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PEOPLE'S REPUBLIC OF CHINA
THEMATIC STUDY ON RURAL FINANCIAL SERVICES IN CHINA

EXECUTIVE SUMMARY



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ABBREVIATIONS AND ACRONYMS

ABC	Agricultural Bank of China
CASS	Chinese Academy of Social Sciences
IFI	International Financial Institution
MOF	Ministry of Finance
NGO	Non-Governmental Organization
PBC	People's Bank of China
PMOs	Project Management Offices
RCCs	Rural Credit Cooperatives
SHG	Self-Help Group
SOCB	State-Owned Commercial Bank
TVEs	Township and Village Enterprises
WFP	World Food Programme

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I. INTRODUCTION

A. Context

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

B. Thematic Study: Rationale and Objective

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



C. Projects Studied

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

II. RURAL FINANCIAL INSTITUTIONS IN CHINA

A. Development and Clientele

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

B. RCCs in Operation

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

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

C. Trends in Financial Service Provision

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

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

D. Interest Rates

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



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

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

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

E. Regulatory Framework

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

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

III. POVERTY ALLEVIATION STRATEGIES

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

Government Loan Programmes for Poverty Alleviation

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



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

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

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

IV. EXPERIENCE WITH MICROFINANCE IN CHINA

A. Willingness to Experiment

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

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

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

C. Target Group

25. Microfinance programmes usually target resource-poor households, with special focus on women in poor regions. Governmental-funded projects for poverty reduction through microfinance using subsidized interest loans emphasize inclusion of the poorest families in the target group. Indeed, poor families registered with the Government form the basic target group. Such programmes do not, however, specially target women, whereas the main target group of



most external donor-funded projects and the CASS Funding the Poor Cooperative are women [see paragraph 4.10 of main report].

D. Design of Financial Services

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

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

E. Sustainability

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

F. Policy Dilemma

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

V. DEMAND FOR FINANCIAL SERVICES

A. Credit Access

Limited Credit for Poorer Households

30. Formal and informal loans are widely available to the public in rural China. Nevertheless, the detailed and unusual survey data used for analysing credit constraints in the present study clearly point to harsh constraints for the resource-poor strata of the population, implying that policy-makers and donors would do well to revisit their policies and procedures in this regard. The survey of farm households in six poor counties undertaken by CASS in 1997 shed much-



needed light on resource-poor farmers' demand for, and receipt of, credit. The majority of households (54%) with outstanding formal loans are unable to obtain additional formal loans [see paragraphs 5.1-2 of main report].

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

B. Credit Supply

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

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

C. Credit Market Participation

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

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

D. Willingness to Borrow

36. Almost 50% of households in the lower income groups were willing to borrow from RCCs under current conditions, provided there was no need for collateral or a guarantor. In the richest quartile, only 30% expressed such willingness (but this is not to suggest that providing such loans would be desirable without building necessary safeguards to ensure repayment). *This implies that*



many of the poor are constrained by supply limitations or loan requirements: they do not lack suitable uses for available funds.

E. Economic Activities, Cash Flow and Demand for Credit

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

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

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

F. Potential for Savings Mobilization

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

VI. EVOLUTION OF THE DELIVERY OF FINANCIAL SERVICES IN IFAD PROJECTS

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

A. Comparison of Financial Services Delivery Models

Products

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



Targeting

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

Review of Targeting Performance

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

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

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

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

Financial Service Delivery

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

49. **Loan size and duration.** The size of loans in the PMO and RCC models depends on project loan regulations and the activities for which loans are sought. Generally, projects provide



uniform loans that are not necessarily in line with household requirements. However, RCCs can provide loans according to the needs of the households, repayment capacity and collateral. Both institutional models were designed to provide mostly medium- and long-term loans as stipulated in the project documents, but as a general rule RCCs provide only short-term loans.

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

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

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

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

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

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

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

57. Earlier IFAD projects provided little training to households, but this problem has since been redressed by collaborating with the World Food Programme (WFP). One very positive finding is that training programmes have been effective, with close links observed between the



purpose of the loan and the training involved. Almost 90% of all credit recipients were trained in relevant economic activities.

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

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

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

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

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

B. PMO and RCC Models Reassessed

63. In the absence of healthy and willing rural financial institutions, the PMO model has been instrumental in infusing much-needed capital into the rural economy. From a purely credit disbursement perspective, the PMO model appears more efficient. The coverage of households within localities with the PMO model (Sichuan Livestock Development Project) was about 66% compared to 20% with the RCC model (Southwest Anhui Integrated Agricultural Development Project).

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



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

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

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

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

VII. FACTORS IMPACTING ON THE INVOLVEMENT OF RCCs IN IFAD PROJECTS

A. Procedural Limitations Pertaining to Use of IFAD Loans

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

70. The PMO model has been a convenient tool in the context of current MOF procedures, as the borrower of IFAD loans. IFAD loans are passed on directly to the provinces and are repayable in 30 years after a ten-year grace period, and with associated exchange risk. The provincial government bears the exchange risk and passes the loan on to the subsequent lower level,



repayable in 15 years after ten years' grace. The township government, which ultimately receives IFAD loan funds, has to repay the borrowed amount to the higher levels of administration.

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

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

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

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

B. Limited Incentive Structure for RCCs

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



Cost of Funds

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

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

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

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

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

Perceived Credit Risk

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



Differences in Lending Policies and Procedures

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

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

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

Limited Demand for External Funding

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

C. Current Scenario

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

VIII. THE FUTURE

A. Shift Towards Sustainable Financial Service Delivery

87. The strengths and weaknesses of the PMO model need careful analysis. It is true that, in the absence of more mature local-level financial institutions, the PMO-administered credit lines have satisfied a need. It is also true that the users (borrowers) of the credit disbursed by PMOs may put a premium on accessing credit and be less concerned about their ability to pay back. In this context, one particular weakness in the PMO model stands out. It is inherent in all project administered credit lines, and is not unique to China. Government officials who administer credit can rarely acquire the information necessary for proper appraisal of clients and their proposed ventures. For a proper review of loan applications, they need information from local informal networks about clients' suitability to reduce the risk of low recovery and of bad debts. In technical literature, limited access to such data is termed 'information asymmetry'. On the other hand, such knowledge is held by local informants or obtained when systems are used for peer



review of credit applications. Local financial institutions that operate at the township, county and community levels build up such information. The PMO model of credit delivery using the Finance Offices does not form part of the local financial infrastructure: PMOs have limited access to reliable information for assessing and reducing risk. Errors in loan appraisals are thus more likely to arise and the probability of bad debts and low loan recovery increases.

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

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

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

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

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

B. Overall RCC Reform

Developing Management Capabilities

93. Depending on the direction that the RCC network takes in the future, two broad recommendations emerge. First, RCCs could be transformed into small, joint-stock single-unit banks, probably with much-reduced minimum capital and other licensing requirements; the related governance issues would need to be addressed in the framework of the existing commercial banking law. A second possibility is that the RCCs develop as genuine cooperative



banks. To that end, an internal management structure with apex organizations at different levels would need to be developed for management support, training, audit and supervision.

94. For the second course of action, it is imperative that the demand for apex-level structures should be mobilized from, and driven by, the primary level RCCs. Otherwise, a supply-driven institution-building approach will too easily appear, with limited efficiency and expensive recurrent cost implications for the RCC network. The latter alternative must be avoided at all costs.

A Specialized Legal Framework?

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

Savings-Based Development Approach

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

Transparency of Loan Rescheduling

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

Loan Write-Off Based on an Adequately Classified Loan Portfolio

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

Strengthening Commercial Lending Capacities

99. The banking skills of RCC staff need upgrading to a level that will allow for sound financial and elementary technical screening of loan applications. The recent trend to separate policy-based lending from commercial lending is a welcome step. In the longer run, the rural



finance system requires a level playing field between the different institutions and the phasing-out of preferential and subsidized lending to priority target groups.

Promoting Complementary Between Non-Financial and Financial Services

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

Improved Mechanisms to Facilitate Learning

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

IX. DESIGN CONSIDERATIONS FOR FUTURE IFAD PROJECTS

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

A. IFAD Loan-Use Procedures

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



counterpart funds. In most other countries, counterpart funds are provided either by the central government or by the provincial government.

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

B. Case for Changed MOF Regulations on Transfers of Funds

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

C. Incentives for the RCCs

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

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

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



D. Product Development

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

110. It is essential that RCCs be permitted to design products that meet the requirements of resource-poor households while yielding the required spread to RCCs to cover the cost of funds, transaction costs, credit risk and reasonable profit. The essential features of the microfinance instruments to be built into the IFAD project framework are:

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

E. RCC/PMO Collaboration

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



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

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

114. Second, the size of the credit components of IFAD projects needs to be substantially reduced. Since the current financial situation of many RCCs may not permit their active involvement in medium- and long-term credit, the capacity of PMO to provide medium- and long-term loans should be enhanced. Systems need to be built to ensure that PMOs do not offer unhealthy competition to the RCCs. The rate of interest on loans should be equal to the yearly interest rate charged by RCCs. The PMOs should be allowed to provide only one loan per client to ensure that they can obtain subsequent loans from the RCCs. Record keeping, loan account monitoring and maintenance of a revolving fund will have to be substantially improved to improve transparency.

F. Technical Backstopping

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

G. Reaching Those Not Reached by Financial Institutions

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

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

118. Financial groups are now well established aspects of the financial infrastructure in many developing countries. In most parts of Asia, SHGs have become channels of microlending



operations through systematic links with financial institutions. In Africa, groups have been used in monetization actions and as a channel for microlending operations. The groups perform the core function of risk absorption essential for the development of financial infrastructure. To perform this function more efficiently, the groups need to build equity with member contributions and, when possible, with donor money. The main issue is the need for institutions to take the initiative to create groups.

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