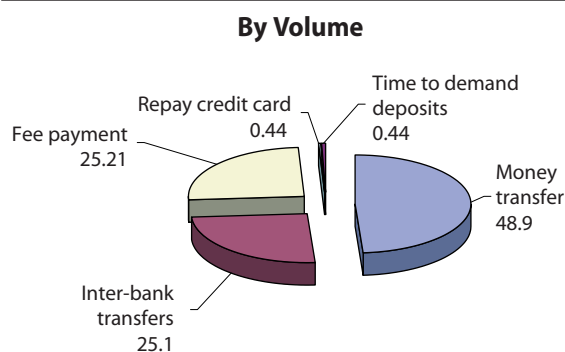
Table 6. The Share of Various Bank Transactions at CRCB, 2010-14, in Percentage¹

		Money transfer	Inter-bank transfers	Transfer time and demand deposits ⁵	Fee payment	Repay credit cards	Total
2010	By volume	81.5	18.8	0.00	0.00	0.00	100
	By value	74.9	55.1	0.00	0.00	0.00	100
2011	By volume	71.3	13.4	0.08	15.04	0.19	100
	By value	75.4	54.5	0.01	0.05	0.01	100
2012	By volume	58.1	13.0	0.59	58.17	0.46	100
	By value	71.4	58.3	0.09	0.05	0.13	100
2013	By volume	48.9	55.1	0.44	55.51	0.44	100
	By value	66.3	33.3	0.17	0.04	0.53	100
2014	By volume	43.3	33.9	0.47	51.83	0.49	100
	By value	55.6	46.8	0.55	0.04	0.31	100

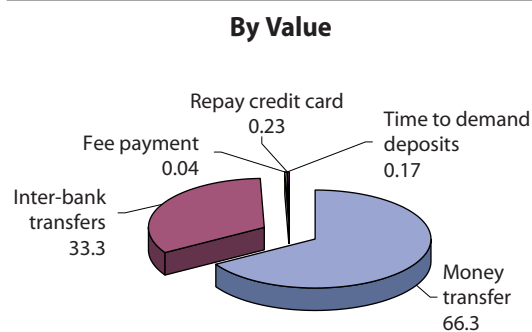
Source: CRCB.

Notes: ¹ Transactions in this table do not include balance inquiries.

² Transfers made by account holders between their time and demand deposits, for example, an account holder transfers money from her demand deposit account to her time deposit account for earning a higher rate of interest.

Figure 1. Share of Bank Transactions by Volume, 2013


Source: CRCB

Figure 2. Share of Bank Transactions by Value, 2013


Source: CRCB

Table 7 and Figure 3 indicate that, from 2010 to November 2014, the overall bank volume of transactions soared from 2011 to 2014.²⁴ They more than doubled in 2011 (5,055) and 2013, and grew by more than 40 percent by November 2014 (and are expected to grow by over 50 percent for 2014). By transaction items, the fastest growth was achieved by cross-bank money transfers, which more than doubled in 2012 and tripled in 2013 and had increased by a massive 90 percent by November 2014. The growth in fee payments tripled in 2012 but has decelerated since then.

Mobile banking has been mainly responsible for the jump in bank transaction volume. As shown in Table 5 and Figure 4, by volume, the share of mobile in total transactions soared from 10.5 percent in 2011 to 84.5 percent in November 2014. By value, the ratio also jumped, from 0.9 percent in 2011 to 59 percent in November 2014. According to CRCB, of all mobile banking users at CRCB, about 80 percent are rural clients. CRCB has attributed the rapid growth in mobile transactions to the attraction of mobile products to its clients, especially rural clients, and the promotional campaigns undertaken by the bank, especially among migrant workers.

²⁴ Here, total bank transactions exclude account balance inquiries and credit card payments, which are negligible in total CRCB transactions.

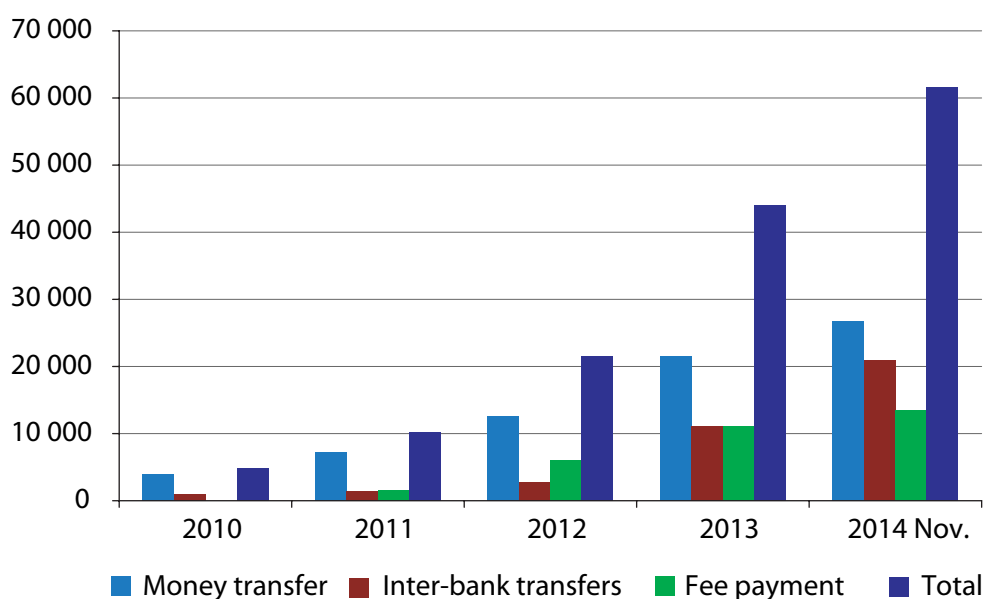
Table 7. Growth in the Volume of Bank Transactions at CRCB, 2010-14 (000)

	Money transfer	% ¹	Inter-bank transfers	% ¹	Fee payment	% ¹	Total	% ¹
2010	3,970		951				4,890	
2011	7,535	85.5	1,356	47.3	1,555		10,141	107.4
2012	15,539	73.4	5,805	106.9	6,085	598.9	51,588	115.9
2013	51,511	71.6	11,059	593.5	11,098	85.5	44,055	103.9
2014 Nov.	56,680	54.0	50,950	89.7	13,465	51.3	61,655	40.0

Source: CRCB.

Note: ¹ Percentage growth over the previous year.

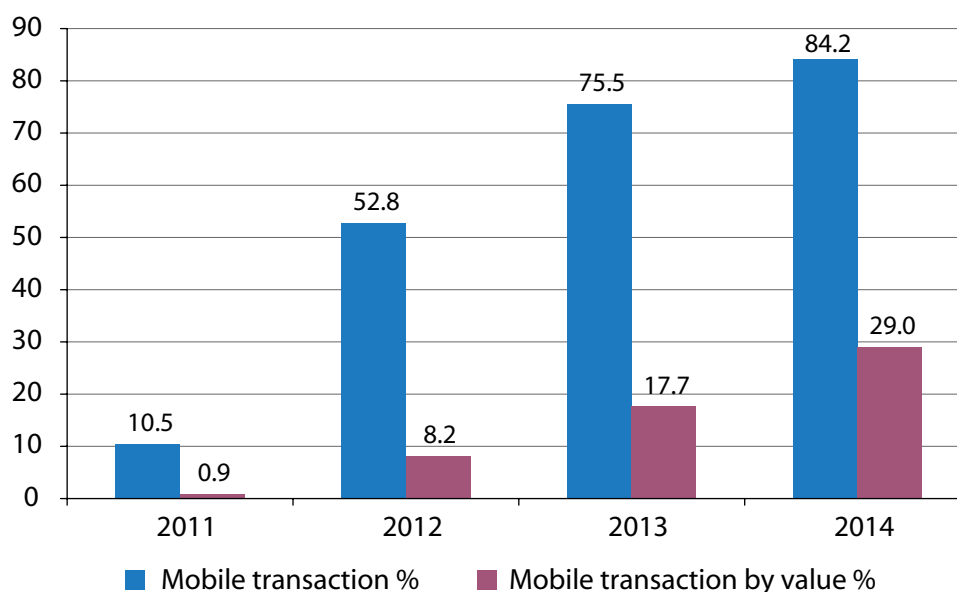
Figure 3. Volume of Bank Transactions in CRCB, 2010-14 (000)



Source: CRCB

Figure 4. The Rapid Growth in Mobile Banking Transactions, 2011-14

(as % of total bank transactions)



C2. Outreach to the small farmers and the poor in rural areas

Mobile banking automatically targets small transactions and the rural poor. Table 8 and Figure 5 show that, compared with all bank transactions, the average value of mobile transactions has been significantly lower.

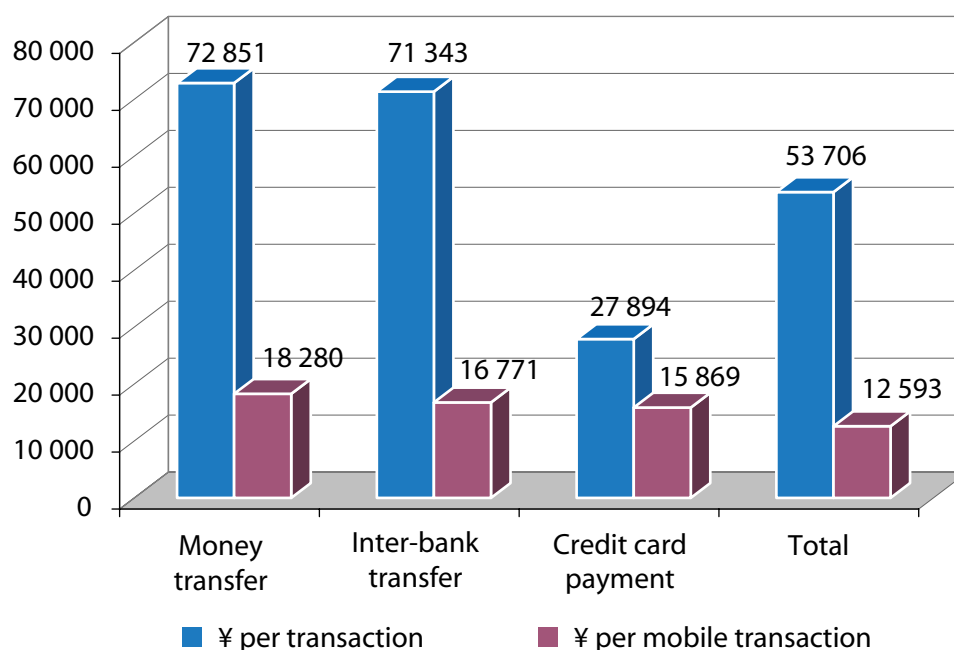
As shown in Table 8, up to 2013, the value per mobile transaction is about one-quarter of that for all bank transactions for money transfers and cross-bank money transfers, two major bank transactions of CRCB. In 2014, the ratio jumped to 45 percent for money transfers and remained at 58 percent for cross-bank money transfers. For fee payments, the disparity between the two has been very minor. It is important to note that about 90 percent of fee payments have been made through mobile banking. The low value per mobile transaction indicates that the mobile product has targeted small rural clients. This is confirmed by our field visit in Hechuan: mobile payments for the village elderly made by the villager woman interviewed were in a small amount, usually RMB 50-200. According to the CRCB staff at the district branch and township sub-branch, migrant workers have used mobile phones mainly for remitting their money home and for shifting money from their demand deposits to time deposits for higher returns. Many rural households have benefited by remitting money to their children at universities and high schools. The rural households and the poor have also benefited from paying mobile fees and other service fees through their mobile phones.

Table 8. The Value of Mobile vs. Other Transactions at CRCB, 2010-14 (RMB)

	Money transfer	Inter-bank transfers	Fee payment	Total
2010				
Average value/transaction	198,714	586,735	0	515,583
Value of mobile transactions				
Value of mobile/total transactions (%) ¹				
2011				
Average value/transaction	153,458	566,594	478	145,148
Value of mobile transactions	15,508	57,653	51	11,818
Value of mobile/total transactions (%) ¹	8.5	10.4	10.7	8.1
2012				
Average value/transaction	95,051	163,317	137	74,874
Value of mobile transactions	15,445	54,609	54	11,605
Value of mobile/total transactions (%) ¹	16.8	15.1	39.4	15.5
2013				
Average value/transaction	75,851	71,343	96	53,706
Value of mobile transactions	18,580	16,771	65	15,593
Value of mobile/total transactions (%) ¹	55.1	53.5	65.0	53.4
2014 Nov.				
Average value/transaction	45,019	51,114	75	37,046
Value of mobile transactions	18,983	14,379	74	15,769
Value of mobile/total transactions (%) ¹	45.5	58.1	105.1	34.5

Source: CRCB.

Note: ¹ The ratio of the value per mobile banking transaction to the value per transaction.

Figure 5. The Value of Mobile vs. Other Transactions at CRCB, 2013 (RMB)


C3. Impact on the clients

Chongqing is a poor municipality directly under the central government compared with the other three, Beijing, Tianjin, and Shanghai. The average income per rural capita in Chongqing is even lower than that for all of China (Table 9). With support from the central government and bank regulators (such as tax concessions and agricultural on-lending), rural financial institutions in China, mainly RCCs, have been assigned a responsibility to support three agricultural activities (*san-nong*), namely, farm production, farmers, and rural economy. According to our understanding, as a listed company, CRCB has also provided more support to its rural clients, including migrant workers and poor farmers, from the perspective of corporate responsibility.

Table 9. Net Income per Capita in Chongqing and All China, 2010-13

Year	Net income per rural capita Chongqing		Net income per rural capita China		%
	RMB	US\$	RMB	US\$	
	4,650.00	751.50	5,153.50	837.90	89.7
2010	5,576.66	858.00	5,919.00	965.40	89.1
2011	6,480.41	1,053.70	6,977.30	1,134.50	95.9
2012	7,383.57	1,500.50	7,916.60	1,587.30	93.3
2013	8,335.00	1,354.80	8,895.90	1,446.50	93.7

Source: Statistical Yearbook of China, 2010-2014.

First of all, CRCB has exempted all fees for mobile transactions that have targeted mainly its rural clients, including cross-bank remittances. We calculated the savings by its clients for cross-bank money transfers only and the results are presented in Table 10. Apparently, for cross-bank remittances only, the clients of CRCB, mainly migrant workers and their families, saved more than RMB 18 million in 2013 and more than RMB 39 million in the first 11 months of 2014. The figures for savings provided by CRCB mobile banking services are very conservative estimates as the shadow unit RMB 5 is the minimum charge by PSBC in China, which has been the largest provider of remittance services for migrant workers in

Table 10. Estimates of Fee Savings by CRCB Clients on Mobile Remittance, 2011-14

	No. of mobile cross-bank transfers	Shadow unit cost ¹	Shadow costs
		RMB	RMB (000)
2010	0	5	–
2011	158,646	5	557
2012	1,413,537	5	5,857
2013	9,344,365	5	18,689
2014 Nov.	19,555,809	5	39,106

Source: CRCB.

Note: ¹ The unit cost is based on the minimum charge on a cross-bank money transfer by PSBC at the end of 2014.

China,²⁵ and we did not include the fee cost savings by using mobile banking for fee payments, money transfers within CRCB, and other mobile banking services.²⁶ The decision on waiving fees for mobile banking by CRCB is based on a number of considerations, including the target client groups of the product, sales strategies, and competition pressure from other banks.

Second, the use of mobile banking services has saved costs for bank clients, mainly its rural clients, for doing bank transactions over the counter. Our field work in Chongqing indicates that the provision of mobile banking services not only saved the fee payments of bank clients for their banking transactions, mainly for cross-bank money transfers, but also reduced their other costs in banking, mainly the costs for rural clients to travel to bank branches (or sub-branches) and the time spent on travel and banking at the counter in a sub-branch. We estimated the savings mainly by the rural clients of CRCB (80 percent of all mobile users) and presented the results in Table 11. Based on a conservative estimator of the unit cost per bank transaction, the cost savings by CRCB clients, mainly rural clients, by using mobile phone services in terms of transportation costs, meals, and time spent on travel and over-the-counter banking transactions jumped from RMB 175 million in 2012 to RMB 355 million in 2013, and further to RMB 493 million in the first 11 months of 2014.

Table 11. Estimates of Cost Savings by CRCB Clients on Mobile Transactions, 2010-14

	Money transfers ¹	Inter-bank transfers ¹	Fee payment ¹	Total ¹	Cost per transaction ⁵	Total costs saved
					RMB	RMB (million)
2010	3,970	951		4,890	8	39.1
2011	7,535	1,356	1,555	10,141	8	81.1
2012	15,539	5,805	6,085	51,588	8	175.7
2013	51,511	11,059	11,098	44,055	8	355.5
2014 Nov.	56,680	50,950	13,465	61,655	8	493.5

Source: CRCB.

Notes: ¹ Number of transactions.

² The cost per transaction is based on the following conservative estimation: the average costs of transportation for a rural client traveling to the bank sub-branch: RMB 50 plus RMB 4 for a meal divided by 3 = (50+4)/

³ We divided the estimated total cost per travel by 3 based on the following consideration: (a) 80 percent of the mobile clients are rural clients; for urban clients, the costs for banking at a branch are much lower; (b) in many cases, while a rural client travels to a township, she (he) may perform more than one duty, such as banking and shopping. CRCB's estimation of the cost per transaction for a client is RMB 10.

²⁵ For remittance services for migrant workers in China, see Enjiang Cheng and Xu Zhong (2007).

²⁶ One reason we did not estimate the fee savings for other services is that some banks in China charge for intra-bank money transfers and fee payments while other banks do not.

Box 1. Three women clients at the sub-branch in Hechuan

Client 1: A middle-aged woman (around 50) who is a high school graduate and her family have 3 mu of land. Her village has 1,560 households and 3,700 people, merged from three to four villages with 1,400-1,500 people outside as migrants and their families. Village people cannot deposit or withdraw money in the village. There is no primary school and only a small shop. It is 10 km to the township center, costing RMB 30 by motorcycle. There is a market fair on three days, where they do marketing and withdraw money for the parents' pension (DI-BAO) at about RMB 90 per month.

She started to use mobile banking in 2012 and regularly sends RMB 1,000 per month to her son (who had an account with ABC), a student at the university. She helps to pay mobile phone service fees for her fellow villagers, and helps about 15 old villagers to pay their mobile phone service fees. For cable TV, the company will collect the fees in the village. For the payment of electricity and telephone bills, the people pay with mobile banking or sign an agreement with the supplier and CRCB for direct deduction from their bank accounts.

The other two clients have also used mobile banking mainly for paying mobile phone service fees and for money transfers. All of them are pleased with the service provided.

Third, indirectly related to the use of mobile phone services, the clients of CRCB have also benefited from a subsidy provided by CRCB on cross-bank money transfers. From 2009, CRCB has reimbursed migrant workers and other clients for the fees they paid to other service providers for transferring money into their CRCB bank accounts (cross-bank money transfers). The subsidies went up from RMB 407 million during 2009-12 to RMB 351 million in 2013 and RMB 385 million in the first 11 months of 2014.

C4. Sustainability of the banking operations

On the whole, the benefits of using mobile banking outweigh the costs, CRCB has benefited from the introduction of the mobile banking product despite the high costs for introducing the product initially. First of all, the launching of the mobile product has helped the bank to increase its deposits, especially savings deposits from rural households and migrant workers. Continuous deposit growth is crucial for the bank's performance (profitability and growth) in China, considering the large interest spread in China compared with other countries. The average deposit rate in China (average time deposits and demand deposits) is below 5 percent and RCCs can lend to their rural clients at 9-11 percent and to other clients at up to 15-18 percent. RCCs can also simply re-deposit their deposits in PBOC for a 3 percent spread or lend to PBOC's money markets at an even higher interest spread with no risks. During the field work in Hechuan, the author was told that the increase in deposits is the most important performance assessment indicator for the bank branches and sub-branches, which is consistent with many other banks in China.²⁷

As shown in Table 12, compared with the rest of the RCC system in China, CRCB has enjoyed a faster growth in its savings deposits. The ratio of CRCB to all China RCC savings deposits moved up steadily from 3.54 percent in 2009 to 5.75 percent in 2014, an increase of 5.51 percentage points (ppt), whereas, in the same period of time, the net income per rural capita in Chongqing was consistently lower than that for all China, between 89 percent and 94 percent of the income in all China (see Table 9).²⁸

²⁷ As a side note, the interest rate for CRCB's WMP is at 5.6%.

²⁸ Note that only a small proportion of RCCs in China have introduced similar mobile phone products.

Table 12. Rapid Growth in CRCB Deposits, 2009-14 (RMB million)

Year	CRCB savings deposits	Savings deposits, all RCCs in China ¹	CRCB/all RCC deposits	Annual increase
	RMB (million)	RMB (million)	%	ppt ⁵
2009	116,903	3,305,300	3.54	
2010	145,106	3,774,000	3.84	0.30
2011	177,898	4,506,100	4.53	0.38
2012	515,388	4,755,100	4.56	0.33
2013	556,130	5,143,500	4.98	0.45
2014	598,876	5,505,300	5.75	0.77

Source: CRCB.

Notes: ¹ All RCCs in China cover all the RCC unions, RCBs, and RCOBs.

² Percentage point change.

Second, the costs of using the mobile phone product to the bank have declined over time. As shown in Table 13, although the annual investment in mobile banking by CRCB has gone up over time, the unit cost per mobile transaction dropped from RMB 7.03 in 2011 to RMB 0.89 in 2014. Moreover, based on the estimation by CRCB, the bank saved RMB 18 million in 2013 and 35 million in 2014 through mobile phones over counter transactions, with the same volume of bank transactions. When we compare the bank's investment in mobile phones in Table 13 with the cost savings to bank clients in Table 11, the benefits of using the mobile phone become much more apparent. More importantly, without the wide use of mobile banking, CRCB would have to set up more bank branches and sub-branches in order to reach out to remote rural communities under the guidance of the government and CBRC. The costs to establish new sub-branches in the remote mountainous areas are huge.

Table 13. The Investment and Cost Savings by Mobile Banking with CRCB, 2009-14

	Investment in mobile banking	No. of mobile transactions	Unit costs to CRCB	Average cost for remittance at counter ¹	Average estimated cost per transaction ²	Cost savings
	RMB (million)		RMB	RMB	RMB	RMB (million)
2011	7.69	1,094,650	7.03	3	1.5	-6.05
2012	35.51	11,609,795	3.03	3	1.5	-17.80
2013	35.86	33,915,080	0.97	3	1.5	18.01
2014	46.85	55,555,590	0.89	3	1.5	31.98

Source: CRCB.

Notes: ¹ Estimation by CRCB.

² Estimation by the authors based on the bank estimation. In general, transactions such as bill payments cost less to the bank than cross-bank remittances.

Third, the use of mobile banking has prepared CRCB for its progress with Internet banking, which is expanding rapidly in China, under the pressure of the new third-party payment system (*zhifubao* or Ali-pay in English, the world's largest third-party payment system, which can be used to pay for water, power, gas, traffic fines, cable TV fees, train tickets, etc.). By November 2013, the mobile users of Ali-pay exceeded 100 million accounts in China, by December 2013 the number of accounts exceeded 300 million, and payments in 2013 totaled more than RMB 900 billion.

Finally, CRCB has achieved other cost savings by promoting mobile banking, such as the savings in the use of paper, energy, and transportation equipment, making the bank's operation greener.

Areas for Improvement and the Next Step

With its well-functioning mobile services, CRCB has gained a bigger clientele in rural areas. CBRC plans to provide more loan services to these clients, potentially linking the loan services to IT solutions. CBRC also would like to provide cash services to these clients, possibly through shops and other agents. Solutions for these new services are available in other countries.

In terms of mobile banking, CRCB would like to improve the current mobile banking services and integrate mobile banking with other electronic banking services, such as Internet and *weixin* (or wechat banking). The bank planned to launch its mobile banking program for its micro- and small enterprise clients at the end of 2014 and in the beginning of 2015.

Our investigations in other parts of China indicate that demand has been rising for loans from farmers for scale farm production following the development of agricultural value chains in recent years. Moreover, the consumption demand from rural households for loans has been high even in China's poor rural areas. As more farmers are moving into large townships and county seats, demand has been increasing for loans for off-farm production and investment. CRCB could further strengthen its lending for farm production, processing, and marketing, and provide more loans for rural consumption and to off-farm micro-enterprises in rural areas.

To further improve its services to rural clients in more remote and mountainous areas, CRCB would like to improve its cash services (for rural households to deposit and withdraw cash in their villages and then travel to the sub-branch in a township). The installation of an ATM in the village is expensive, however, and it is also very difficult to maintain the ATM. Another option is to provide cash services through village agents such as village shops.

Case 2. Sustainable Micro loans to Small Farmers – The Case of CFPA MF

1. Introduction

CFPA MF grew out of a pilot microcredit program under a World Bank-funded anti-poverty project in the Qingba mountainous area started in 1996. CFPA MF has developed in the following three main phases: (i) pilot stage (1996-2004), (ii) innovation stage (2005-09), and (iii) transformation stage (after 2009). At the end of 2008, CFPA's microfinance department split from the China Foundation for Poverty Reduction²⁹ and the CFPA Microfinance Management Co. was born.

CFPA Microfinance is by far the largest not-for-profit microfinance institution in China. It provides microcredit services to vulnerable populations in underdeveloped areas. By the end of 2014, CFPA Microfinance had 141 branches and subsidiaries across 16 provinces of China. Since 1996, it had disbursed a total of RMB 8.437 billion in 938,006 micro loans to rural clients, with an average loan size at RMB 8,996. The loan portfolio at the end of 2014 was RMB 1.879 billion, with 237,817 active clients. Statistics show that 89 percent of CFPA Microfinance clients were previously unable to borrow from traditional financial institutions; among these, more than 93 percent are females.³⁰

Recently, CFPA Microfinance has made an effort to raise its capital so as to serve more rural people and poor. In January 2015, CFPA MF raised about RMB 500 million from China's Shenzhen Exchange through its loan assets securitization. The company has also raised loan funds by launching a P2P program.

²⁹ Founded in 1989, CFPA is a not-for-profit organization dedicated to national development and poverty reduction. It has been awarded Class 5A status NGO by the Ministry of Civil Affairs and is regulated by the LGOP (Class 5A NGO is the highest rating for NGOs in China). CFPA is the largest NGO working in poverty reduction in China.

³⁰ See CFPA MF website: www.cfpamf.com.cn.

According to the management, CFPA MF is ready to expand its products and services to micro-insurance and other financial products and services for the rural poor.

In its heyday, China had more than 200 NGO MFIs. Today, however, only 10 to 20 of them remain active. The growth of CFPA Microfinance suggests that, with proper management and support from the government and society, not-for-profit microcredit still has huge room to grow. In this brief case study, we document the process of development for CFPA MF and summarize the key lessons.

2. The Reforms in 2005

Prior to 2005, CFPA adopted a cooperative model for its microfinance program by cooperating with the county-level MFIs. CFPA contributed funding and technical and management services. But, as the county MFIs were controlled by the county government, CFPA found it difficult to manage and supervise the program and to standardize the microcredit products of the county MFIs. Loan quality declined in some counties and financial problems resulted. In 2005, CFPA launched an overall reform of its microcredit program. A single line of command was established between CFPA headquarters and the county MFIs (hereafter referred to as “county branches”), thereby giving the program unambiguous property rights and clear responsibilities, and allowing more efficient management. The program expanded its geographic scope from four counties in 2005 to 17 by the end of 2008 and was institutionalized following the creation of the CFPA Microfinance Management Co. With investment funds from the International Finance Corporation (IFC) and Sequoia Capital, CFPA Microfinance became a joint-venture company in January 2011.

For the county branches, 2005 marked an important year of reform. Besides clarifying property rights and responsibilities, the reform measures increased loan funds from the head office to the service branches, improved wages and benefits, and raised loan interest rates. In Zuoquan County, branch employee salaries more than doubled, from RMB 700-800 monthly before the reform to RMB 4,000-5,000 by 2008. The branches, like the other service branches, have also been providing their staff with endowment, medical, unemployment, employment injury, and maternity insurance since 2006. The reform measures likewise strengthened branch operating rules and regulations, as well as the information technology systems at the head office. Moreover, whereas CFPA Microfinance served only poor towns and villages before 2005 because of limited funds, it has since expanded its services to other towns and villages in the various counties.

3. Management of CFPA Microfinance

The company follows a management responsibility system under the supervision of its board of directors. The board has seven members—four from CFPA, one from the IFC, and two representing other investors. The company draws up 3-year development plans, updates each plan at the end of the year to reflect actual experience and prospects, and implements the updated plan after it is approved by the board of directors.

After the reforms in 2005, the head office became responsible for product development, fund use planning and allocation, credit management, and the recruitment, technical training, and supervision and monitoring of staff. The branches, on the other hand, disburse and collect loans according to rules issued by the head office.

The head office mostly provides credit management training, develops procedures and manuals for credit management (including the management of individual loans and group loans), and audits loans. It does not intervene in specific loan operations. Branches approve and collect loans, and deal with bad debts. The head office has been responsible for approving loans over a certain limit to control credit risks. In 2010, the head office independently developed an online credit tracking system. Loan officers are required to enter loan applications, approvals, disbursements, and collections into the system in real time.

Unlike other NGOs in China, whose county branches or institutions recruit loan officers and other staff, CFPA Microfinance, through its head office, takes a direct hand in recruitment, to ensure good-quality hires. The head office selects and oversees the performance of branch managers. Many of the present county branch managers are former government officials, who have retired from government service. Those selected for the position are good at coordination and familiar with the local situation and government operations. They are generally older and relatively less well educated but have a great deal of local experience and organizational skills, and communicate well with local officials. Such managers are invaluable to the rural lending operations of CFPA Microfinance. CFPA Microfinance signs contracts with the county branch managers, who then sign contracts with their staff at the branch and assume management responsibilities.

4. Loan Products and Services

CFPA Microfinance has three standard loan products: group (joint liability) loans, usually below RMB 12,000; individual loans, usually below RMB 50,000; and micro-enterprise loans, from RMB 50,000 to RMB 200,000. Group loans are the most important product of the three.

- **Group Loans**

CFPA Microfinance's group loans have targeted farmers in farm production and home consumption. The loans are used mainly for farm and off-farm income generation activities, like rural microcredit loans in other developing countries. The loan period ranges from 6 months to 1 year. One-year loans, with a 2-month grace period and repaid in 10 monthly installments, are most common. No collateral and no other guarantors, apart from the loan group, are needed. Before 2010, the nominal interest rate on the loans was 12 percent, and the actual rate was around 18 percent. Now, the interest rate is 13.5 percent nominal and the effective rate over 20 percent. Once the last installment is paid, clients can apply for another loan after a week. Some old clients qualify for a new loan after 3 days.

Group loan amounts have been increasing with rising farmer incomes, from RMB 1,000 in 1997 to RMB 8,000 in 2011, and finally to RMB 12,000 in 2012. The increase in loan amount also depends on the repayment performance of group members. If they repay their loans on time, then the group could obtain an upgrade in loan amount. No such upgrade is possible if there are late payments from one or more group members, but other members can still borrow.

- **Individual Loans**

The individual loans and micro-enterprise loans of CFPA MF are based on cash flow analysis,³¹ which is similar to the individual loans disbursed by city and rural commercial banks in China discussed in Case 3 of this report.

At the beginning, the loan officer prepares a simple balance sheet and income statement after the client investigation, and examines and gathers information about the guarantor. Then, the loan officer sends electronic files with the client's information to the members of the loan approval committee. The files include the application form, the loan approval form, and the client's balance sheet and income statement. The branch staff conduct phone interviews with the client and the guarantor. With this information in hand, the branch holds a loan approval meeting. At the meeting, the loan officer states the purpose of the loan, and the committee members discuss the loan application and the results of the investigation, and decide whether or not to approve the loan. If the loan is approved, the loan officer sets a suitable time and place for disbursement with the borrower, the other members of the loan group, and the guarantor, and asks them to ready their identification cards, both the original and a copy. The loan officer and back-office staff arrive at the agreed location on the appointed date to disburse

³¹ For cash flow-based lending, see Case 3, microfinance downscaling by city and rural commercial banks in China in this report.

the loan. The interest rate for individual loans is 24 percent higher than that charged by CCBs, RCBs, and the PSBC. But, CFPA MF clients have generally accepted the CFPA MF lending rate, as it is usually difficult for the formal banks to penetrate rural markets.

5. Analysis and Conclusions

The rapid growth of CFPA Microfinance as a poverty reduction microfinance institution, at a time when many other NGO MFIs experienced setbacks, can be attributed to its insistence on targeting small farmers in China's poor counties while promoting commercial microfinance operations. We summarize the following major success factors for CFPA MF:

- *Support from government agencies:* CFPA Microfinance is under the umbrella of the LGOP in China and it has support from the LGOP system throughout China; as an unregulated microfinance institution, CFPA has a semi-legal status to undertake microfinance operations in China. With a permit for microfinance pilot programs from the State Council's Leading Group Office for Poverty Reduction (LGOP) and PBC, CFPA Microfinance has access to the credit bureau service of the PBC.
- *Strengthened organizational structure and improved corporate governance:* While further strengthening the head office, CFPA Microfinance transformed county institutions into branches and directly hired branch managers. The head office hence gained more direct control over the branches, including fund management, cost control, and implementation of consistent standards and regulations. The transformation into a branch system enables the rapid growth of CFPA MF based on a chain model. The branch system of CFPA MF is in striking contrast with some other MFIs in China, such as the network created by the CASS. The transformation of CFPA from an NGO MF into a social enterprise with a clean ownership and governance structure, and joining of IFC and Sequoia Capital as shareholders, facilitated the sustainable growth of CFPA MF.
- *Improved staff management and incentives:* A common problem of non-profit MFIs in China is low salaries for workers and frequent changes in management by the county government. But, operating costs are not necessarily low. After the reform, CFPA Microfinance was able to pay the county staff higher salaries while keeping operating costs low, on the strength of rising interest rates and more efficient microfinance operations. CFPA Microfinance has also linked branch managers' salaries with loan officers' income and performance.
- *Improved products and services:* The company successfully improved rural group (joint liability) loans as its main product, efficiently controlling credit risk. At the same time, it pushed into individual lending to meet market demand. Now, individual loans account for 25 percent of loan disbursements and 10 percent of all loans issued by the company, and have boosted its profitability.
- *Partnership with formal financial institutions for wholesale funding:* CFPA Microfinance has accessed wholesale loans from a number of Chinese and foreign banks, including CDB, ABC, and standard and chartered banks. Outside financing has helped the company grow and enabled it to expand its operations. The company has also raised funds by asset securitization and P2P.

Some of the success factors above can hardly be replicated by other NGOs and rural financial institutions in China, such as its link with PADO and the network of CFPA across China's poor areas. However, the principle of commercial operations and management, including the application of a market rate of interest, incentives provided to its managers and staff, and the development of new financial products and services, could be easily adopted by similar institutions in China. The ownership and governance structure of CFPA MF can also be learned by other rural and microfinance institutions in China and elsewhere.

Case 3. Microfinance Downscaling by City and Rural Commercial Banks in China

1. Introduction

Around 2005, under the guidance of CBRC, China introduced the IPC model of microfinance based on cash flow analysis into China's small and medium banks, mainly city and rural commercial banks, to increase the access of MSEs (micro and small enterprises) to formal credit. By the end of 2014, it was estimated that more than 100 Chinese banks had adopted the model based on their own choices. The introduction of the model and its application in China have a profound effect on China's banking system and on MSE lending in China.

The IPC model of microfinance was introduced into China through a project sponsored by the World Bank and KfW. The China Development Bank (CDB), which was already in contact with the World Bank, was selected as the implementation unit. CDB provides microfinance technical support and wholesale loans to the participating financial institutions to improve their capacity for micro-lending.

The IPC model is centered on evaluating the capacity and willingness of clients to repay loans. The procedure for assessing loan repayment capacity includes field visits by a credit officer to understand the client's production, marketing, and fund flows, and to prepare financial statements for the client to harden soft data. During the field visits, the loan officer collects information on the purposes of the loan and on the client's assets and liabilities, income, profit and loss, cash flows, and sources of funds for loan repayments, according to IPC procedures. As far as willingness to repay loans is concerned, the IPC model uses soft data, such as personal reputation and credit history, to make judgments. For instance, the banks collect non-financial information about the client, pertaining to honesty, family relations, and reputation, and cross-check the information.

The city and rural commercial banks in China have conducted a number of institutional and management reforms to apply the model in China. First, many banks have set up special branches or departments responsible for piloting MSE lending. Second, the banks have usually created new incentive systems for recruiting and managing microfinance managers and loan officials. Finally, many of the innovations made in applying the model have been replicated to the overall management and operation of these banks, hence raising the overall banking efficiency in serving MSEs and rural people.

2. The Pilot Program

Before MSE lending models were introduced into China around 2004-05, Chinese banks had more lending to large and medium-size enterprises. Complicated organizational structure, centralized lending decisions, and a lack of proper credit techniques have been blamed for the failure of the banks to reach out to MSEs.

The China Development Bank Microfinance Project consisted of two closely linked components: (i) a credit facility for on-lending to eligible partner financial institutions (PFIs) and (ii) a technical assistance facility to support the capacity building of the CDB and the PFIs. After slow progress at the start, the pilot project quickly grew, and the model has since been tested and proven by at least 10 CCBs serving urban or peri-urban MSEs with an average loan size of RMB 100,000 (range: RMB 20,000-500,000) and non-performing loans below 1 percent of the loan portfolio (generally below 0.5 percent), and reaching breakeven point in 12-24 months. The technology is spreading to rural areas. The major events and activities during project implementation are summarized in Table 14. The project supported 12 Chinese banks (PFIs) to conduct MSE lending, including Maanshan Rural Commercial Bank.

Table 14. Key Project Implementation Dates

Nov. 2005	Project launch and a team of nine IPC experts arrived in China
Dec. 2005	First loan officers selected and first micro loan disbursed in Baotou
Feb. 2006	First version of loan processing documents prepared and tested
March 2006	Monthly disbursements exceeding 100 loans
Jan. 2007	CDB requested IPC to develop a strategy for mass outreach
March 2007	Monthly disbursements exceeding 1,000 loans
May 2008	<ul style="list-style-type: none"> • Monthly disbursements exceeding 3,000 loans • Outstanding portfolio exceeding RMB 1 billion
June 2008, April 2008	<ul style="list-style-type: none"> • IPC's assignment under the CMFP ends • CMFP MSE lending was launched at JZCB • Monthly disbursements exceeding 3,000 loans • Outstanding portfolio exceeding RMB 1 billion
May 2008	<ul style="list-style-type: none"> • GCB graduated from on-site technical support • MRCB graduated from on-site technical support
June 2008	<ul style="list-style-type: none"> • IPC's assignment under the CMFP ends

With consulting input from IPC, CDB provided on-lending and on-site TA support to the PFIs from December 2005 to 30 June 2008. The MSE loan disbursement and portfolios of PFIs increased over time. Monthly disbursements of micro loans exceeded 100 loans by March 2006, 1,000 loans by March 2007, 2,000 loans by September 2007, and 3,000 loans by April 2008.

3. Major Results

The quality of MSE loans disbursed by the PFIs was consistently excellent. The percentage of loans overdue for more than 30 days was less than 0.3 percent of the total loan portfolio, and well below the 3 percent level set in the project appraisal document. The project also put the average size of MSE loans under some control. The average loan size for the 12 PFIs was RMB 15,000 in 2005, RMB 52,857 in 2006, RMB 68,981 in 2007, and RMB 79,189 in 2008. For the six selected PFIs, the average loan size was RMB 110,561 in 2008-09 and RMB 118,370 in 2010. The increase in the average MSE loan size (in nominal terms) over time might partly explain the rapid increase in national incomes in China.

The following indicators are used here to measure the sustainability and profitability of the MSE operations of the PFIs: the breakeven month, the length of time (months) required for the MSE lending operations of PFIs to break even, the lending rate of interest, and the costs of the MSE lending operations. As shown in Table 15 for the six selected PFIs, on average, the MSE lending operations were projected to reach the breakeven point by the 11th month but three of them reached the breakeven point by the sixth month. Again for the six PFIs, on average, MSE lending was projected to cover its costs within 2 years. The participating banks reached the breakeven point for their whole MSE operations within a year, a remarkable result. Jiujiang Bank, the slowest of the six to reach the two breakeven points, has set a profit target of RMB 500,000 for each MSE loan officer. The commercial viability and profitability of the PFIs can also be demonstrated by their lending rates and the cost of providing the micro loans. The average lending rate of PFIs is around 14.6 percent, whereas the average total cost of providing the micro loans is around 4.5 percent. The 10-percentage-point difference is due to the low funding costs, low loan-loss provision due to good loan quality, and low staff costs.

Under the TA component, the project succeeded in transferring the MSE lending technologies to PFIs and in building the capacity of CDB and the PFIs. After the training provided by the consultants, CDB created a microfinance business unit, consisting of two special teams for MSE lending, with one team specializing in the evaluation and monitoring of commercial banks and the other specializing in the provision of technical support for PFIs. Two manuals were compiled by CDB: a project monitoring and

Table 15. Breakeven Months Required for the Participating Financial Institutions

	MSE startup ¹	Breakeven month ²	Breakeven month ³
Baoshang Bank	Dec. 2005	15	25
Taizhou Bank	Oct. 2005	6	12
Jiujiang Bank	Sept. 2006	27	33
Guiyang Bank	May 2007	7	14
Maanshan RCB	May 2007	6	14
Daqing Bank	July 2007	6	15
Average		11.2	18.8

Source: Field visits in China.

Notes: ¹ The month when the MSE lending operation started.

² The actual number of months required for the MSE lending operation to reach financial breakeven point.

³ The number of months required for the entire MSE lending project to reach breakeven.

evaluation manual and an MSE lending operations manual. CDB selected the 12 PFIs for the project implementation and has participated in the provision of technical support to these 12 PFIs.

The project's TA component has been singled out for positive comment by the PFIs. An overwhelming number have expressed the view that the TA component has been much more useful to them than the provision of wholesale loans, as the city and rural commercial banks in China have adequate low-cost funds. According to the PFIs, the two major contributions of the project were (i) the training provided by the consultants, and the selection and management of loan officers, and (ii) the systematic approach to MSE lending characterized by cash flow analysis.

The PFIs agreed that they benefited from the project in various ways. They

- learned MSE lending technology, as well as a systematic approach to micro-lending;
- used MSE lending technology in their small-business and agricultural lending;
- were introduced to a well-structured and efficient method of recruiting, training, and managing loan officers and other MSE lending staff;
- significantly increased their MSE lending market share and profits from MSE lending (some PFIs from zero), thus helping to build a good foundation for increased bank competitiveness in local markets;
- gained a diversified loan portfolio with reduced credit risk for the bank as a whole;
- achieved a good MSE client base, to which the PFIs provide not only MSE loans but also deposits and other financial services; and
- established their MSE lending reputation and brand in local markets, with local governments, and with bank regulators.

In summary, by participating in the project, most PFIs established or strengthened at least five major assets for their bank: (i) well-trained and experienced loan officers and middle-level managers in MSE lending, (ii) a good micro-lending client base, (iii) a good-quality micro-lending portfolio, (iv) an established methodology and system for micro-lending and training, and (v) a good reputation in MSE lending. Some PFIs have used these assets to develop their business further. For example, Maanshan RCB and TB have transferred and, in some cases, promoted trained and experienced MSE loan officers to other bank operations, especially small-business, corporate, and rural lending. Most PFIs have extended the micro-lending methodology, with certain modifications, to their other lending operations as well. Many PFIs have been able to provide their micro-lending clients with comprehensive financial services, including savings to raise the savings deposits of these clients. A couple of PFIs have used their reputation in MSE lending to expand their territory and establish new branches in other cities and provinces.

The information collected during the field work and communications with the PFIs, microfinance consultants, and others indicated that the project also had a profound impact on others beyond the PFIs. A number of bank leaders pointed out that what they gained most from the project was a change in their understanding of, and approach to, the overall lending operation and to the training and management of loan officers and middle-level managers. To them, this new understanding has been much more important than the introduction of a lending methodology alone.

The micro-lending technologies and management systems introduced by the project have been transferred to a growing number of microfinance institutions in China through the PFIs and consultants, many of whom were trained by IPC under the project. To the limited knowledge of the authors of this report, the following financial and non-financial institutions have hired former project consultants to provide MSE technical support in the past 2 years:

- Changchun Rural Commercial Bank (Jilin Province)
- Changshu RCB (Jiangsu Province)
- Chengdu Rural Commercial Bank (Sichuan Province)
- China Postal Savings Bank
- Dongying City Commercial Bank (Shandong Province)
- Jiaxing Rural Commercial Bank (Zhejiang Province)
- Jijin Rural Cooperative Bank (Jiangsu Province)
- Jingjiang Rural Commercial Bank (Jiangsu Province)
- Jining Bank (Shandong Province)
- Pingdingshan City Commercial Bank (Henan Province)
- Suqian Minfeng Rural Cooperative Bank (Jiangsu Province)
- Wuhan Rural Commercial Bank (Hubei Province)
- Xinyu Rural Cooperative Bank (Jiangxi Province)
- Zhangjiagang Rural Commercial Bank (Jiangsu Province)

In addition to the city and rural commercial banks, many MCCs and VTBs have received similar technical support in micro-lending. A number of project consultants have been employed as high-level or middle-level managers in charge of MSE lending operations by the banks. It is expected that more city and rural commercial banks and other MFIs will follow suit as the financial reforms deepen.

At the national level, the project impact can be understood from the following two perspectives. *First*, the implementation of the project among the 12 PFIs strongly indicates that micro-loans to urban and semi-rural micro-entrepreneurs and small enterprises in China can be provided in a commercially sustainable way. In other words, commercial financial institutions, especially the local banks, can benefit in terms of profit, local market share, and a diversified loan portfolio by providing MSEs with micro loans ranging from RMB 10,000 to RMB 500,000, without subsidies from the government. On the other hand, urban and semi-rural micro-entrepreneurs and small enterprises can benefit from the institutional micro loans, which provide them with increased working capital and funds for business expansion. *Second*, the universally accepted lending methodologies, such as the micro-lending methodology based on cash flow analysis that was introduced by IPC into China, can be applied elsewhere in the country, with certain modification. This shows the importance of international cooperation and mutual learning in China's banking and rural finance reforms.

4. Project Success Factors

The success of the project should be attributed, first of all, to the timing of the project and the market-oriented reforms in rural finance and microfinance undertaken by the government before the project. The success of the project can also be attributed in part to the selection of the PFIs. The World Bank and CDB selected mainly CCBs as partner institutions on the assumption that these banks were more likely to support MSE lending. It is mainly the small-scale and locally based city and rural commercial banks

that have developed their microfinance operations. It appears that, at least for the time being, the small banks are more likely to support MSEs. This theory has been endorsed by a number of economists in the country. The selection of IPC as project consultant also contributed to the success of the project. Many PFIs were impressed by the technique and performance of the IPC consultants, though some would have preferred to increase the scale of their micro-lending earlier. Many people interviewed agreed that most consultants from IPC were committed to their work and provided good training and technical support. The regulatory authorities in China, including CBRC and PBC, have been supportive of the PFI's MSE lending and showed themselves to be willing to accept or tolerate some PFI micro-lending practices that do not entirely conform to the current lending regulations.

For the PFIs, three factors were crucial for the success of the project at the institutional level: (i) a strong commitment to micro-lending operations from the board and top management, (ii) local market conditions, and (iii) the institutional setup and incentives for MSE lending within PFIs. The commitment of bank management and its vision, long-term goals, and patience were the most important factors in the successful implementation of the project at the bank level. Both BSB and TBTB, which have outperformed other participating banks, have demonstrated a strong commitment to MSE finance on the part of their top management. There are generally two kinds of internal institutional settings for banks in China to conduct micro loan operations: (i) to create a separate micro loan department (MSE department) to be responsible for designing micro loan product, loan policies, and procedures, and for monitoring and evaluating micro loan operations while the actual micro loan operations are conducted by the existing bank branches; (ii) to set up one or two new branches specializing in micro loan operations (usually called micro loan branches) and to restrict micro loan operations to those specialized micro loan branches. Most PFIs under the project have taken the first approach. Under CMFP, PFIs have been required to design an incentive package for micro loan officers and managers linked to the number of loans disbursed and managed and the loan quality to achieve the dual objective of outreach and sustainability for micro loan programs.

CHAPTER 6

Conclusions, Policy Recommendations, and Way Forward

6.1 Conclusions

The continuous income growth and urbanization in the last decades have resulted in dramatic changes in the demand for loans and other financial services in rural China. China's formal banking system has coped relatively well with the provision of savings, money transfers, and payment services to agriculture and rural communities and households in China. Marked progress has been achieved by the regulated RFIs in rural lending though more efforts are needed to outreach the lending services to small rural households, especially poor households, and to micro-entrepreneurs in urban fringe areas for off-farm activities.

Mobile banking is a pilot undertaken by CRCB, one of the largest RCBs in China. The mobile phone product developed by CRCB has had a mass outreach to rural people, including migrant workers, and it had a large impact on bank clients. CRCB itself has also benefited from the development of such a technological and product innovation, and the product is sustainable and replicable. In the mobile technology case, by appropriate pricing and marketing policies, rural low-income people can easily move to mobile phone-based services. This and the enlarged rural clientele serve as an excellent base for expanding the bank's services from money transfers and deposits to more advanced operations, which in China could immediately include IT-solution-supported rural loans and village agent-/shop-based cash services in remote rural areas.

CFPA MF is a semi-formal RFI unregulated by CBRC. Unlike its peers in China, CFPA MF has enjoyed significant growth in its assets, loans, and geographic coverage driven by the organizational reforms, and improved in its governance structure and promotion of new products and services. A key lesson behind the success of CFPA MF is its commercial operation while sticking to its focus on the rural market. A key conclusion worth emphasizing is that, in China and most other countries of the region, there is room in the rural market for these institutions, if they follow the "best practices" of microfinance management. Critically, if this is the case and the MFI's indicators show financial strength, the liquid commercial banks in Asia are happy to advance large wholesale loans to these institutions for on-lending, and in most cases on reasonable terms.

Microfinance downscaling by city and rural commercial banks in China provides a good case for the success factors behind the replication of a lending model in China. In the case of downscaling by the commercial banks to the SME sector, the key conclusions are already clearly stated in the draft report: (a) a key to success is the change in understanding of the overall nature of modern SME lending by the middle-level managers and loan officers, (b) high-class capacity building is required to make this change happen, and (c) these two things are much more important than the provision of credit lines by the state or donors, as most city and rural commercial banks have adequate low-cost funds of their own. The leadership and commitment from the bank management, organizational adjustment, training, and the provision of incentives to loan managers and loan officers are noted to be crucial for the successful replication of best practices in rural finance. The downscaling pilot itself has also had a large impact on the provision of microfinance services to MSEs in China.

The innovations in China's rural financial markets and services have been driven by a number of factors since the beginning of this century, chiefly among them a change in the demand for rural financial

products and services following income growth and the process of urbanization; increased market competition for the provision of financial services in China's urban and rural areas; relaxation in rural financial regulations, mainly the liberalization of lending rates of interest; and technological progress in Internet and mobile phone uses. We believe that many of these changes will continue to drive China's rural financial innovations.

6.2 Policy Recommendations

Replicate the best practices: The pilot on mobile banking undertaken by CRCB should be replicated by RCCs and other RFIs in other parts of China, especially for the institutions that serve remote rural communities and households. Replication of the pilot is expected to benefit rural communities and households as well as the relevant RFIs. The pilot could also be replicated in other Asian countries. The success factors of CFPA MF could also be replicated by other NGOs and poverty-oriented RFIs in China to improve their operational efficiency. The cash flow-based lending practiced under microfinance downscaling has been undertaken mainly in China's eastern and central regions, and the lending technologies should be replicated by those RCCs in China's poor areas such as in those of Qinghai, Ningxia, and Guizhou to support SMEs in off-farm activities.

Provide support to China's village community funds and cooperative finance: Some of China's village community funds could be developed into cooperative financial organizations if their organizational structure and monitoring and supervision are improved. Some of the lessons from CFPA MF could be applied to set up a national-level monitoring and supervision platform for VCFs in China so as to promote cooperative finance and to improve financial services for the rural poor.

Promote agricultural chain credit: Agricultural value chain finance involves financing inside and outside a value chain. For financing outside the value chain, processing machines, inventory, and receivables, the important assets of agro-processing plants, should be accepted as collateral for loans, and purchase orders provided by agro-processors or farmers could also be accepted as collateral for loans under certain conditions. For financing inside a value chain, first, RFIs can use value chain transactions and relationships to reduce credit diversion by farmers so as to improve loan repayment rates. For example, a farmer's cooperative could purchase bulk farm inputs for its members with bank loans so the loans would not be diverted for other uses. Second, RFIs could accept the guarantee and collateral pledged by inter-linked enterprises for loans provided to individual farm households.

Apply cash-flow lending to MSEs in China's rural townships: RFIs should be encouraged to cope with the rising demand for loans from small and micro-enterprises (many of them operated by migrant workers) in non-farm activities at the county level and below by using cash-flow lending. Cash-flow lending has been piloted and replicated in China since 2006 and 2007 but confined mainly to prefecture-level cities and above in China's eastern and central regions. The governments and regulators should promote the lending techniques to RCCs in China's western regions to support MSEs at the county level and below by conducting training activities and organizing study tours. The technology has proved suitable for MSE loans from RMB 10,000 to RMB 200,000. A standard training and TA package by a private provider costs RMB 2-3 million for an RCC. Loan repayment performance can be enhanced by the application of cash-flow lending coupled with the requirement for physical collateral.

Strengthen RFM competition: We think that competition is the most important driving force for the downscaling of rural financial services to MSEs and small farmers in China. More small-size bank permits for rural financial institutions should be issued to private capital and others for operation in rural counties and in China's western regions where formal rural financial services have been dominated by RCCs. Well-performing non-deposit-taking institutions such as MCCs and NGO MFIs that have provided substantial support to MSEs and to agriculture could be granted licenses for banking operations at the county level and below to enhance competition and to demonstrate the effects for others. Poorly performing formal RFIs should be pushed to exit the market through M&As and other means, following the establishment of a deposit insurance facility in China.

Accelerate the reform of formal RFIs: The reforms of the RCC system have been ongoing for more than a decade. Further reforms are required to clarify the relationship between the RCCs and local governments, especially the provincial-level governments and their agencies – the provincial RCCFs. The provincial RCC federations, with influence from the local government at the county level, are responsible for appointing the board chairman and the top management of RCCs. The provincial RCC federations and the county-level governments also have influence on the uses of funds by the county-level RCCs in China. The corporate governance of RCCs needs to be improved further, including the rights of the shareholders and board in the appointment of managerial staff. Poorly performing RCCs should be allowed to exit the market.

Expand the rewards for the RCCs and village banks to others: The Chinese government has encouraged RFIs to provide loans to MSEs and agriculture by providing formal financial institutions with tax concessions for their loans under RMB 50,000 and by awarding village and township banks fiscal grants equivalent to 2 percent of their average loan portfolios provided that their average loan portfolios are rising and at least 70 percent of their loans are extended for agriculture and related uses. It is recommended that the same tax concessions and awards be applied to all the financial institutions in China, including MCCs, registered NGO microfinance institutions, and other registered lending institutions.

6.3 Way Forward: Pilot Testing the Good Practices

All three cases discussed above could be replicated in China and other Asia-Pacific countries after first pilot testing and adjusting. The mobile banking product used by CRCB should be tested by RCCs and other rural financial institutions in China's poor and remote areas, such as in Qinghai, Yunnan, Guizhou, Sichuan, or Inner Mongolia, as well as in other Asian countries. Given the lessons from CRCB, the banks conducting the pilot are advised to have a strong IT department for promoting the product, as well as giving timely technical support. These banks should also establish performance assessment criteria, including the use of mobile phone banking by clients for bank branches and subsidiaries. The pilot is more likely to be successful in the countries where there is strong competition for rural deposits.

Many success factors and key lessons from CFPA MF could be replicated by other NGOs and semi-formal rural and microfinance institutions, including the rural community funds sponsored by PADO and MoF in China. A formalized structure (or platform) could be created at the national level to monitor and supervise the operation of about 20,000 village community funds across China's poor areas, with a sound MIS. The platform could also provide technical support and provide wholesale finance to the village funds based on their performance.

The downscaling of microfinance by city and rural commercial banks in China has provided us with valuable lessons for the replication of a best practice or a lending technique in a different environment. Such lessons are useful for the replication of the best practices under this project. The key lessons include the commitment from management, the necessary institutional arrangements for the pilot, and the incentives provided to the branches and loan officers for the pilot program.

The other pilots that could be undertaken in China include a pilot on cash services for RFIs in China in remote villages, cash depositing and withdrawing, and a pilot on the development of cooperative finance at the grass-roots level (based on the village community, not beyond a township), with the priority given by the Chinese government on a comprehensive outreach of financial services to all rural areas in China, including the remote villages.

The proposal for the pilot, including the possible institutional and cost barriers, will be discussed with the Country Working Group of China and will be presented for acceptance.

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ANNEXURE 1

Survey in Hechuan District of Chongqing

The rural township the study team visited has 35,000 rural households and approximately two-thirds are migrant workers living outside the township.

The CRCB sub-branch: the sub-branch has more than 10 million loans and 450 million (net growth: 55 million in 2012 and over 60 million in 2013) deposits by the time of the survey, the CRCB's deposits were more than half of the total deposits in the township. ABC and PSBC in the township shared the other half, each with about 55 percent. The head of the sub-branch explained why so few loans were outstanding in the township: the sluggish local economy, many rural laborers working as migrant workers outside, little demand for agricultural loans, and low consumption demand. This also further underpins the importance of deposits to CRCB. The branch linked mobile banking to deposit increases in the sub-branch.

Mobile banking has a positive impact on clients: (1) migrant workers often use mobile phones to send money home and also shift their money from demand deposits to time deposits to enjoy a higher rate of interest for their deposits at no cost and with easy access (WMP is important for the future); (2) small businesses and micro-entrepreneurs can transfer money to their clients and suppliers after the work, thus paying fees; (3) rural households can send money to their children at universities and schools for living expenses and fee payments; and (4) clients can balance checking and pay other fees; otherwise, they need to travel to the sub-branch and bring their ID card.

The bank has several benefits: reducing pressure at the counter; in the past, transactions at the counter involved deposits, loan applications, remittance and money transfers, paying mobile and other phone bills, transport fines, water and electricity bills, paying mortgage, and paying school fees. After the use of electronic and mobile banking, transactions at the counter declined by 60-70 percent, of which over half then involved mobile banking and others ATMs. Lots of paperwork, papers, and forms were saved.

- *Effect on deposits:* Free money transfers attracted deposits: for cross-banking money transfers, CRCB reimbursed the fees paid to the other bank.
- *Cost savings:* Before mobile banking, the average cost for money transfers was around RMB 5. Afterward, it cost the bank about RMB 0.04-0.05 per money transfer. For fee payment, the substitution rate is about 90 percent, 90 percent of which is through mobile banking. Installing an ATM in a village will cost more than RMB 100,000 and security and maintenance are major difficulties.
- *Loans to non-farm micro-entrepreneurs:* 500 households.
- *Market segregation:* Mobile banking targets mainly rural clients who are sensitive to costs. It is user-friendly and requires no Internet and no mobile charges. Urban residents can use APP, WMP, Internet banking, good Internet access, weixin, also WMP, and can make an appointment.

The performance assessment criteria for branches and sub-branches follow:

1. Deposits (15 percent of the weight) for this year with net growth of 50 million, for a total of 430 million
2. Loans (NPLs)

3. Profit
4. Bank cards issued
5. Mobile banking
6. WMP
7. Internet banking by enterprises and individuals
8. Other services – CRCB *di-bao*, medical insurance, subsidies on grain, pigs, etc., channelled through CRCB



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