The World's Largest Credit Co-operative System: Facing an Uncertain Future

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China's rural credit co-operatives (RCCs) are in the midst of a major reform whose outcome will determine whether they continue to be the world's largest credit co-operative system. RCCs in wealthier areas have consolidated into rural commercial banks, but those in the poor, rural interior are still mutual in form. The authors report on an assessment of the RCC sector that is currently being conducted jointly by the People's Bank of China (the Chinese central bank) and the World Council of Credit Unions, focused initially on RCCs in Guizhou Province. Their conclusion so far is guardedly optimistic: RCCs in Guizhou are beginning to function as true co-operatives, and, with appropriate changes in government policies supported by technical assistance, a co-operative model may be best-suited to meet the credit needs of subsistence farmers in China's poorest provinces.

Virtually unknown outside China, the world's largest credit co-operative movement serves an estimated 800 million Chinese citizens, most of them very poor farmers. For over 50 years, the Chinese rural credit co-operatives have been the primary source of basic banking services for peasant farmers throughout the country. Although the RCCs hold nearly 12% of China's bank deposits, they account for more than 90% of legitimate agricultural lending in a country where almost half the workforce are still farmers.

Now in the midst of a major government-engineered reform, the RCCs are going through profound changes. The outcome of this process will determine whether they become true mutuals or, instead, a collection of relatively small stockholder-owned banks – in either case, competing with giant nationwide banking firms in one of the world's most dynamic economies.

The World Council of Credit Unions and the People's Bank of China (the Chinese central bank) have partnered to explore how modernisation of the RCCs can be improved and what policy framework is best for their future. A joint WOCCU-PBC project team headed up by the authors is in the process of completing an assessment of RCC restructuring in Guizhou, a very poor but ruggedly beautiful province in southwestern China, where the current reform started in 2003. This article is based on that study in Guizhou, as well as on interviews the authors have conducted with RCC managers, government officials and academics elsewhere in China.

The team's conclusion so far: Reform of the Guizhou RCCs has progressed impressively well, but there are major challenges remaining. Many of them flow from the risks and scale diseconomies of making very small loans that are vulnerable to crop failure and other disasters, often to families who live in remote areas. But also, the RCCs have long operated more like units of local government than as self-directed co-operatives, and in the past they have suffered from poor management and government interference.

Some of the needs identified by the study can be addressed through a technical assistance project, and getting one started is the next step for the PBC/WOCCU joint effort. Other needs call out for the consideration of tax, regulatory and other policy changes by national government.

But a central question that was posed by PBC's senior leadership for WOCCU to analyse is whether the RCCs can become true member-owned and directed co-operatives. What the team learned is that progress toward that end is encouraging, but the future outcome is still very much uncertain.

Rebuilding the RCCs is a critical priority for the Chinese government. The country's amazing economic growth over the past 25 years has lifted more than 200 million people out of absolute poverty, according to the World Bank. But China's new wealth has disproportionately flowed to Beijing, Shanghai and other commercial and manufacturing centres where a growing middle class is thriving from massive domestic and foreign investment and from international trade. The resulting disparity between urban and rural incomes is widening year by year, and it carries the threat of social instability, historically the greatest fear of Chinese leaders.

As a result, the current five year plan gives

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rural development a high priority, with the stated goal of creating a 'harmonious society' in which farmers get a bigger share of the nation's prosperity. China's leadership fully recognises that affordable personal credit is essential to achieving that objective. Hence, reform and modernisation of the RCCs is a major priority.

Fifty Years as the Bank for Peasant Farmers

The official history of the RCCs dates their origin to the early 1950s. But their roots go back to the pre-war period, when there was a large credit union movement in China, started a half century earlier with American philanthropic help. Although credit unions largely disappeared during the turmoil of World War II and the subsequent Revolution, the positive experiences of Chinese people with the credit union idea presumably helped inspire the creation of RCCs at the start of the modern era.

After coming to power in 1949, the Communist Party of China embraced co-operatives as appropriate structures for certain purposes, since the concept of collectively owned enterprise is consistent with socialist principles. Accordingly, the Party fostered the early development of RCCs as a key part of the nation's banking sector. From the 1950s through the end of the 1970s there were only two legitimate banking systems in China: The People's Bank of China (PBC) was then the single state-owned commercial bank, whose operations covered the whole country. Outside the cities, RCCs gathered peasant savings and made loans to finance village-owned businesses.

Beginning in 1979 the government created four big state-owned banks, with PBC thereafter serving as central bank and financial regulator. One of the 'big four', the Agricultural Bank of China (ABC), was assigned responsibility for industry management of the RCCs, and the RCCs became, in effect, a big part of ABC Bank's enormous branch network. Although local Party officials continued to exert a large degree of influence over individual RCCs (basically by managing their personnel decisions), the RCCs' surplus funds were funnelled into ABC for it to lend to large agricultural enterprises.

During the 1980s, county-level rural credit co-operative unions (RCCUs) were set up throughout China. Nominally owned by the RCCs they served, these RCCUs brought a degree of co-ordination and support at the local level.

The RCC industry appeared to be in relatively good shape well into the 1980s, when a delegation of US credit union leaders made a study tour to China in 1987 and held the first meetings since the Revolution between Chinese credit unions and their foreign brethren. Those initial meetings led to on-going co-operation between the Chinese RCC industry and foreign credit unions that has continued to the present day.

The Latest Chapter in RCC Reform

The modernisation of Chinese manufacturing in the 1980s and 1990s that brought prosperity to the coastal regions created serious competitive challenges for older manufacturing companies in the interior. Many of those factories (producing such things as machine tools, bicycles and home appliances) were owned by local government and financed by the RCCs. They were unable to compete effectively in the new market environment, and many failed.

Thus, by the end of the 1990s, RCCs in many areas were carrying a large burden of non-performing loans. Inept and sometimes corrupt attempts by local officials to develop new enterprises to replace lost jobs were funded by the RCCs, at local government's behest, and that created even more bad debt for the sector. According to government statistics, non-performing loans grew to 26% of RCC loans outstanding, but unofficial estimates put the figure as high as 50%.

Over the past ten years, however, central government has directed serious attention to reforming the industry. By 2001, city-level RCCUs had been set up in all the large metropolitan areas, where RCCs still had 'rural' in their name but served areas that had become mostly urban and industrial. Those city RCCUs provided centralised data processing, investment and liquidity services, personnel management and back office support. The individual RCCs functioned like branches of the city RCCU, which exercised substantial management control over them.

In 2003, PBC's supervision over the RCC industry was transferred to the newly created China Banking Regulatory Commission (CBRC), which accelerated the process already underway of merging individual RCCs into each other and then into their county level RCCUs. Hence, the total number of RCCs has declined from nearly 40,000 at the start of this century to around 25,000 today. As RCCUs absorbed their member RCCs, some started dropping 'co-operative' from the English form of their name, referring to themselves as 'rural credit unions'.

The most important step was the current reform, which got underway in Guizhou and seven other areas in 2003 and has since expanded throughout the country. Funded with RMB 160 billion of public money, the programme has several elements:

- Issuance of special PBC bonds that allowed RCCs to write off bad debt and restructure their balance sheets.
- Subsidised loans from PBC to fund more RCC farm lending.
- A temporary reprieve from income and other taxes.
- Flexibility for RCCs to charge higher rates to offset their higher lending risks.

Perhaps most significantly, the 'industry management' role traditionally exercised by central government was devolved to the provinces through creation of provincial RCCUs. Operating like the central finance facilities found in other credit union movements, the provincial RCCUs provide liquidity, centralised investing, data processing, auditing, training and other services to the local RCCs, who own them. But they also exert a large degree of top-down authority over the individual RCCs, recruiting their staff and setting basic operating policies.

Today, in the eastern urban areas the consolidation of RCCs into their city RCCU has been largely completed. Most of the city RCCUs have become 'rural commercial banks' – joint stock companies with outside investors. Individual members were compensated for their shares at par (usually just a few yuan per member) and given first rights to subscribe to the new shares.

In those large cities, the new RCC entities have become multi-billion RMB commercial banks, with gleaming new headquarter office towers, up-to-date IT systems, ATMs, internet banking and a full range of modern financial services. They have largely re-branded themselves to shed their old image as farmer co-operatives, and some have courted foreign investors. For example, a joint venture between Rabobank of The Netherlands and the International Finance Corporation acquired a 15% interest in the one serving Hangzhou.

But some of the big city RCCUs instead became 'rural co-operative banks' and remain depositor-owned co-operatives. Although they can also have outside investors, they are nominally still governed on a one-member/one vote basis. And in central and western provinces like Guizhou, where poor farmers have almost no other legitimate source of credit, most of the RCCs are also still co-operatives.

As the WOCCU-PBC team discovered, reform in the countryside has generally followed, at least on paper, international best practices for the structuring and operation of true financial co-operatives.

Guizhou as a Potential Model for New Chinese Credit Unions

Guizhou (population 40 million) is one of the poorest provinces in China, with per capital rural incomes averaging less than RMB 2,000 a year. In the aggregate, however, its RCC system is substantial. With 14,500 employees, total assets of RMB 66 billion, and nearly 2,000 retail outlets, the Guizhou credit unions dominate rural banking and have a significant presence in urban areas as well.

Since the reform began, all 2,000 village level RCCs have been merged into 84 county RCCUs and four rural co-operative banks (RCBs). The new Guizhou Provincial RCCU has a staff of 120 operating out of its headquarters in the capital Guiyang and eight district offices. Most are new to the RCC industry and came from commercial banks and from CBRC and PBC.

Just four years into the reform, the improvements are striking. New county level management has started coming on board, with experience in modern bank operations. Internal controls have been strengthened, and the provincial RCCU conducts a fairly robust auditing programme of the whole system. For the first time in years, the Guizhou RCCs as a whole had a small net profit for 2005, and last year every one of the RCCUs and RCBs operated in the black.

All the same, the challenges faced by the Guizhou RCCs are formidable. Although profits are generated by their growing portfolio of loans to small businesses in the villages and towns, about two-thirds of their lending is to farming households. In some counties, those loans average less than RMB 4,000 apiece. The annual interest on a loan that small is barely enough to cover administrative costs, let alone the large risk of default.

Farmer loans are subject to the unpredictable risks of weather and vagaries in the market for agricultural produce. Although RCC loan officers insist that their borrowers are good people, with strong community ties and the desire to repay, all too often natural disaster or calamity stands in the way. While bad debt levels are down overall, in some counties they are still as high as 10%.

A big need for RCCs (and for agricultural lending generally in China) is some form of crop insurance, such as found in the US and Canada. Permanent relief from income and business taxes is also essential. Other needs are just as critical but easier to address through straight-forward technical assistance.

But a more complex matter is whether the Guizhou RCCs can become true co-operatives that are self-governed democratically by their owner-members.

Mutuals or Banks?

The big debate, on which policy-makers, academics and RCC people themselves are divided, is what ownership and governance structures will best suit rural RCCs in the future. In most eastern cities, the new rural commercial banks have completed their demutualisation process and are no longer co-operative, even in name. But for rural areas, many question whether profit-motivated commercial banks will be willing to make low-margin, high-risk micro-finance loans to poor farmers.

At least in Guizhou, the RCCs have been moving in the direction of becoming real member-governed co-operatives. Although RCC people themselves acknowledge that governance is still weak, it is in real ways as democratic as one finds in many co-operative systems elsewhere in the world.

The board of directors of the Guizhou Provincial RCCU is elected by representatives of the county RCCUs and RCBs that own it. Their directors are in turn elected by secret ballot at their annual general meetings. The electors are delegates chosen through a village-level election process by the individual members. Although the provincial RCCU nominates most of the candidates for directorships at the county level, there are more candidates than positions, so the elections have actual significance. In at least two cases over the past couple years, the county level delegates refused to accept the individuals nominated by the provincial RCCU for the key position of board chairman.

As noted above, moreover, even in wealthy parts of China, some of the city RCCUs have stayed mutual. While tempted by the perceived advantages of a public company structure for raising outside capital, their leaders also recognise that one of their principal competitive advantages is their historical ties to their individual owner-members.

Thus in Guangzhou and Tianjin, for example, many RCC customers are people who used to be farmers but whose land is now urban and industrial. Now they are factory workers or shopkeepers, but their loyalty rests with the RCCs who were always their family banker. As a result, outside the city centres, these rural co-operative banks rank high in market share, often well ahead of local branches of the much larger state-owned banks. The tie to the customer that comes from mutual ownership has real value for these RCBs.

Moreover, in other sectors of the Chinese economy, co-operatives are seeing a bit of a renaissance. A new Farmer Professional Co-operatives Law was adopted in October 2006, and new producer co-operatives are starting to appear. Under a pilot programme of the bank regulator, provincial governments can sponsor new village credit co-operatives, but so far only two have been formed.

At this juncture, it is difficult to predict whether true credit co-operatives can re-establish themselves in modern China. But the signs are encouraging, and World Council and PBC are working together to see whether the co-operative ideal, properly implemented, will be the best way forward to meet the needs of poor Chinese farmers for affordable credit.

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