

**Testimony before the U.S.-China Economic and Security Review Commission:**

**“China’s Banking System and Access to Credit”**

**By**

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Commissioners Cleveland and Goodwin, and other members of the Commission, it is my pleasure to provide testimony on China's banking system. My name is Lynette Ong. I am an associate professor at the Munk School of Global Affairs at the University of Toronto in Canada. My comments will focus on the rural credit sector in China, particularly the rural credit cooperative system, looking at its importance to the rural sector, its lending patterns, and the role of local governments in loan allocation.

## **Introduction**

Rural credit cooperatives (RCCs) are the backbone of official finance in rural China. They collectively account for 80 percent of rural deposits and loans. Despite their overwhelming importance to the rural economy, they have long been the weakest link in China's financial system. Saddled with mountains of bad loans, the official non-performing loan rate stood at 50 percent in the late 1990s.<sup>1</sup>

The ownership nature of RCCs has always been ambiguous. Prior to 1996, they were subsidiaries of the state-owned Agricultural Bank of China. Between 1996 and 2003, they were rural credit institutions loosely managed by local branches of the central bank, the People's Bank of China (PBoC). Since 2003, they have been managed by provincial credit unions, which report to their respective provincial governments.

Notwithstanding the frequent changes in the reporting structure of RCCs, local party or government influence over loan allocation has been a constant throughout. This has resulted in a large proportion of loans being allocated to local government-related borrowers, who often fail to repay in full.

Starting in 2003, a restructuring process for RCCs has seen the better-performing ones privatized and transformed into rural commercial banks and rural cooperative banks. As of 2010, the RCC system included 2,646 RCC county unions, 223 rural cooperative banks, and 85 rural commercial banks. Collectively, RCCs are still the dominant credit institutions in rural areas, covering about 50 percent of all townships in the country. This dominance continues despite shrinking coverage and smaller networks in rural areas since the late 1990s due to ongoing cost-cutting by the central government. Beijing is now pushing for the transformation of all county RCC unions into a shareholding system, paving the way for them to become rural commercial banks. The underlying motive is to make RCCs self-sustaining commercial institutions.

To put them in a national perspective, RCCs account for 10 percent of total deposits and loans nationwide (Table 1). Overall, the financial sector is still dominated by the state-owned commercial banks,<sup>2</sup> which account for about half of total deposits and loans. Shareholding commercial banks, such as China Merchants Bank and Shanghai Pudong Development Bank, come second with a collective share of about 16 percent of total deposits and loans.

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<sup>1</sup> The unofficial rate was likely much higher, around 70-80 percent.

<sup>2</sup> Bank of China, Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, and Bank of Communications.

**Table 1 Financial Institution by Size of Loans and Deposits (2010)**

	<b>LOANS</b>	<b>%</b>	<b>DEPOSITS</b>	<b>%</b>
<b>State-owned commercial banks</b>	24,137	47.4%	38,536	52.6%
<b>Shareholding commercial banks</b>	8,098	15.9%	11,264	15.4%
<b>State-owned policy banks</b>	6,721	13.2%	801	1.1%
<b>Rural comm. banks and rural credit co-ops</b>	4,752	9.3%	7,276	9.9%
<b>City comm. banks and urban credit co-ops</b>	3,567	7.0%	6,047	8.3%
<b>Postal Savings Banks</b>	841	1.7%	3,238	4.4%
<b>New rural financial institutions<sup>1</sup></b>	60	0.1%	75	0.1%
<b>Others<sup>2</sup></b>	2,724	5.4%	6,063	8.3%
<b>Total</b>	<b>50,900</b>	<b>100.0%</b>	<b>73,300</b>	<b>100.0%</b>

Source: Author's own calculation from *Almanac of China's Banking and Finance* (2011), and *Report of the Implementation of the Monetary Policy of China* (4<sup>th</sup> quarter, 2010)

All figures in billion *yuan*, 2010 year-end.

1. New rural financial institutions include township and village banks, microcredit companies, and rural mutual aid funds.
2. Others consist of non-bank finance companies and overseas banks.

### **The Rural Credit Cooperative (RCC) system and its reform**

In contrast with their earlier weak performance, RCCs enjoyed a net profit of 23.3 billion *yuan* and an official non-performing loan rate of just 5.6 percent in 2010. The remarkable improvement in their asset quality can be largely attributed to subsidies and bailouts from the central government.

In the late 1990s it became abundantly clear to central policymakers that without a capital injection the RCC system was simply unsustainable. The capital adequacy ratio and net equity of RCCs were in negative territory, meaning their liabilities were so enormous that they were eating into shareholders' equity. Furthermore, more than half of RCCs nationwide (55 percent, or 19,542 credit cooperatives) were technically bankrupt at the time. By this, I mean that their asset value was smaller than the sum of their liabilities and equity, implying that they would have closed down if they had operated under market conditions.

The problem was that for the central government, shutting down RCCs was very much out of the question. RCCs are both the primary holders of rural households' savings and the primary providers of households' credit. Closing them down would deprive rural residents of a major formal credit service and expose many to abject poverty. More importantly, as I have argued in my new book, *Prosper or Perish: Credit and Fiscal Systems in Rural China*, because RCCs hold the bulk of rural savings, signs of financial instability would trigger panic and social

unrest in the countryside; there have been several instances of failed credit institutions triggering social unrest in rural China. In other words, RCCs were “too big to fail” because of their political significance.

This risk of social instability is buttressed by rural residents’ perception that their savings at credit cooperatives are guaranteed by the central government. Although the central government is under no formal obligation to do anything should RCCs fail, it has strong incentives to keep the RCC system from collapsing. Indeed, while the central government got rid of many unstable financial institutions after the Asian Financial Crisis in the late 1990s, RCCs have remained in business despite having negative net assets. In 2007, the PBoC provided two forms of financial assistance—168 billion *yuan* in debt-for-bonds swaps and 830 million *yuan* in earmarked loans— to assist RCCs in disposing bad assets and writing off historical losses.

As part of the restructuring, RCC management rights were transferred from the PBoC to the provincial RCC unions, which represent their respective provincial governments in managing the credit cooperatives in their territories. The policy intention is to make regional governments financially responsible for RCCs in their jurisdictions.

RCCs are best understood as a myriad of locality-based credit institutions with varying financial performance and asset quality. Reforms have also transformed some credit cooperatives with better asset quality in economically developed regions into rural commercial banks and rural cooperative banks.

Rural commercial banks conduct business like any urban commercial bank and are similarly bound by few policy requirements. Rural cooperative banks are a hybrid of rural commercial banks and credit cooperatives. While they can raise equity by bringing in individual and enterprise investors, they are required to allocate a certain proportion of their loan portfolios to agricultural projects. Though rural credit cooperatives are largely profit-oriented institutions, they are strongly encouraged to lend to rural households and agricultural borrowers.

Of the three kinds of institutions, credit cooperatives have the fewest workers per unit (208), followed by cooperative banks (363) and commercial banks (1137) (Table 2). This indicates that rural credit cooperatives are still predominantly small-scale credit institutions serving local rural communities, while rural commercial banks, at the other end of the spectrum, are relatively large banks in urbanized areas.

**Table 2 Rural Credit Institutions by Type (2010)**

	No. of units	No. of workers	No. of workers/unit
Rural credit cooperatives	2,646	550,859	208
Rural commercial banks	85	96,721	1137
Rural cooperative banks	223	81,076	363
New rural financial institutions & Postal Savings Banks	396	152,820	385
<b>Total</b>	<b>3,350</b>	<b>881,476</b>	<b>263</b>

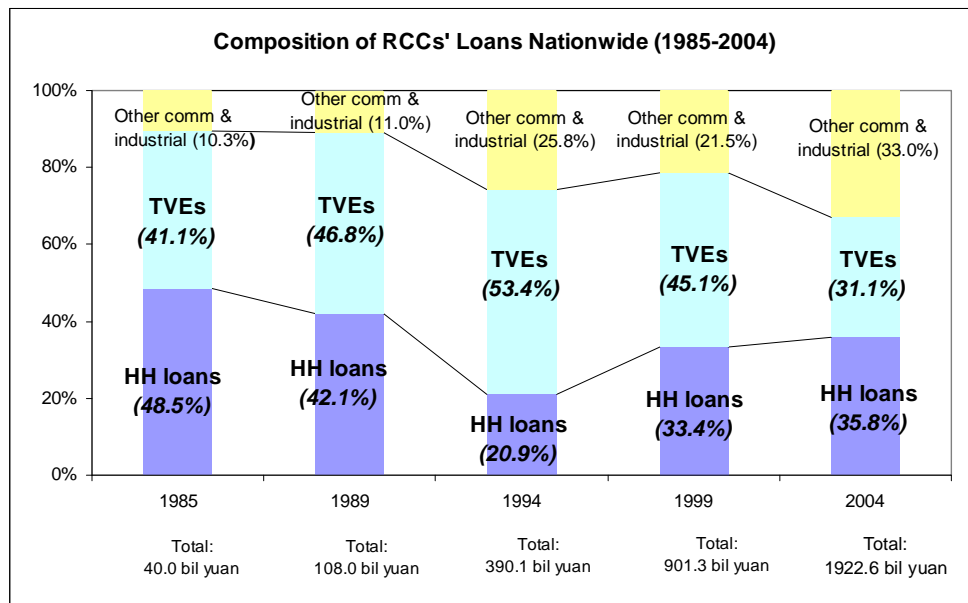
Note: New rural financial institutions include township and village banks, microcredit companies, and rural mutual aid funds.

Source: *Almanac of China's Banking and Finance* (2011), p.471

## Lending decisions and loan allocation patterns

Historically, an overwhelming proportion of rural savings had been directed to finance the development of collective township and village enterprises (TVEs). TVEs were largely local government-owned enterprises before their privatization in the mid- to late-1990s. They accounted for more than half of RCCs' loans in the mid-1990s, while rural households took up only one-fifth of the total (Figure 1). While TVEs contributed to economic development by creating jobs in the countryside and augmenting local government coffers, they undoubtedly crowded out credit that could have been allocated to farmers and private small and medium-sized enterprises. This loan allocation pattern basically persisted through to the 2000s, though some or all of the TVEs had been privatized by then.<sup>3</sup>

**Figure 1 Composition of RCC Loans Nationwide (1985-2004)**



Source: Almanac of China's Finance and Banking, *various years*.

Up until the mid- to late-1990s, RCC personnel decisions were made by local Chinese Communist Party leaders. Since credit managers were appointed and evaluated by local party secretaries, they were first and foremost accountable to the party, rather than to depositors or shareholders. This is an institutional feature that is not unique to RCCs, but common across all state-related financial and non-financial institutions in China. RCCs are often urged to support local government enterprises and projects in order to help promote local development. Even though local party leaders no longer appoint bank managers, they can still influence loan allocation decisions.

<sup>3</sup> Data for RCC loan allocation nationwide is not available after 2004.

How stable are the RCCs? They have become much more financially sound after the central bailout. However, RCCs—like all other banks in China—were drawn upon to support the 2008-09 stimulus program. Despite the lack of concrete data, we are almost certain that their asset quality has deteriorated in recent years, even though not all the loans have immediate maturity dates, meaning that indicators may not manifest themselves until later. That said, given the locality-based nature of RCCs, any financial contagion is likely to be contained and would not spread across different regions.<sup>4</sup>

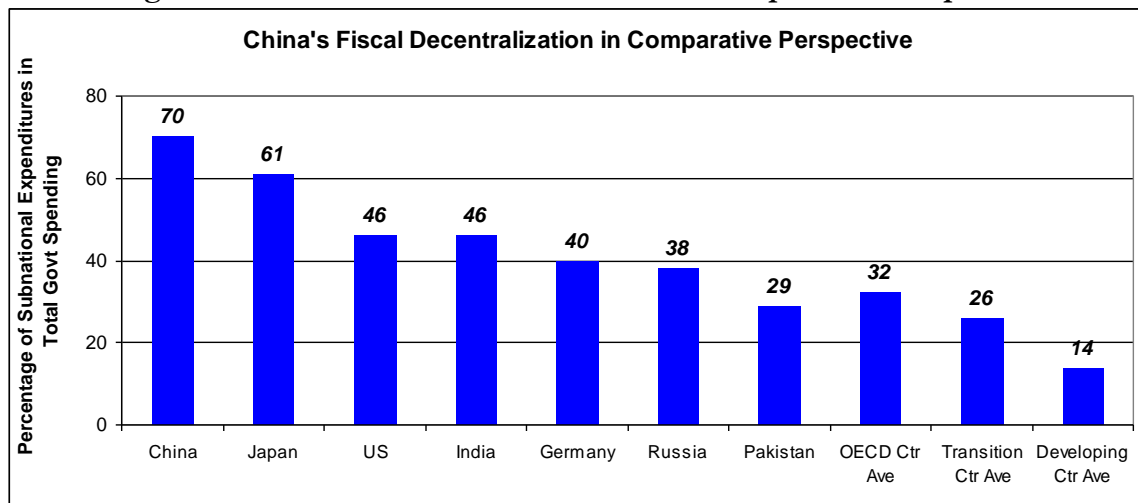
### Fiscal decentralization and local governments' fiscal constraints

To fully appreciate why local governments interfere in loan allocations, it is important to understand the nature of China's intergovernmental tax system. It is too simplistic to dismiss the interference as a form of corruption, though venality does account for the less-than-arm's-length relationship to some extent.

With Deng Xiaoping's reform and opening in the early 1980s, China underwent tremendous fiscal decentralization, with fiscal powers being devolved from the central to subnational governments. Local authorities were given the prerogative to collect and retain tax revenues, giving them the incentive to promote industrialization and local economic growth. Meanwhile, subnational governments were made responsible for providing social services to local residents, including education, healthcare, pensions, and unemployment benefits.

However, in 1994, the central government recentralized major tax revenue sources, while leaving local expenditure responsibilities unchanged. This has resulted in highly lopsided revenue-expenditure ratios for local governments. Although China is a unitary state, the World Bank has called it one of the world's most decentralized countries in terms of the share of subnational expenditures in total government spending.

**Figure 2 China's Fiscal Decentralization in Comparative Perspective**



<sup>4</sup> An exception may be if negative news about RCCs in neighboring towns prompts depositors to rush to withdraw their savings from local credit cooperatives *en masse*. This could trigger bank runs and cause financial instability to spread.

Local governments require resources to promote economic activities and fulfill their fiscal functions. Under severe revenue constraints, local officials tap into the financial resources of local credit institutions. Traditionally, the state-owned banks have played an important role in supporting state-owned enterprises. In rural areas, RCCs perform a similar function, acting as indispensable financiers for local government projects. Throughout the 1980s and 1990s, RCC loans were mostly used to support development of local government-owned TVEs. Despite the privatization of TVEs and the collapse of many unprofitable ones, RCC loans are still channeled to finance local government projects, including infrastructure spending and real estate development.

What are the implications of channeling savings to finance fiscal expenditures? As we know, financial and fiscal systems are supposed to play different functions. Financial systems intermediate capital between savers and borrowers, while fiscal systems allow governments to draw resources from taxpayers to redistribute income and provide essential public goods and services. High bad debt levels in the financial system can be partly attributed to the fact that financial resources have been siphoned off—at various levels of government—to fulfill fiscal functions. While public goods and services bring benefits to the general population, this comes at the expense of efficiency of capital allocation and creates instability in the financial system.

### **Recent rural credit market liberalization**

Liberalization of the rural credit market in the mid-2000s was premised on the belief that existing financial institutions had limited coverage in rural areas, and that the sector suffered from limited competition and shortages of capital supply. In a regulatory break from the long-standing pattern of government control of the rural financial sector that gave rise to the monopoly of RCCs, new types of financial institutions were introduced in late 2006: township and village banks (contrary to the name, these are primarily based in county-level cities), microcredit companies, and rural community-based mutual aid funds.

Of the three new forms of institutions, township and village banks have attracted the most enthusiasm from private domestic banks and foreign banks. In December 2007 in Hubei province, London-based HSBC became the first international investor to open a wholly owned subsidiary in a rural county, offering deposit and loan services to local residents and agricultural businesses. Some domestic regional banks have also acquired township-and-village-bank licenses, enabling them to conduct business in rural areas that would otherwise be beyond their territorial boundaries.

In contrast to township and village banks, microcredit companies can provide loans to individuals and companies, but are not allowed to absorb savings. Formal rural mutual aid funds, which are regulated by the China Banking Regulatory Commission (CBRC), are typically set up in either townships or villages and are not allowed to operate across regions. They are essentially community-based banking institutions; they absorb savings from and provide loans to local communities.

Thank you for the opportunity to testify today.

