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Rural Banking in China

Although China's banking and financial markets have undergone significant reforms in the last two decades, its rural banking market remains relatively underdeveloped. To address this situation, the Chinese government has focused considerable attention on increasing access to financial services in rural areas through policy initiatives such as easing market-entry requirements and creating new incentive mechanisms. This Asia Focus report presents an overview of China's rural banking system, historical and recent reforms, and additional areas for improvement.

Structure of China's Rural Banking Market

China's rural banking market is serviced mainly by four types of financial institutions: a large commercial bank; a policy bank; a postal savings bank; and small and medium-sized rural financial institutions (see chart below). Of the major players focused on the rural banking market, small and medium-sized rural financial institutions collectively account for the lion's share of the market in terms of number of institutions.

The financial institutions listed in the chart below represent roughly 28% of China's banking system assets. While other banks in China operate in the rural market, they are generally not considered major players. For example, large domestic banks such as ICBC and Bank of China have operations in rural areas, but are generally more focused on pursuing other markets and business activities (e.g., corporate lending, diversified financial services, and international expansion). At the same time, China's large and mid-size banks have begun expanding their rural operations on a small scale by opening village banks and lending companies, taking advantage of recent government policies (discussed below). While a small but growing number of foreign institutions such as HSBC and Citibank have recently entered China's rural banking market, foreign banks represent only 2% of banking system assets in China and their rural operations are still in their initial stages.

Impact of Reform and Opening Up on Rural Banking Sector

China's ongoing process of *gaige kaifang (*reform and opening up), which began in 1978, has been highly successful in supporting economic growth and decreasing poverty on a national level, but the gains have not been spread equally across the country. A combination of economic and social policies has resulted in a widening rural-urban income gap, with the annual per capita net income of rural households reaching just RMB5,153 (US$755) in 2009, compared with RMB17,175 (US$2,516) for urban households.[1] In response to these inequalities, authorities in China have made rural development the focus of many recent policy initiatives. In fact, 2010 marked the seventh consecutive year that the government's annual *yihao wenjian* (No. 1 Document) has emphasized rural issues. This policy docu-

Major Players in China's Rural Banking Market

Type of Institution	Name of Institution or Sub-Type	Number of Institutions (end-2008)	Total Assets (RMB billion, end-2008)
Large Commercial Bank	Agricultural Bank of China	1	7,014.4
Policy Bank	Agricultural Development Bank of China	1	1,354.6
Postal Savings Bank	Postal Savings Bank of China	1	2,216.3
Small and Medium-sized Rural Financial Institutions	Rural credit cooperative institutions • Rural credit cooperatives • Rural commercial banks • Rural cooperative banks	 4,965 22 163	 5,211.3 929.1 1,003.3
	New-type rural financial institutions • Village and township banks • Lending companies • Rural mutual credit cooperatives	 91 6 10	N/A

Source: China Banking Regulatory Commission Annual Report 2008; ABC and ADBC websites ment is jointly issued by the Central Committee of the Communist Party of China and the State Council to highlight significant economic concerns of the State.

With respect to financial services, the reform and opening up policy facilitated the development of a more market-oriented banking system. In the mid-1990s, many banks began closing branches in rural and interior regions, which were generally less profitable than branches in urban and coastal regions. Structural issues such as incomplete interest rate liberalization contributed to the problem as banks had a limited set of tools with which to make rural banking cost effective. As a result of these structural and developmental issues, many rural residents and businesses had few options in terms of banking services and access to credit. From a policy perspective, reform of the rural banking market is a part of the government's broader framework aimed at improving conditions in rural areas. Despite recent progress, the total number of villages and towns in China without financial institutions was 2,792 as of end-2009; the total number of villages and towns without access to financial services was 342.[2]

Development of the Rural Banking Market

Given that the major players in China's rural banking market are diverse in nature—in terms of target client base, asset size, relationship with central/local government entities, etc.—the government has allowed for a varied approach to reform. Overall, historical and recent policy responses have tended to focus on implementing gradual steps toward structural change and market liberalization.

Agricultural Bank of China and Agricultural Development Bank of China

Agricultural Bank of China (ABC) was established as a state-owned bank in 1979 to provide financing for agriculture-related activities. The Agricultural Development Bank of China was spun off of ABC in 1994 to become a specialized policy bank, originally focused on government procurement of grain, cotton and other goods.[3] In the mid-1990s, as China's Big Four banks began transitioning toward a more commercial-based lending model, ABC started to withdraw from rural areas. It closed a number of branches below the county level, particularly those focused on agricultural lending, due to their high level of non-performing loans, and turned to urban areas and a broader lending strategy to increase revenue.[4] However, in early 2007, the central government asked ABC to refocus on rural areas, and ABC renewed its commitment to serving the agri-related sectors, namely agriculture, rural areas and farmers. It began setting up pilot programs to establish and purchase shares in village and township banks, resulting in ABC setting up two such entities in Hubei and Inner Mongolia in August 2008. In 2009, the China Banking Regulatory Commission (CBRC) released special supervisory guidance to encourage ABC to take further steps toward setting up its rural-based Strategic Business Unit and improving its banking services to the rural economy at the county level.[5]

In October 2008, China's State Council formally approved a shareholding reform plan for ABC, which is the only bank among the Big Four that has not yet held an IPO. Following a capital injection from Central Huijin of US$19 billion in cash (equivalent to RMB130 billion) and the removal of RMB816 billion (US$120 billion) of bad assets, ABC changed its registration in January 2009, marking its transformation from an exclusively stated-owned commercial bank to a joint-stock commercial entity.[6] ABC currently has two shareholders—Central Huijin and the Ministry of Finance, each with a 50% stake—but ABC has reportedly been preparing for a dual listing in Shanghai and Hong Kong before the end of 2010.[7]

Postal Savings Bank of China

China's modern postal savings system was established in 1986 through the China Postal Savings and Remittance Bureau, which was part of the State Post Bureau.[8] As the postal savings business grew in subsequent years, officials began to consider ways to separate the various functions of the large postal system and to provide improved oversight. In the late 1990s, China's government separated postal and telecommunications businesses from each other and the People's Bank of China (PBOC) raised the notion of establishing a stand-alone postal savings bank. After its founding in 2003, the CBRC supported the concept of a separate postal savings bank as a means to split the postal savings service from the main postal delivery service. In June 2006, following approval from the State Council, the CBRC formally endorsed the establishment of a separate Postal Savings Bank of China (PSBC). In March 2007, PSBC officially began operations with registered capital of RMB20 billion (US$2.9 billion).

China's early postal savings system accepted deposits, but did not offer credit services, which resulted in an outflow of funds from rural areas. Since 2007, PSBC has initiated several pilot programs to offer rural residents more banking services. For example, it launched trial operations of small loan products in seven provinces starting in mid-2007. Small loan products include loans to rural micro enterprises, farmer credit loans, and loans mutually guaranteed by groups of farmer households. In 2008, PSBC took steps to strengthen its corporate governance structure, set up an independent financial accounting system, and operate in line with commercial bank requirements. It also expanded its micro finance services in 2008, issuing over RMB60 billion (US$8.8 billion) in small deposit-pledged loans and micro loans, more than 70% of which was used in rural areas.[9]

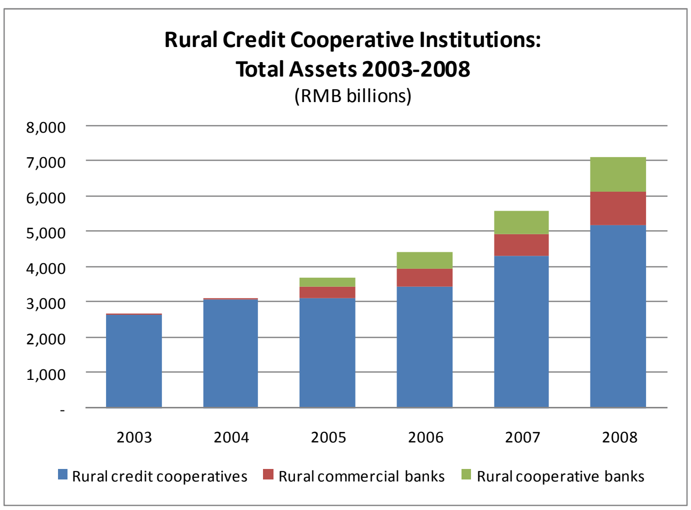
Rural Credit Cooperative Institutions

While individual rural credit cooperative institutions are relatively small, they collectively play a large role in China's rural banking market. Rural credit cooperatives (RCCs), which were initiated during China's rural cooperative movement in the 1950s, originally provided financial services to cooperative members, who were generally farmers. Later, during most of the 1980s and 1990s, ABC had administrative responsibility over RCCs, which played a critical role in developing Township & Village Enterprises.[10] In 1997, the central government decided to transfer oversight responsibility from ABC to the PBOC, due in part to rising non-performing loans among RCCs. Although the

PBOC encouraged RCCs to strengthen support services for rural areas, RCCs were often more inclined to fund projects with lower risk and higher capital returns. This exacerbated an existing shortage of institutional lending in rural areas.

In 2003, the State Council issued the *Pilot Program for Deepening Rural Credit Cooperative Reform* to fundamentally restructure RCCs. The reform program clarified RCC ownership structures, transferred management of RCCs to provincial-level governments, and assigned supervisory oversight of RCCs to the CBRC. As part of this reform process, the authorities, mainly through the PBOC, provided substantial funds to RCCs to remove and write down non-performing loans and to raise their capital levels. Over a number of years, the PBOC injected RCCs with RMB169 billion (US$25 billion) in special central bank bills and loans, helping to reduce their average non-performing-loan ratio to 9.3% as of 2007 from 37% in 2002.[11] In 2004, RCCs made an aggregate profit for the first time in roughly ten years.[12]

Authorities restructured some of the stronger RCCs into rural commercial banks (with joint-stock ownership) and rural cooperative banks (with hybrid ownership). (See chart below for asset size of these new institutions.) Some other RCCs were merged to form credit unions at the county and provincial levels, with the latter generally responsible for administering multiple institutions.[13] However, as of end-2008, just 185 new banks, including 22 rural commercial banks and 163 rural cooperative banks, had been created through the RCC reform program, with the CBRC reporting another 4,965 institutions as RCCs. The CBRC's ultimate goal is to transform the remaining RCCs into viable banking entities, through further restructuring, consolidation, or another method of reform.



Source: China Banking Regulatory Commission Annual Report 2008

New-type Rural Financial Institutions

To improve the quality of financial services and increase competition in rural areas, the CBRC changed market-entry requirements for rural banking in December 2006. The new policy promoted the development of new-type rural financial institutions, which are village and township banks, lending companies, and rural mutual credit cooperatives. To encourage both domestic and foreign firms to invest in these new-type entities, the policy lowered minimum capital requirements, expanded the scope of permitted banking activities, authorized flexibility in corporate governance structures, and liberalized shareholder rules for new-type rural financial institutions. In addition, the government enacted a series of preferential tax policies and other incentives. Through end-June 2009, 118 new-type rural financial institutions had been established, attracting a variety of capital worth RMB4.7 billion (US$689 million), absorbing RMB13.1 billion in deposits (US$1.9 billion), and providing RMB5.5 billion (US$806 million) in loans to rural households and RMB8.2 billion (US$1.2 billion) to rural small and medium-sized enterprises.[14] According to the CBRC, these new financial institutions have helped to bring financial services to underserved regions, channeling funds from urban to rural areas and delivering specialized products to local customers.

Over the next three years, authorities expect that 1,300 more new-type rural financial institutions will be established across China, with a focus on under-banked rural areas. To date, types of domestic financial institutions setting up village and township banks have spanned the full spectrum of China's banking market. In addition, microfinance companies, which were introduced through a pilot program in May 2008, may apply to transform into a village bank if they meet certain criteria.[15] Foreign banks may also apply to the CBRC to open new-type rural financial institutions. As of end-2008, foreign bank entities, including HSBC Bank (China) Co. Ltd., Citibank (China) Co. Ltd. and Standard Chartered Bank (China) Ltd., had established seven new-type rural financial institutions in China.[16]

Further Challenges

Address ongoing structural and operational issues

In a May 2007 interview with Beijing-based *Caijing* magazine, CBRC Chairman Liu Mingkang highlighted a number of challenges in reforming China's rural financial markets.[17] While recent policies have begun to address some of these challenges, China's process of reform is gradual and work on these issues is ongoing. He noted six aspects of systematic reform:

- *Reform the loan application process:* streamline and tailor the process to meet rural conditions
- *Differentiate between small-scale loans to farmers and loans to large companies:* develop separate assessment and performance measurement schemes to incentivize bankers to issue loans to farmers
- *Enhance information sharing among different financial institutions:* track borrowers in default and develop a comprehensive nationwide credit rating system
- *Train more people to work in the rural lending business:* provide specialized training to bankers on the management of rural credit risks
- *Set up professional performance measurements and award/penalty mechanisms:* align compensation and promotion for rural lenders with performance

- *Use interest rates as a tool in pricing risks:* continue to liberalize interest rate policies, particularly with respect to rural lending

CBRC leaders have also emphasized the need to strengthen regulatory capacity to oversee the growing rural banking market, especially as new types of entities are established. In light of the unique characteristics of small and medium-sized institutions, the CBRC is implementing a differentiated supervisory program to better monitor and assess risks in this submarket. Structurally, the reform of RCCs remains incomplete, and the RCC sector will need to undergo further consolidation and equity reform in the future. Completing this process would help resolve some of the outstanding legacy issues within China's banking system such as the historical accumulation of non-performing loans, which remain relatively high among RCCs. Other ongoing challenges relate to broader social and economic policies regarding land reform and property rights.

Incentivize banks to participate in rural banking markets

Authorities in China face a challenging task in concurrently promoting rural banking inclusion and general market-oriented financial reform. With respect to new-type rural financial institutions, CBRC Vice Chairman Jiang Dingzhi commented in December 2009 that there are two major problems requiring CBRC attention: progress in developing these institutions has been relatively slow, and mid- and large-size commercial banks are not playing a large enough role.[18] In general, the CBRC has highlighted corporate social responsibility as a factor that banks should take into consideration while continuing to pursue reasonable profits. While financial institutions have the freedom to select the location of new operations, the banking regulator intends to create incentive mechanisms to steer banks toward the areas of greatest need. For example, the CBRC will introduce measures to link together different regions (east-west, urban-rural, developed-underdeveloped) for the purposes of assessing applications, and will streamline the approval process for those institutions that are actively establishing village banks in poor areas.[19]

Conclusion

With strong support from China's top leaders, authorities have implemented a range of policies to promote increased access to banking services in rural and underserved areas. These policies have been somewhat successful in expanding the number and range of institutions serving these communities. However, the Chinese government faces the ongoing and difficult task of balancing both social and commercial goals, namely to support a more inclusive banking sector and to continue the market-oriented reform process. To achieve more progress, officials will need to further address outstanding structural issues, not only in the banking sector, but also in the broader economy.

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1. A conversion rate of US$1 = RMB6.825 is used throughout this report. "Statistical Communiqué of the People's Republic of China on the 2009 National Economic and Social Development." National Bureau of Statistics of China, 2/25/10.

2. "The CBRC highlights support for rural financial services in 2010." CBRC website, posted in English 2/26/10.

3. *Note:* Today, the Agricultural Development Bank of China also provides credit support to rural infrastructure construction and small rural businesses. "Vice Chairman Wang Zhaoxing speaks on small business financing and rural financing." CBRC website, posted in English 3/19/09.

4. Pei Guo and Xiangping Jia. "The Structure and Reform of Rural Finance in China." Working Papers in Economics & Management (Working Paper 2008E002), China Agricultural University, October 2008.

5. "The CBRC released the supervisory guidance on rural-based SBU in Agricultural Bank of China." CBRC website, posted in English 5/31/09.

6. For further details, see Agricultural Bank of China Annual Report 2008.

7. Bei Hu. "Agricultural Bank Said to Aim for Initial Public Offer by July." Bloomberg, 4/16/10.

8. Cindy Marks. "Postal Savings Reform in Northeast Asia, Part Two: China." Asia Focus Report, Country Analysis Unit, Federal Reserve Bank of San Francisco, July 2008.

9. China Banking Regulatory Commission Annual Report 2008.

10. Pei Guo and Xiangping Jia. "The Structure and Reform of Rural Finance in China." Working Papers in Economics & Management (Working Paper 2008E002), China Agricultural University, October 2008.

11. "The reforms of rural credit cooperatives have achieved significant progress." CBRC website, posted in English 7/18/05. "OECD Economic Surveys: China." OECD, February 2010.

12. "Latest Developments in China's Banking Reform, Opening-up and Supervision." CBRC website, posted in English 12/5/05.

13. Fred Gale and Robert Collender. "New Directions in China's Agricultural Lending." WRS-06-01, Economic Research Service, U.S. Department of Agriculture, January 2006.

14. "The CBRC called for comprehensive implementation of the General Working Plan for New-Type Rural Financial Institutions: 2009-2011." CBRC website, posted in English 7/29/09.

15. "The CBRC issued the Provisional Rules Governing the Transformation from Micro-finance Companies to Village Banks." CBRC website, posted in English 6/18/09.

16. China Banking Regulatory Commission Annual Report 2008.

17. Huawei Ling. "Liu Mingkang's Vision of Rural China's Financial Reform." *Caijing* magazine online, 5/15/07.

18. "Vice Chairman Jiang Dingzhi emphasized that middle and large sized banks should actively play their roles in helping the development of new-type rural financial institutions." CBRC website, posted in English 12/22/09.

19. "The CBRC called for comprehensive implementation of the General Working Plan for New-Type Rural Financial Institutions: 2009-2011." CBRC website, posted in English 7/29/09.

Contacts: Walter Yao (walter.yao@sf.frb.org) and Nkechi Carroll (nkechi.carroll@sf.frb.org)
Written by: Cindy Marks