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URBAN CREDIT CO-OPERATIVES IN CHINA

by

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LIST OF ABBREVIATIONS

ABC	Agricultural Bank of China
BOC	Bank of China
CCCB	City Co-operative Commercial Banks
CPI	Consumer Price Index
DG bank	Deutsche Genossenschaftsbank
ICBC	Industrial and Commercial Bank of China
NIEs	Newly Industrialising Economies
PBC	People's Bank of China
RCCs	Rural Credit Co-operatives
RMB	Rimimbi
SMEs	Small and Medium-Sized Enterprises
SOBs	State-Owned Banks
SOE	State-Owned Enterprise
TICs	Trust and Investment Companies
TVE	Township and Village Enterprise
UCCs	Urban Credit Co-operatives

RÉSUMÉ

Ce document technique étudie le fonctionnement des coopératives de crédit urbaine en Chine. Il s'appuie tout d'abord sur une mise en perspective par rapport à l'expérience de l'Allemagne, de la France, des États-Unis, du Japon, et de plusieurs pays en développement. Il comporte ensuite une analyse macro-économique du fonctionnement, de la réglementation et du rôle des coopératives de crédit urbaine dans les circuits de collecte d'épargne et de crédit. Enfin, il étudie au niveau micro-économique les activités des coopératives de crédit, à partir d'une enquête réalisée auprès de 57 coopératives dans huit villes chinoises. Cette enquête permet de montrer que les coopératives de crédit ne respectent en général pas la législation bancaire. Elle permet aussi de détecter l'existence d'une grande hétérogénéité. Les coopératives les plus profitables sont, sans surprise, situées dans les régions côtières à croissance rapide, mais ont tendance à utiliser une partie importante des fonds collectés à des prêts au secteur étatique, plutôt qu'au secteur collectif.

SUMMARY

This Technical Paper is a study of the working of urban credit co-operatives in China. It begins by putting the German, French, US and Japanese experiences into perspective, before constructing a macro-economic analysis of the operation, institutional context and the role of urban credit co-operatives within the savings and credit systems. A survey of 57 co-operatives in eight Chinese towns is used to study credit co-operative activities at the micro-economic level. The survey shows that within their heterogeneity the credit co-operatives generally ignore the laws governing banking operations. Unsurprisingly, the most profitable are located in the fast-growing coastal regions, but they tend to use a large proportion of their funds for loans to the state, rather than the co-operative, sector.

PREFACE

The reform of the banking and para-banking systems is among the urgent and difficult tasks which the Chinese authorities need to undertake to consolidate the benefits of economic opening.

Such a reform is difficult, since part of the system developed anarchically without control or oversight from the Beijing authorities. Particularly sensitive in this respect is the urban credit co-operatives sector which, while only responsible for a small part of Chinese savings has shown the most expansion within the banking system. To a great extent, in reality if not legally, these co-operatives avoid the rules of the People's Bank of China (PBC) which seems to know little of their operations. This unawareness of their procedures is one of a number of obstacles to the creation of a stable financial system under the established control of the Central Bank.

This explains why the Development Centre has undertaken an in-depth study of the Chinese urban credit co-operative system. This study was carried out in close collaboration with the PBC to which one of the authors, Xie Ping, belongs. Based in large part on surveys in a number of Chinese towns, the study is the first to document the characteristics and financial behaviour of urban credit co-operatives.

By comparing the Chinese experience with that of credit co-operative movements in advanced, particularly OECD countries, the study provides information and ideas for the benefit of the Chinese authorities and those of other economies in transition.

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Jean Bonvin
President
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OVERVIEW

Banking sector reform in China favoured a parallel and phased approach. After initially protecting existing state banks from external and internal competition, in the 1980s the Chinese authorities allowed successive waves of entry of new types of non-bank financial institutions, which in theory should not compete directly with state banks, since they are supposed to finance exclusively the non-state sector. Over the last decade, these institutions gained an increasing share of financial assets with an impressive growth which was particularly helpful in satisfying the growing demand for investment loans by enterprises both in the state and non-state sectors.

Chinese Urban Credit Co-operatives (UCCs) have been the most dynamic of these non-bank financial institutions. It is thus all the more surprising that they have been so little studied.

The emergence and rapid development of UCCs can easily be understood in the perspective of recent theoretical work on financial institutions. In China Urban Credit Co-operatives developed in response to controls over, and deficiencies in, the state banking sector. The state-owned banks face difficulties in solving the problems of asymmetry of information and in monitoring the performance of their borrowers. By contrast — as shown by the so-called peer monitoring view — credit co-operatives enjoy comparative advantages in using local information, monitoring and enforcing sanctions on borrowers. They can diminish the adverse selection and moral hazard problems and reduce the costs of loan collection.

These comparative advantages are certainly the major reason why credit co-operatives, which developed in Germany in the 19th century, were then adopted in many countries and survived in developed market economies with sophisticated credit markets. The experience of Japan is a good reference since the merging of some credit co-operatives into Shinkin banks in the 1950s did not deprive credit co-operatives of their function. The experience of other Asian countries with informal credit is also of relevance. This shows that the downside of such credit arrangements is manifest at the macroeconomic level, and this is directly applicable to credit co-operatives. The latter are usually more efficient than large scale banks in granting loans

for productive uses, but this advantage implies that they do not comply with the wishes of the authorities in the attempt by the latter to direct capital to priority sectors. A similar problem arises with stabilization policies, since being less under the control of monetary authorities, credit co-operatives can fuel demand pressures in particular markets when policy is aimed at limiting inflationary pressure.

Credit expansion by credit co-operatives may indeed be viewed as a source of difficulty for monetary control in China. While such credit expansion is bound by ceilings set in the comprehensive credit plan, compliance with the plan has proved difficult to monitor. Thus UCCs would represent an important source of faster than planned credit expansion. However, this assertion should be qualified since the loans granted by UCCs have been only a fraction of the deposits they collect. Of course this does not imply that they have not participated during certain periods in "excessive" credit expansion.

Finally, prudential concerns are relevant since the protection credit co-operatives offer to depositors is not as substantial as that offered by large scale banks which often benefit from the backing of the state. The lack of supervision and the risks assumed by them implied that some UCCs in China went through convulsive restructuring. These excesses have led the authorities to try repeatedly to enforce existing regulations and to reinforce them. Furthermore they designed asset liability ratios as an alternative form of management to the credit ceilings. A more recent strategy for reforming the urban co-operative financial system has consisted both in standardizing UCCs and in merging them into new urban co-operative banks, similar to the Japanese Shinkin banks of the 1950s.

Given the lack of first hand data on Chinese urban credit co-operatives, surveys were conducted in 8 cities in three regions with different levels of economic development. This provided detailed indicators on the structure of their balance sheet, their management, and about their financial performance or solvency.

The sample UCCs do not as a rule comply with many existing regulations. Thus their equity structure gives a predominance to individuals, and collective enterprises, in excess of what is stipulated by existing regulations. Besides, even though UCCs are prohibited from granting loans to state-owned enterprises, such loans represent 20 to 30 per cent of credits granted. However, this is understandable in as much as state-owned enterprises (SOEs) tend to be less risky. Besides, the financial performance of sample UCCs is much better than the national performance of state owned banks. Their share of non performing loans is four times smaller and their earnings-asset ratio ten times bigger.

A principal component analysis shows that there is a clear separation of UCCs according to the level of development of the region in which they operate. In highly and mildly developed regions, i.e. the eastern and middle parts of China, UCCs are profitable and have a low proportion of non-performing loans while they to some extent collect deposits from collectives and lend to SOEs. In the western part of China, composed of less developed regions, UCCs have a poor financial performance and to some extent do the opposite type of intermediation. The fact that UCCs do the rest of their intermediation between collective enterprises rather than between SOEs improves their financial performance. Actually, the more advanced the region the higher is the share of intermediation between collective enterprises. Overall, it is only in these regions that it seems rational for UCCs to side-step regulations in order to grant loans to SOEs. The SOEs which borrow from them may be keen at servicing their debts in order to keep their reputation and may divert funds to put UCCs first on the list among creditors.

This survey also shows that apart from the scale of assets, there is often no difference between UCCs and commercial banks. This is particularly true of payment risk. Since it is impossible for the Central Bank to carry out regular supervision over these UCCs, their lack of compliance will occur widely. A transformation of such UCCs into regular banks seems imperative because without more regulation the risks will be borne by depositors. This implies that UCCs should be merged into City Co-operative Commercial Banks (CCCBs) in medium- and large-sized cities. These new local commercial banks with powerful strength, large amounts of assets and support by local governments will directly compete with state-owned commercial banks in the local financial industry. However, these new banks will undoubtedly be unable to provide financial services, in large and medium-sized cities, to self-employed persons and individually-run enterprises, because such banks will have higher cost, linked to better credit screening. Therefore, in such cities, several UCCs of community co-operative characteristics should be established. Besides, in smaller cities, where no merging of UCCs into CCCBs occurs, UCCs should be transformed into small-scale commercial banks so as to enable better regulation from the authorities.

There is undoubtedly one drawback in such a strategy which aims at improving the functioning of the co-operative system in China. This is that such financial intermediaries suffer from geographic specialization and, for a number of them, from a narrow focus on specific sectors of the regional economy. This makes them highly vulnerable to sector and/or region specific shocks. Moreover, given the inefficiency of the state banking sector, such a weakness is not sidestepped when credit co-operatives re-lend their "excess" deposits to SOBs in order to try and benefit from a diversification effect. These difficulties are real ones and require strict supervision and the

enforcement of prudential ratios, which are part and parcel of the strategy aimed at integrating credit co-operatives in the banking sector. However, as our survey study shows, a number of UCCs have taken some steps in solving it by lending to different types of enterprises, and in particular their lending to a segment of the low risk state-owned enterprises is certainly a sign that the need for diversification is at least partly taken into account.

The strategy underlying the current reforms of the credit co-operative system will contribute to remedying such problems. The merging of urban credit co-operatives, and the build up of a pyramid structure close in inspiration to the previous Japanese experience are indeed positive "steps" in such directions. However improving the efficiency of state-owned banks is yet another step which has to be made before the financial system can start functioning effectively.

I. INTRODUCTION

Standard analyses of economic development¹ stress that achieving sustained growth requires the development of a broad range of supporting institutions, among which financial institutions play a major role². Viewed from such a perspective the role played by banks in financing the impressive growth³ enjoyed by China since the start of the reforms in the late 1970s seems relatively minor. While accounting for over 60 per cent of industrial production, the non-state sector receives only about 15 per cent of loans granted by formal financial institutions. There is thus a widespread view that China has achieved record rates of growth, despite the lack of apparent fundamental reforms in key sectors, such as banking⁴. Such a lag in reforming the financial sector compared to reforms in other sectors of the economy is indeed generally considered to be a characteristic feature of transitional economies⁵.

However, the experience of other high-growth Asian economies⁶ shows that despite the shortcomings of the formal banking system, 'the financial system as a whole must have contained enough resilience and elasticity to meet the most urgent needs of a rapidly growing economy in a great transformation process'⁷. In the literature on Asian economies, but curiously not in the case of China, this resilience is usually attributed to non-banking credit arrangements, which bridge the needs of small or medium-sized businesses excluded from bank credit. There is thus need to examine further the structure and dynamics of the Chinese financial institutions to see whether agents other than state-owned banks have played an increasing role.

Among non-bank financial intermediaries in China, UCCs were both the most dynamic over the last ten years, and one of the least studied. Thus, in their otherwise exhaustive study of the 'Chinese Financial System', Dipchand et al (1994) devote only two pages to UCCs with meagre details compared to extensive developments on Rural Credit Co-operatives (RCCs) or Trust and Investment Companies (TICs). A very short case study of 'UCCs in Shanghai' is provided by a recent World Bank (1995) country study. UCCs are hardly mentioned by Yi (1994) or Yang (1996). This report aims at filling in such a gap both by studying in detail the characteristics of UCCs at the

macroeconomic level and by implementing an original survey study on UCCs in different cities located in regions with varying levels of economic development.

We will provide in the first chapter a general background on Urban Credit Co-operatives. This will first imply considering recent theoretical advances which have highlighted their comparative advantages in using local information, monitoring and enforcing sanctions. We will then examine briefly the comparative experience of advanced market economies and newly industrializing countries with UCCs.

The second chapter will consider the Chinese macroeconomic context of UCCs. This will involve examining their history and major broad characteristics. We will also look at their financial specificities, as well as the regulations to which they are subject and the reforms which are under progress.

The third chapter will present the results of the survey study with, first a description of the major features of our sample of UCCs. We will then consider the relationships between their main characteristics by using principal component analyses. Finally, we will examine the underlying problems and prospects for reform.

Notes

1. King and Levine (1993a); for a survey Galetovic (1994).
2. In a broad cross-country comparison, King and Levine (1993b) find financial depth to be the single most important factor explaining differences in growth rates across countries. They show that countries with a greater proportion of credits intermediated by commercial banks grow faster.
3. This growth remains impressive even when account is taken of the underestimation of producers' prices in official statistics, see Woo (1995).
4. Lin (1995).
5. See, for example, the survey by Caprio (1995).
6. Ghate (1992).
7. Lundberg (1979) quoted by Besley and Levenson (1996).

II. THEORETICAL BACKGROUND AND COMPARATIVE EXPERIENCES

An assessment of the situation and dynamics of Urban Credit Co-operatives in China involves both looking both at the pros and cons of the non-banking credit arrangements, and examining international experience with such credit co-operatives.

There is no ambiguity as to the fact that in China the non-state financial sector has been reactive rather than autonomous, with reference to the typology suggested by Chandavarkar (1985), *i.e.* it developed in response to controls over, and deficiencies in, the formal banking sector, rather than antedated the latter. Indeed, the state-owned banks are typically poor at solving the problems of asymmetry of information and at monitoring the performance of their borrowers, mostly state-owned enterprises. Non-bank financial intermediaries such as credit co-operatives by contrast have a comparative advantage in these respects. The main results of the recent literature emphasizing the factors behind such comparative advantages, as well as the downside of these institutions, must be presented.

The pioneering example of credit co-operatives has been the German co-operatives of the 19th century which were adopted throughout the world¹, both in urban and rural areas. They can even survive in situations where credit markets are fairly well developed. This is not surprising if co-operatives can diminish the adverse selection and moral hazard problems that persist in fully developed financial systems and reduce the costs of loan collection. However, the relative importance of this kind of institution may decline as the credit system becomes more developed, reflecting the decreasing importance of local knowledge and enforcement. It thus seems useful to examine the experiences of various countries, developed market economies, as well as newly industrializing countries, with this type of credit institution, so as to see whether such intuitions are validated.

A. The Rationales for the Superiority of Credit Co-operatives

1. A Comparative Advantage in Using Local Information, Monitoring and Enforcement

Credit co-operatives typically borrow funds from inside sources, mostly their members, and outside sources, mainly banks. They work in some respect like formal sector banks, collecting deposits from and granting loans to their members.

Recent theoretical advances have been made in the study of the motivation for and design of risk sharing institutions in general and credit arrangements in particular². One recent strand of the literature on mechanism design (Moore, 1994) has stressed the possibility of finding efficient outcomes in environments where agents are well informed about each other. This literature focuses on selecting a set of rules that induce people, given their private information, to take some prescribed action. Credit institutions can then be seen as mechanisms that aim at dealing with the various information and enforcement constraints to bring about more socially efficient outcomes. The approach of Banerjee et al (1994) to the study of different forms of credit contracts views the constitution design problem in a credit co-operative as a mechanism design problem.

Two major approaches to analysing credit co-operatives have thus been put forward. The first has focused on the long-term interaction that they ensure. According to this view, co-operatives should be designed to ensure that members have durable long-term relations among themselves or else identify sufficiently with the collective (Banerjee et al. 1994). This approach gives reasons why privately optimal, short-sighted behaviour may be curtailed in a credit co-operative. The sociological reason emphasises the role of the community in sustaining non opportunistic behaviour among participants. Social sanctions are typically not available in a conventional bank, but are available in a credit co-operative. The second reason is based on the fact that the co-operative is sustained by repeated action among the participants.

Another approach considers that credit co-operatives are an organisational form that tries to use local information and enforcement, and aims at providing a closer monitoring of borrowers than do conventional banks³. They have a comparative advantage in using local information, monitoring and enforcing sanctions on borrowers. This is the so-called peer monitoring view⁴ (Stiglitz, 1990; Arnott and Stiglitz, 1990). Individuals who interact in a variety of non-market contexts tend to know each other well. Thus they may have greater ability to monitor each other than do formal financial institutions, such as banks. This can explain why many non-market institutions function effectively where formal institutions fail. For example, the frequent failure of formal banking arrangements in low-income situations

is commonly attributed to informational problems such as adverse selection and moral hazard (Braverman and Guash, 1986; Binswanger, 1986). In such contexts non-market institutions may still be able to work.

While in a large-scale bank an individual may wish to monitor those who have been granted loans and on whose performance the return to his savings depends, it is usually extremely costly for him to do so. By contrast, in a credit co-operative such monitoring may be easier, given the individual's local knowledge of borrowers and the relatively small size of membership. This may reduce the two kinds of agency problems experienced in banking: the borrower's and the monitor's. Borrowing members of the co-operative undertake projects about which they have some private information. If there is a moral hazard problem, the other members of the credit co-operative have to be induced to monitor.

There are at least three ways of providing incentives to the borrowers and to the monitors. The first consists in making the non-borrowing member liable for the debts of the credit co-operative, so as to encourage him to monitor, by serving as a guarantor, to which outside creditors will appeal in case there is a default on loans from non-members. The second involves making the non-borrowing member a creditor. Internal fund raising is then of major importance, as well as generating internal funds. The third implies altering the terms of the contract. For instance the interest rate on internal funds may be made to depend on the success of the borrower's project. Banerjee et al. (1994) show that providing incentives via liability rules and via using internally generated funds are substitutes. Each system can be optimal under some configurations of parameters.

The comparative advantage of informal non-market institutions in terms of enforcement has two features. The first concerns the scope of sanctions. In most social structures, mechanisms of social control already exist to limit antisocial behaviour. The second feature concerns the depth of sanctions. In low-income countries, many formal institutions, such as banks, are new, but there is a long history of co-operation in informal settings.

In theory as well as in practice, credit co-operatives raise two major problems : free riding and collusion (Besley, 1995b). The first stems from the fact that among the members of a co-operative many may very well be non-borrowers. Each of them may be required to play some monitoring role according to the type of structure which prevails among the three mentioned above. Free rider problems would emerge in case none of the non-borrowers is ready to put in the effort required to get the optimal level of monitoring. The second problem is linked to the possibility of collusion between non-borrowers and borrowers who may find themselves in a better situation by not repaying their loan to the lender. The fact that individuals have good information about each other may indeed be both a good thing — since this

would make co-operatives more effective from a monitoring point of view — and a bad thing, in as much as these individuals know each other well and can potentially collude.

2. ...but an Obstacle to Credit Direction, Monetary Stabilization and Prudential Supervision

The lessons of the experience of Asian countries, excluding China, with informal finance, gathered in an exhaustive study by Ghate *et al.* (1992), is that as a result of its comparative advantages, informal credit is better distributed than formal and is used more productively. However, there are three main concerns often put forward (that are undoubtedly shared by the Chinese monetary authorities). First, informal credit violates the planning objectives that the government sets itself. Indeed, it frustrates the selective credit policy of the authorities by responding to demand conditions rather than to the credit priorities that the government seeks to enforce through state-owned banks. However, this is the other side of the coin, in this way informal credit acts as a safety valve: by ameliorating efforts to control credit too tightly, it improves productivity and allocative efficiency.

Second, with respect to stabilization policy, informal credit frustrates, or at least dampens, the efficiency of monetary policy. It is unlikely that it completely frustrates it, but it does fuel demand pressures, in particular markets such as those for securities, real estate, or commodities, when such pressures exist independently. The share of the informal sector is affected by credit expansion and contraction in the formal sector. Among the short-term factors affecting especially the reactive component of the informal sector, one finds inflation, which reduces the real interest rate on formal-sector deposits while often increasing the demand for credit for investment in real estate, in stock building and in real assets generally.

Third, there are prudential concerns. The informal sector cannot offer the same degree of protection to depositors that can be enforced in banks, for example benefiting from the backing of the state or other prudential safety nets. While the default rate by borrowers on which depositors' security partly depends is much lower in the informal sector than in large parts of the formal, the informal sector certainly appears to experience its share of failures occasioned by fraud and mismanagement. Governments of a number of countries have had to pick up the pieces of credit co-operative systems that were close to bankruptcy. One possibility is that the information needed for peer monitoring was not available. However, other explanations⁵ include the failure of co-operative design to make due allowance for covariant risk. Indeed, credit co-operatives typically focus their activity on specific regions or specific sub-groups of the population. Savings are, in this case, not allocated to the investment projects with the highest returns, but at best to the “best” projects

in the region or sub-group. This is well known for instance from the experience of African savings clubs, or of American Savings and Loans Associations, and generalises to credit co-operative type of institutions. One remedy to such sub-optimal intermediation can arise whenever credit co-operatives diversify some of their portfolio by rechannelling funds to financial intermediaries which operate efficiently on a nation-wide basis. The experience of Asian countries indeed shows that such a flow of funds between different types of financial intermediaries is desirable⁶. However, this certainly raises problems when, as is typically the case in transitional economies, the banking sector is itself very inefficient, suffering as it does from an inability (or the absence of the possibility) to screen loans properly, due to the asymmetry of information, and from moral hazard problems. Thus, minimal prudential regulation of the informal sector is an important area for policy action, while it has to be accomplished in a careful way so as not to destroy this fragile construction.

While theoretically there will always be scope for informal finance if it can improve on formal sector transaction costs, financial dualism is likely to become less pronounced as the formal sector is progressively liberalised⁷. The reactive informal financial sector grows and contracts in a countercyclical manner to liberalisation in the formal sector.

B. International Experiences with Urban Credit Co-operatives

The diversity of experiences with urban credit co-operatives is particularly striking. We may classify them in three categories. The first one involves western developed market economies ranging from the pioneer German experience with *Volksbanken*, to the French *Banques Mutualistes*, and to the United States credit unions. The second refers to the Japanese experience with major teachings for the Chinese case. Finally the Newly Industrialising Economies (NIEs), both from Latin America and Asia, offer another series of lessons.

1. Western Developed Market Economies

a. The German Experience with Volksbanken

Urban Credit co-operatives, along the lines pioneered by Robert Owen in the United Kingdom, were founded during the 19th century in Germany by Frank Hermann Schulze-Delitzsch (1808-1883) with the aim of providing credit in anticipation of future revenue⁸. Since that time they have flourished, mainly because their enabling Act of 1989 granted them the privilege to add 50 per cent to their equity capital when determining their lending ceiling. This additional 50 per cent arises from the legal form from which most co-operative

banks adopt — i.e. the limited liability of their members to make additional contribution should they become insolvent. Such a legal concession was a permissive factor behind the rapid expansion of their business by the co-operative banks.

As a result of their fast expansion, their central clearing bank (the so-called DG bank — for *Deutsche Genossenschaftsbank*) has become very sizeable. Their specificity as co-operative banks is such that their business mainly consists in attracting savings and in granting short- and medium-term loans. However, they tend to behave more and more as universal banks.

There are ten central institutions of the co-operative banks, including the DG bank. They act as cheque clearing houses and central banks of the co-operative banks. These central institutions rely exclusively on these co-operatives for their funds and hold their members' banks liquidity. Such deposits account for 75 per cent of their volume of business and the cost of these funds rose sharply in the 1980s, while these costs could not always be met in the lending business, with a consequent fall in profitability.

The DG bank, which was established in its present form only in 1975, has an important co-ordinating power and manages the liquidity of the co-operative banking sector.

b. Mutual and Co-operative Banks in France

In France, Mutual and Co-operative banks were created or organised under the impetus of the government⁹. Initially they aimed at covering particular needs that standard banks were unable or unwilling to meet: granting loans to small and medium-sized enterprises (SMEs) or craftsmen. With time this specialisation has been blurred. However, this type of bank keeps some characteristics which still make them different from standard banks. Their structure is always very decentralized because of their mutual character: the basic cell is the local level, with a varying capital held by members, who are most often the recipients of loans. They enjoy privileges, most often tax breaks, but to a decreasing extent. Finally they do not generally lend much to big firms. Three categories of such banks must be distinguished.

The Crédit Mutuel

This is a private body which mainly does business with households. Initially it aimed at lending to poor households. The different components were unified in two stages with the national confederation created in 1958 and the *Caisse Centrale* (central office) in 1964.

This bank is very decentralized with 3 000 local offices which are very often managed by volunteers. It collects time deposits and grants loans to households. The regional federations manage their cash flow, refinance local offices and guarantee the security of deposits. The national confederation represents collectively the local offices, controls their management and labels them.

The main privilege enjoyed by the *Crédit mutuel* is that it offers time deposits with the same interest rate as offered by banks but without tax. As a counterpart, it has to use around 60 per cent of these funds to contribute to local and regional development.

The People's Credit

The *Crédit populaire* mainly does business with SMEs. It is made up of two components. On the one side an original system of guarantee aimed at assuming the risk for customers of *People's banks*. The latter are a co-operative banking system with local, regional and federal units. Both were set up by law in 1917.

The *Sociétés de Caution Mutuelle* are spontaneous groupings of shopkeepers and SMEs, generally by type of business, guaranteeing the payment of loans granted to their members by different financial institutions. About 280 of them are co-operatives.

The Co-operative Credit

The *Caisse Centrale de Crédit Coopératif* is the financial centre of a number of institutions. Created by law in June 1938, its capital is held by its members who belong to the non-rural co-operative sector and to some non-profit institutions. Its chairman and general manager are appointed by the government. Its resources are composed mainly of bonds, guaranteed by the state. The finance ministry gives interest subsidies to its medium- and long-term loans which are geared to its members. Inside the group the French Co-operative Credit Bank is a commercial bank in charge of collecting and managing the group's liquidity.

c. Credit Unions in the United States

In the United States, Credit Unions are mutual associations that serve only their members, and it is not opened to everyone to join¹⁰. Indeed to be eligible, one has to share a "common bond" with other members in the Union. Such a common bond may be defined either in a quite restrictive way, people

working for the same employer — or very broadly — people living in the same county. The result is, however, that most of the time credit unions are small, with 50 per cent of them holding assets smaller than \$1 million.

Credit unions can be characterised as small non-profit savings and lending institutions which aim at encouraging thrift and at providing cheap consumer credit to their members. They emerged in a reactive manner. Indeed at the beginning of this century, commercial banks were not accepting small saving deposits and did not offer consumer credit. Moreover, usury laws were extremely restrictive in many states, with the result that numerous consumers could not have access to cash credit.

Credit unions enjoy tax privileges and exemption from antitrust restrictions. The former reduce their costs and enable them to accumulate capital. The latter allows them to establish and develop co-operative arrangements in order to share the overhead costs needed to develop specialised financial services. On top of this, regulators have recently relaxed the “common bond” restriction. It let family members and “associate” groups join or merge with them.

The trade associations backing the credit union movement have developed co-operative activities on both state and national level. Moreover, credit union associations developed their own central credit union, allowing them to function in a way very similar to a national bank.

2. The Japanese Experience

a. Credit Co-operatives

Credit co-operatives in Japan are co-operative financial institutions based on the mutual support of owners and workers in small businesses¹¹. They are organised under the Law for Small Business Co-operatives of 1949. The credit co-operatives that were similar in nature to general financial institutions were converted into Shinkin banks (see below); as a result, the credit co-operatives of today are more like co-operative societies than like Shinkin banks. The independence of credit co-operatives is respected, and supervision is made as simple as possible. In principle, their business is conducted only with members of the co-operative, and thus their purpose as co-operative financial institutions is more clearly carried out. Because credit co-operatives also manage financial business, however, it is necessary for them to be managed soundly in order to protect their depositors. To this end, the Law Concerning Financial Undertakings by Co-operative Societies was established in 1949. It placed limits on how the surplus funds of such co-operatives might be used, and provided administrative guidance concerning the regulation of payment reserves against deposits, limits on size of credits

granted, and requirements for retained earnings. The administrative authority for supervision of credit co-operatives is currently, and since 1951, vested in the prefectural governors.

The major expansion of credit co-operatives in the 1950s and 1960s caused a gap between theory and practice of credit co-operative operation. In 1968, several revisions of the system were undertaken, in which their areas of business were expanded to include lending collateralised by deposits to local governments and public bodies and lending to financial institutions. In addition, their capital base was improved by raising their minimum amount of capital; the limit on lending to any single individual was also revised. A second set of reforms in 1973 permitted up to 20 per cent of deposits to be taken from non-members and also strengthened the requirements for membership.

When the conversion of credit co-operatives to Shinkin banks occurred in the early 1950s, only 72 credit co-operatives were left. The establishment of a credit co-operative is automatically approved whenever particular conditions, as defined by law, exist; many credit co-operatives were established after the original conversions. By May 1968, there were 544 credit co-operatives. In that year, the Finance Ministry took measures to reduce the founding of credit co-operatives, and thereafter the merger and conversion of such institutions continued. By the end of 1985 there were 448 credit co-operatives remaining.

Credit co-operatives may accept deposits and instalment savings only from certain types of depositors: members of the co-operative; the national government, local governments, local public bodies, and non-profit organisations (only deposits may be accepted from these institutions); spouses and relatives of co-operative members who are living in the household of the member; and non-members (only up to a maximum 20 per cent of total deposits). The interest rates payable on these deposits are subject to upper limits.

On the lending side, credit co-operatives may lend or discount bills, in principle only to members. However, up to 20 per cent of loans (excluding loans and discounting bills to financial institutions) may be lent to non-member depositors on the collateral of their deposits or instalment savings, or to local governments and public bodies. There is a limit on lending to any single member (about 20 per cent of own capital). The interest rate on lending is also subject to a ceiling.

Over the 1977 to 1991 period the share of personal deposits held with these institutions has been slightly decreasing compared to the share held with banks (Table 2.1).

Table 2.1. **Share of Japanese Credit Co-operatives and Shinkin Banks in Personal Savings Deposits**
(unit: 1 billion yens)

	1977	1980	1983	1986	1989	1991
Banks	60.4	83.3	106.5	133.0	177.9	205.5
Credit Coop*	26.9	37.3	47.2	57.1	71.7	83.2
Shinkin banks	17.9	25.2	32.0	39.5	51.8	59.6
Post off.	37.7	61.9	86.2	110.3	134.5	155.0
Trusts	16.2	21.9	35.8	53.0	79.8	79.5

* Credit co-operatives and credit associations: includes credit, agricultural and fisheries cooperatives, as well as labour credit associations.

Source: Zahid (1995)

b. Shinkin Banks

The origins of Shinkin banks go back to the credit co-operatives of the Meiji period, but their immediate precursors were the credit co-operatives based on the Law for Small Business Co-operatives etc., of 1949. In June 1951, the Shinkin Bank Law was promulgated, and those credit co-operatives that had previously been regular credit co-operatives in fairly urbanised areas and that were relatively large in scale and similar to general financial institutions became Shinkin banks. The operations of Shinkin banks centre on taking deposits and making loans and thus are not particularly different from those of ordinary banks. Shinkin banks, however, are organised on a membership basis. They are limited to certain geographical areas because of their character as regional financial institutions, and differ as well in this respect from banks. They are, however, similar to general financial institutions and dissimilar to credit co-operatives in another respect, that of the ability to take deposits from non-members without upper limit.

The development of Shinkin banks in the post-war period was quite rapid. They held an important position in the field of financing small and medium-sized firms; but they underwent a remarkable change in the content of their business in the process of development. First, the membership system became largely a matter of form. That is, in order to borrow, all one needed to do was to become a formal member. On the deposit side, the proportion of deposits coming from non-members grew substantially, and the Shinkin banks became more and more like ordinary banks. Secondly, considerable differences emerged in scale of operations among different Shinkin banks

across the country, reflecting differences in regional development. Thirdly, the various regulations imposed on Shinkin banks, such as qualifications for membership and limits on lending to any individual, did not necessarily match the development of social and economic conditions. As a result, the laws concerning Shinkin banks were revised in 1968, 1973, and 1981.

The important characteristics of the Shinkin banking system as it is today are fourfold. First, to qualify for membership members must be operators of businesses with either an address or a place of business within the geographical area served by the bank and must have either fewer than 300 employees or less than a certain amount of capital; or members must be workers from within the geographical area. Secondly, there are minimum limits to the funding provided by a single member and to the total of the Shinkin bank. Thirdly, there are restrictions on types of business in which the bank may engage, which reflect the character of the Shinkin banks as an institution for its members. Fourthly, maximum lending to any single individual may be as much as 20 per cent.

On the basis of revisions in the system and the merger and conversion laws, an amalgamation of Shinkin banks occurred. The number of Shinkin banks was reduced from 520 in May 1968 to 456 at the end of 1985. It is expected that the amalgamation of Shinkin banks will continue, as they seek a stable basis for business through economies of scale in an environment of intensified competition among financial institutions as liberalisation progresses.

Between the late 1970s and the early 1990s, their share of personal deposits was maintained at a steady level compared to the share of banks (Table 2.1).

c. The Zenshinren Bank

The Zenshinren Bank is established under the Shinkin Bank Law as the central institution for Shinkin banks. The individual Shinkin banks are its members. The precursor of this institution was the National Federation of Credit Co-operatives which was established as the central organisation for credit co-operatives in 1950. But with the start of the Shinkin banks under the Shinkin Bank Law of 1951, the Zenshinren Bank was established in November of that year.

The operations in which the Zenshinren Bank may engage are: the acceptance of deposits from members, lending to members, and foreign exchange operations with members; of deposits from the national government, local governments, and public bodies, and non-profit organisations; the acceptance of deposits from, and provision of lending to,

non-members as approved by the Ministry of Finance; and auxiliary operations similar to those carried out by Shinkin banks, *i.e.*, operations related to securities, and agent operations for the People's Finance Corporation.

Because Shinkin banks were originally oriented toward specific regions, the demand for funds at each individual Shinkin bank is subject to large influences from the special characteristics of that region and from seasonal factors. Such regional and seasonal fund demands must be accommodated; the Zenshiren Bank does this by accepting deposits from the individual Shinkin banks and then lending these funds to other Shinkin banks with a strong funds demand, either as direct lending or as an agency loan.

By concentrating the surplus funds of the Shinkin banks, the Zenshiren Bank can improve the efficiency of their investment and obtain a better yield on investment than could the individual banks if they invested these funds on their own. The Zenshiren Bank pays specified interest rates on deposits to its member institutions but also adds special incentive payments. This system of borrowing from the member banks is one way of concentrating the funds within the Shinkin bank system; but because the interest rate on such funds is determined on a sliding scale based on the call rate, there is a conspicuous withdrawal of funds by the member banks when the call rate falls, and transfer to time deposits that are more advantageous. When the call rates rise, funds flow in the opposite direction.

This pyramid structure of the credit co-operative system in Japan represents an example of an answer to the prudential concerns raised by such institutions. It enables them to side-step the excessive regional or sectoral specialisation which is, as we discussed above, a major difficulty faced by individual credit co-operatives.

3. The Experiences of NIEs

a. South America

The Latin American experience in the late 1970s is of some relevance¹².

At that time *Argentina* experienced an interesting case of mergers of credit co-operatives. From 423 in early 1977, they were merged and transformed into commercial banks, so that their number was reduced to a little more than a 100 at the end of 1979. They are allowed to accept time deposits, while they can grant short and medium term loans to small businesses, producers, employees, professionals and non profit institutions.

In *Peru* their presence was even more sizeable since co-operatives play a widespread role in many different fields (consumer, credit, insurance, production, etc.). The number of credit co-operatives was around 750 in the late 1970s. They were regulated by a law of 1964 describing them as being

of 'national necessity and public benefit'. Moreover they had their own financial institution, the National Bank of Co-operatives. The latter was the first banking institution to be organised as a co-operative and not as a limited liability company.

b. Asia

In *Malaysia*, the co-operative central bank was established in 1958. Its main objective has been to mobilise funds from individuals and co-operative societies and to direct these funds to viable co-operative enterprises. This bank accepts fixed and savings deposits. Interest paid on these deposits most of the time has been higher than interest served on deposits with commercial banks. Such deposits are far more important as a source of funds than shareholders' funds.

At first, the co-operative central bank was allowed to grant loans only to member co-operative societies. However, new regulations introduced in 1971 the possibility to grant personal loans to individual members, as well as a hire purchase financing scheme for its member societies. This bank also grants loans to member co-operatives, in addition to mortgage loans for individual members. The funds which are not used in this way are deposited with various financial institutions or used to buy long-term government securities.

In *South Korea*, credit co-operatives are non-profit organisations established by members of a company or local community, or by small independent business firms. The members' savings are used to grant loans to the other members of the co-operative. They number tens of thousands, but most of them are village credit unions. They started in the 1960s but gained support by the Law on National Credit co-operatives in 1972. They are subject to government regulation on the maximum interest rate, the credit ceiling to a single person and reserve holdings.

Similarly, in *Thailand*, savings co-operatives, dating from 1946 but having developed since the mid-1950s, are simply credit unions. They were regulated by the Co-operative Act of 1968 and are supervised by a government ministry. They are mostly on an occupational basis, and there are hundreds of them. They have little access to borrowing and rely primarily on their members' contributions coming in the form of paid-up shares in the co-operative, usually by monthly subscriptions made through regular payroll deductions. Loans, which are mostly medium term, finance purchases of consumer durables and are repaid by similar regular deductions.

In *Hong Kong*, urban co-operative societies are mostly co-operative building societies formed by various civil service employee groups. In addition to funds from members, they receive financing from a number of private,

government (possibly with special loan assistance and land grants) and international sources. The remaining urban co-operative societies include consumers' societies, salaried workers' thrift, apartment owners and loan societies. Overall their number is about 250.

Conclusion

Recent theoretical advances have approached credit co-operatives as a peer monitoring device. They have shown that compared to banks, such co-operatives enjoy comparative advantages in using local information, monitoring and enforcing sanctions. The experience of developed market economies, such as Japan, shows that such advantages do not necessarily vanish when credit systems become more developed, since credit co-operatives persisted even after some of them had been merged into banks.

The experience of other Asian countries with respect to informal finance shows that the downside of such credit arrangements is particularly manifest at the macroeconomic level. Indeed, non-banking credit institutions are usually more efficient than large-scale banks in granting loans for productive uses, but this advantage implies that they do not follow the wishes of the authorities in the attempt by the latter to direct capital to priority sectors. A similar problem arises with stabilization policies, since being less under the control of monetary authorities such institutions can fuel demand pressures in particular markets when policy is aimed at limiting inflationary pressure. Besides, prudential concerns are relevant since the protection non-banking credit institutions offer to depositors is not as substantial as the one offered by large-scale banks which often benefit from the backing of the state.

The major drawback of such institutions may be their excessive regional and sectoral specialisation. There are two ways out of such a difficulty. The first consists in a diversification of their assets through lending to large scale nation-wide banks. However, such a remedy could prove worse than the disease in transition economies when the inefficiency of banks is still an unresolved issue. This leaves as a viable alternative the merging of credit co-operatives into larger institutions and their integration into a pyramid structure with regional and national components which, as shown by the Japanese experience since the 1950s, can successfully contribute to the necessary diversification of assets.

Notes

1. Besley (1995b).
2. In most of this literature, risk sharing and credit are closely tied for three reasons (Besley, 1995). First, credit serves as an insurance substitute when market opportunities for risk sharing are limited; an individual may borrow in lieu of receiving an insurance payment, thus smoothing out transitory shocks. Second, the distinction between credit and insurance becomes blurred when lenders are willing to relend on some part of the repayment in the event of an unforeseen negative shock to the borrower. Third, the optimal form of contract when information is incomplete and/or enforcement is a problem seems to look like a combination of credit and insurance. A pure credit arrangement, rather than a contract with contingencies is unlikely to be optimal in many risky environments.
3. The following paragraphs draw on the survey by Besley, 1993.
4. Banerjee, Besley and Guinnane (1994) have studied the optimally designed credit co-operative as a peer monitoring problem. This approach emphasises that the constitution of the credit co-operative can affect the amount of monitoring that is undertaken. They examine how the amount of monitoring will be influenced by any guarantee provided by non-monitoring members, the amount that such members lend to the co-operative, and the interest rate paid on deposits.
5. Ghate et al. (1992).
6. see Ghate et al. 1992.
7. Ghate et al. (1992).
8. Owen Smith (1985).
9. Patat (1993).
10. Kidwell and Petersen (1988).
11. Suzuki (1987).
12. Skully (1989).

III. MACROECONOMIC BACKGROUND OF CHINESE UCCS

Banking sector reform in China favoured a phased approach. After initially protecting existing state banks both from outside, and from internal, competition, the Chinese authorities allowed in the 1980s successive waves of entry of new types of non-bank financial institutions, which do not benefit from the backing of the state. Moreover, they do not compete directly with state banks, since they should exclusively finance the growth of the non-state sector, but tend to gain an increasing share of financial assets. The impressive growth of UCCs, in the late 1980s, early 1990s was particularly helpful in satisfying the growing demand for investment loans by enterprises. However, this implied an uncontrolled, and sometimes risky, development which led to successive attempts by the authorities to regulate them.

A. The Emergence and Development of UCCs

1. The Most Dynamic Element Among Financial Institutions

Since the national economic adjustment and economic system reform initiated in 1979, China's economic structure has been characterised by the co-existence of multilayered economic structures, diversified economic types, and different commercial channels. In the context of economic reform, township and village enterprises (TVEs) and private enterprises have developed quickly. However, at the same time, since the existing state banks mainly serve the needs of state-owned enterprises, TVEs, private enterprises and individual businessmen encountered difficulties in opening accounts at banks, getting loans from banks, and settling business through banks. As a result, Urban Credit Co-operatives emerged and developed rapidly.

Urban Credit Co-operatives are collectively owned urban financial institutions, which are under the supervision of the People's Bank of China, enjoy separate accounting, self-decision for operation, and self-responsibility for profit and loss.

There are two main types of UCCs : urban credit co-operatives and urban credit co-operative affiliates. Normally, the co-operatives are located in large and middle-sized cities (for instance there are about 60 in Beijing)

and have no branches. Their main business is to take deposits, grant loans, and undertake settlement and remittance transactions for collective enterprises and private industrial and commercial households. On the other hand, the affiliate is usually a financial organisation owned by urban credit co-operatives. The affiliate is a legal entity with separate accounting, independent operation, sole responsibility for profits or losses, and an independent obligation to pay taxes. While transactions between a UCC and its affiliate should be on an equal basis, in reality, the affiliate is like a “servant ” in a location where the UCC may not be otherwise represented.

At the onset of China’s economic reform in 1978, the non-state-owned economy in cities burgeoned and developed very fast, while in the financial sector, state-owned banks had an absolute monopoly. In the lending structure of the state-owned banks, arranged according to the credit plan, loans to urban private enterprises were taken into consideration very little. Against this background, UCCs emerged at that time with the primary purpose of facilitating the financing of non-state-owned small and medium-sized enterprises. Therefore, the development of UCCs and that of non-state-owned enterprises were closely related (See Table 3.1).

Table 3.1. **Comparison of the Growth Rate of Assets of UCCs (*r*) and the Growth Rate of Production of Urban Non-State-Owned Enterprises (*R*)**
(in percentage)

	1987	1988	1989	1990	1991	1992	1993	1994
<i>r</i>	225.1	111.2	46.6	26.8	27.0	57.3	56.3	85.6
<i>R</i>	31.7	41.5	22.9	12.3	22.4	44.7	55.7	69.2

Source: China Statistical Yearbook (1995)

UCC’s appear as the most dynamic element among Chinese financial institutions over the most recent period. As a rule the rate of nominal growth of the assets of financial institutions was higher than the Consumer Price Index (CPI) inflation rate from 1988 to 1993 (Table 3.2). On average nominal assets grew at the same rate for the PBC, state banks and Rural Credit Co-operatives (i.e. 22 per cent), corresponding to more than twice the average official inflation rate, and a little more for the growth of assets of Trust and Investment Companies but with more variance. UCCs represent the main exception to the rule. The average rate of growth of their assets was indeed nearly three times higher than for specialised banks. Some years, like 1988 and 1992 even saw a doubling of the assets of UCCs.

Table 3.2. **Rate of Growth of the Assets of the Different Financial Institutions**
(in percentage)

	1988	1989	1990	1991	1992	1993	1994
PBC	20.6	24.2	25.8	24.8	12.7	31.7	33.2
Specialized banks	18.0	21.2	25.9	22.3	20.4	26.2	10.2
RCCs	8.8	18.2	24.6	24.7	29.8	27.8	12.0
UCCs	105	28.6	32.1	51.3	96.4	70.0	15.0
TICs	45.6	6.0	34.0	41.5	37.7	11.3	N.A.
(CPI inflation rate)	18.8	18.0	3.1	3.4	6.4	14.7	24.1

Source: PBC

Table 3.3.a. **Assets of UCCs and Assets of all Financial Institutions in 1994**
(in percentage)

Items	Total	State Banks	Other Banks	Urban Credit Cooperatives	Rural Credit Cooperatives	Financial Trust Institutions	Finance Companies
Total Loans	100	79.5	1.5	3.2	10.2	4.9	0.5
Loans to Industrial Production Enterprises	100	97.5	1.7				0.8
Loans to Material Supply & Sale Enterprises	100	100					
Loans to Commercial Enterprises	100	98.6	1.4				
Loans to Construction Enterprises	100	99.5	0.5				
Loans to Urban & Township Collective Enterprises	100	55.1		54.9			
Loans to Individual Proprietors	100	34.3	1.2	64.4			
Joint ventures, foreign and cooperative enterprises	100	93	7.0				
Loans to Agricultural Sector	100	33.5	0.05		66.45		
Loans for Fixed Assets	100	99.6	0.3				0.1
Other Loans	100	28.7	4.9	5.4	20.0	37.7	3.0
Bonds Purchases	100	97.0	1.5	1.0		0.05	0.4
Gold Purchases	100	100					
Foreign Exchange Purchases	100	100					
Deposits with International Financial Institutions	100	100					
Advances to Treasury	100	100					
Uses of Fund in Total	100	82.9	1.3	2.7	8.4	4.1	0.5

Table 3.3.b. **Liabilities of UCCs and other Financial Institutions in 1994**
(percentage)

Items	Total	State Banks	Other Banks	Urban Credit Cooperatives	Rural Credit Cooperatives	Financial Trust Institutions	Finance Companies
Total Deposits	100	72.5	2.0	5.8	14.1	5.2	0.4
Deposits by Enterprises	100	87.0	4.1	8.3			0.5
Deposits by Treasury	100	100					
Deposits by Government Departments & Organisations	100	100					
Savings Deposits in Urban Areas	100	73.6	0.5	3.4	22.4		
Deposits from Rural Areas	100	18.3	0.3		81.4		
Other Deposits	100	4.45	5.2	17.2		69.2	3.8
Bonds	100	97.6				2.0	0.07
Liabilities to International Financial Institutions	100	100					
Currency in Circulation	100	100					
The Banks' Own Capital	100	63.2	1.6	3.1	19.3	11.8	1.2
Others	100						
Sources of Funds in Total	100	82.9	1.3	2.7	8.4	4.1	0.5

Source: PBC

Despite their rapid development, UCCs are still dwarfs compared to the giants represented by the state banks. By the end of 1994, there were 5,229 urban credit co-operatives in China. Their outstanding credit of RMB 132.3 billion accounted for 3.2 per cent of the total credit and their deposit of RMB 235.3 billion accounted for 5.81 per cent of the aggregate deposits (Table 3.3). In China's financial industry, they are thus large in number but small in market share.

2. Emergence and Vicissitudes

a. An Explosive Start

The first UCC was set up in Luho county, Henan Province in 1979. In 1984, the Industrial and Commercial Bank of China opened individual business departments specialising in granting credit to individual businessmen and private enterprises at urban and township level. Subsequently, UCCs grew fast in terms of their number, their employees, and the volume of the deposits collected and loans granted.

Table 3.4. **UCCs: Staff and Institutions**
(thousands)

	1987	1988	1989	1990	1991	1992	1993
Staff	26.5	49.7	60.3	68.6	77.3	90.9	122.9
Institution	1.6	3.2	3.4	3.4	3.5	4.0	4.8

Source: China Statistical Yearbook (1994)

At the end of 1986, there were about 1 114 UCCs with 15 000 employees; the outstanding deposits were 2.87 billion yuan, outstanding loans were 1.93 billion yuan. By the end of 1988, the number of UCCs increased to 3 265, and employees reached about 50 000. Outstanding deposits of UCCs increased to 15.7 billion yuan from 7.56 billion yuan in 1987, outstanding credit reached 13.4 billion yuan from 6.34 billion yuan in 1987.

In order to implement the "Regulation Governing the Management of UCCs" and the "Central Decision on Restoring Financial Orders in China", the People's Bank of China slowed down the licensing of UCCs, and focused its daily work on standardising operation and quality of service of UCCs.

b. Efforts to Restore Financial Order for UCCs in 1989

The efforts to restore financial order in UCCs started in 1989 and achieved the following:

- i)* Filling up the gap between the paid-up capital of UCCs and the capital required. By the end of 1991, the total paid-up capital for 3 518 UCCs in China was 1.38 million yuan. Almost all UCCs met the capital requirement, i.e. 0.5 million yuan for each.
- ii)* Limiting new establishments of UCCs and liquidating the loss-making UCCs. Up to 1995, about 75 UCCs and 48 branches had been abolished while 58 UCCs had been merged.
- iii)* Clearing the illegal deposits collected and loans granted by UCCs. According to the relevant regulation, UCCs can only take deposits from and grant credits to certain categories of customers. However, some UCCs collected deposits from and issued loans beyond this coverage. Since 1989, the People's Bank of China has tried gradually to clear the illegal deposit accounts and loans.
- iv)* Suspending part-time jobs for UCCs. In the past, some of the staff working in other institutions had a part-time job with UCCs. Since 1989, the People's Bank of China has regulated that such staff should either resign their part-time job with UCCs or officially shift full-time to UCCs they are working for. For instance, in Xian, capital city of Shanxi province, all the part-time staff who enjoyed the position of Director of UCCs or Chairman of Council of UCCs gave up their part-time jobs in UCCs; 13 staff officially moved to UCCs. There were 531 staff in Hebei province who did the same.
- v)* Enhancing legal system constructions. According to our incomplete statistics, there were about 11 local regulations for UCCs. Since 1989, the People's Bank of China has unified the regulations for UCCs, and set up internal control systems in some of them.
- vi)* Establishing Federal Urban Credit Unions on a trial basis. In order to promote the management and quality of services of UCCs, some Federal Urban Credit Unions were established in certain cities on an experimental basis.

By the end of 1991, there were 3 518 UCCs, with 77 000 employees; outstanding deposit of UCCs were 41.7 billion yuan, and outstanding credit granted by UCCs were about 30.3 billion yuan. By the end of 1993, there were about 4 892 UCCs, 43 Federal Urban Credit Unions, 120 000 employees and 187.8 billion yuan total assets in the whole country.

3. The Unique Features of UCCs

Even though UCCs have a short history in their development, they have enjoyed a high growth potential. On the one hand, the rapid development of urban collectively owned enterprises and urban private enterprises creates a favourable environment for the development of UCCs. On the other hand, the characteristics of UCCs themselves determine their further development. Generally, UCCs enjoy a comparative advantage with respect to the state banks in their smaller size of operation, larger number, and greater flexibility in operations. The characteristics of UCCs are customarily summarised as “collectivity in organisational structure, democracy in management, and flexibility in operations”.

- a) *Collectivity in organisational structure:* The “Regulation on UCCs” issued by PBC in 1988 defined that the UCC is a membership financial institution whose shareholders could be urban collectively owned enterprises, individual businessmen and individual citizens. The shares of UCCs can be transferred and inherited, but not withdrawn. The capital of UCCs should consist of shares purchased by enterprises and by individuals. Whoever the shareholder is, the principles for the establishment of UCCs are self-financing business, self-renting places for their own use, and autonomous management.
- b) *Democracy in management:* The managerial philosophy of UCCs is democracy, i.e. the Shareholder Representative Committee of the UCC held annually elects the Council of the UCC as an executive body of the Shareholder Representative Committee and Steering Committee of the UCC engaging in the supervision over daily operations. The Director of the UCC, appointed by the Council, is responsible, to shareholders, for the management on a daily basis. The staff are under contract. Many UCCs also employ some retired bank staff who have special skills. In principle, UCCs enjoy much autonomy in personnel, financing and management of material resources.
- c) *Flexibility in operations:* UCCs insist on functioning on the basis of equilibrium, i.e. they grant loans according to the deposits they have collected. Compared to other financial institutions, UCCs enjoy more variety in their services. For instance, customers can open a time deposit account with the right to withdraw interest, an interest-bearing chequing account, and other special accounts for their convenience. On the lending side, UCCs offer not only guaranteed loans but collateralized or mortgage loans as well. They also show flexibility in mode of services. The interest rate for deposits offered by UCCs is in accordance with the level set by PBC. However, the lending rate can be floated within the margin set by local branches of PBC. In addition, as agents of insurance company,

many UCCs provide insurance services. They also pay wages on behalf of enterprises. The high quality of services, efficient work and strict disciplines of UCCs earn a favourable response from the public.

4. The Role of UCCs

The development of UCCs has played an active role in China's economy. It has facilitated the daily life of citizens, invigorated financial industry, promoted local economic development, and satisfied the financial needs of private enterprises and individual businessmen neglected by the state banks.

- a) It has facilitated people's daily life and centralised the idle funds from the public. Taking Zhengzhou, capital city of Henan Province as an example, by the end of 1991, there were 37 UCCs whose capital reached 69.88 million yuan; their deposit amounted to 891 million yuan, only next to the Zhengzhou branch of the Industrial and Commercial Bank of China and the Agricultural Bank of China. In order to be convenient to their customers, particularly individual businessmen, some UCCs in China prolong their working time and open their offices even on public holidays.
- b) It has strengthened the development of the collectively owned enterprises and the private enterprises. According to our statistics, by the end of 1994, the total amount of outstanding loans issued by UCCs were about 48.72 billion yuan, of which the loans to industrial collectively owned enterprises amounted to 13.13 billion yuan, loans to individual businessmen amounted to 4.47 billion yuan. In other words, the loans to collective enterprises and individual businessmen occupied 70 per cent of total loans granted by UCCs.
- c) It makes up for the shortage of networks suffered by State Banks, and plays a supplementary role in the economy. The establishment of UCCs remedy the difficulties encountered by collectively owned enterprises and private enterprises in opening accounts, borrowing and settlements. It increases the competition with state banks, and strengthens the co-developments of UCCs and the state banks. In this sense, UCCs become the important assistants of state banks.
- d) It provides more employment opportunities. UCCs not only recruit young staff, but also invite some retired professionals in banks to work for them under contract. By the end of 1993, the employees of UCCs were more than 120 000.

5. Problems Lying Ahead

The evolution of UCCs has shared in some of the usual phases of a life-cycle process from consolidation to gradual improvement and finally to maturity. The problems lying ahead are as follows:

- a) Some UCCs become the subsidiary of their investors. The establishment of UCCs can be classified into three types in terms of investor: (1) banks; (2) local governments; (3) enterprises and quasi-enterprises. The motivation of some investors in UCCs is not to assist them to become a real membership financial institution, but to be convenient to themselves as their own subsidiary. The purpose of the investment can be summarised as follows: (1) to provide an employment opportunity for their children; (2) to make money for their own institutions' convenience; for instance, to transfer some money from the UCC in which they invested to their "secret" account to pay for their staff's bonus, or to claim some illegal expenses from UCCs' account. (3) to transfer some credit business which the investors are not entitled to conduct to UCCs in order to grant loans at their own disposal.
- b) Some UCCs de facto become shareholding commercial banks, diverting from the principle of the establishment of UCCs, which requires that UCCs should be set up on a membership basis. Some UCCs ignore the democratic management requirement. Even though they have set up the Shareholder Representative Committee, the Council and the Steering Committee, these Committees do not convene meetings regularly, nor supervise the operations of UCCs as their function requires.
- c) Some UCCs do business beyond their entitled scope. They prefer granting loans to state-owned enterprises rather than to the collectively owned enterprises, individual businessmen and urban citizens.
- d) Some UCCs do not expand their business by enlarging business scope, improving services and improving the structure of revenue and expenditure; but by making profits from the interest rates differentials.
- e) Some UCCs do not abide by the regulation on the establishment of UCCs, and illegally set up subsidiaries and offices.
- f) The distribution of profits after tax in most UCCs does not abide with the relevant regulations. They put aside a lesser proportion than required to be used for the credit funds, a much higher proportion for welfare, bonus and dividends. The high ratio of dividend to capital especially impairs the development of UCCs.
- g) Some UCCs lack a sense of risk management. The quality of the assets in these UCCs is poor in the sense that there are relatively more bad-loans than in others.

The above problems call for a pressing need to strengthen the audit and supervision of UCCs.

B. Operational and Fund Management

1. The Balance Sheet of UCCs

Among total assets of UCCs, loans saw their share fall from nearly two-thirds until the early 1990s to two-fifths in 1993 (Table 3.5). The share of deposits with banks witnessed a much less dramatic fall from around a fifth to a sixth. Interbank lending was the major beneficiary of these movements, reaching nearly 15 per cent of assets in 1993. On the liabilities side, movements were less sharp. However within a share of total deposits with no clear trend, the strong rise in the share of deposits from households (especially time deposits) is quite noticeable. Indeed households' savings represent 20 per cent of total liabilities of UCCs in 1993. By contrast loans from banks have followed a downward trend.

The balance sheet of UCCs in 1994 had four main characteristics (Table 3.6). Firstly, total deposits exceeded aggregate credit. The total credit of RMB 132.4 billion granted by UCCs nation-wide accounts for 56 per cent of the aggregate deposits of RMB 235.4 billion with them. The aggregate credit of RMB 6.816 billion of the sample UCCs accounted for 49 per cent of their total deposits of RMB 3.335 billion.

Secondly, in the inter-bank market, UCCs are net lenders. The share of interbank borrowing in total liabilities is half the share of interbank lending in total assets. In addition, UCCs are not financed by the Central Bank, which distinguishes them from the state-owned commercial banks.

Thirdly, the majority of UCCs' liabilities are deposits by collectively-owned enterprises, accounting for 24.40 per cent, followed by 23.13 per cent of individual deposits and 11.78 per cent of other deposits.

Fourthly, the major borrowers of UCCs are urban collectively-owned enterprises, accounting for 25.31 per cent, followed by 10.72 per cent of deposits with commercial banks, and 5.90 per cent of investments. Only a small proportion of credit is lent to self-employed persons. The majority of the lending is credit without security compared with only a small amount of collateralized credit.

Fifth, diversified assets of UCCs. Net lending of UCCs account for 10 per cent of the total assets and portfolio investment accounts for 17 per cent.

Table 3.5: Decomposition of Urban Credit Cooperatives' Assets and Liabilities
(in percent and Yuan)

	1987	1990	1993
Assets			
Loans	64.5	66.9	41.4
Collectives	42.3	43.4	31.8
Individual enterprises	6.9	6.6	3.6
Other	15.3	16.9	5.9
Required reserves	4.7	8.4	7.1
Deposits with banks	22.1	20.8	16.1
Bonds			4.8
Cash in vault			1.1
Interbank lending			14.6
Other	8.6	3.8	14.8
Total Assets	100 (9.2 bil)	100 (37.2 bil.)	100 (187.9 bil)
Liabilities			
Deposits	76.9	83.2	71.3
Collectives	35.0	26.9	33.2
Individual enterprises	6.3	4.5	3.6
Household savings	8.2	23.0	20.0
Demand	3.1	6.9	7.3
Time	5.0	16.1	12.7
Other	27.4	28.7	14.5
Loans from banks	7.0	3.8	1.5
Own capital			4.5
Interbank borrowing			7.7
Other Liabilities	15.9	12.9	14.9
Total Liabilities	100	100	100

Source: PBC

Table 3.6. **Balance sheet of UCCs (December 1994)**
(100 million yuan)

ITEMS	AMOUNT	ITEMS	AMOUNT
Deposits, of which		Loans, of which	
<i>deposits from collectively-owned</i>		<i>loans to collectively-owned</i>	
industrial enterprises	136	industrial enterprises	270
commercial enterprises	271	commercial enterprises	319
others	366	others	214
<i>deposits from</i>		<i>loans to</i>	
state-owned industrial and commercial enterprises	119	state-owned industrial and commercial enterprises	126
self-employed persons	106	self-employed persons	100
savings deposits from residents	734	collateralized loans	92
time deposits from entities	204	loans in trust	53
deposits in trust	43	other loans	149
other deposits	374		
payables in securities dealings	7	receivables in securities dealings	15
borrowing from banks	35		
deposits from banks	91	deposits to banks	168
		reserves to PBC	230
deposits from non-bank financial institutions	18	special deposits to PBC	46
		deposits to non-bank financial institutions	16
special loans in trust from PBC	16	bonds of PBC	20
		bonds in custody of banks	340
<i>due to</i>		special loans in trust from PBC	42
banks	66	<i>due from</i>	
non-bank financial institutions	26	banks	154
<i>due to</i>	159	non-bank financial institutions	124
equity	162	<i>due from</i>	174
retained earnings	12	investment	187
loan loss provision	9	cash	33
others	218	others	299
total liabilities	3 172	total assets	3 172

Source: PBC

2. “Regulation on Management of UCCs”

In 1988, some managerial principles for UCCs were emphasised in the “Circular Relevant to Distributing the Regulation on Management of UCCs”. These principles are: *First*, UCCs should only be established in large and medium-sized cities; certain counties where the economy is relatively well developed could set up a few UCCs on a trial basis; *Second*, each province, municipal city and autonomous region can select one or two cities as the pilot site to set up the Federal Urban Credit Union to monitor the operations of UCCs at the municipal level; *Third*, in view of the early stage of development of UCCs, their equity and accumulated profits can be calculated into their capital; if some UCCs can still not meet this requirement, the local branch of PBC should instruct them to make up for it within a certain time period; *Fourth*, all UCCs set up either before the promulgation of the “Regulation” or after this issue, shall be under the supervision of the PBC, and shall be instructed by the local branch of PBC in which bank they should open their account and how to deposit the required reserves. All the Federal Urban Credit Unions shall open their account and deposit their reserves in the local branch of PBC.

The rules governing the management of UCCs are contained in the “Regulation on Management of UCCs” issued by PBC in 1989. “The Regulation” defined UCCs’ establishment, their scope of business, operational management, and the function of the Federal Urban Credit Union.

The scope of business of UCCs, defined in Chapter III of “The Regulation” is: to collect deposits from and grant loans to urban collectively owned enterprises, private enterprises, small-sized state-owned enterprises which are under the leasing contract; and do the settlement for them; to absorb deposits from urban individuals; to deal with the security business on behalf of security companies; to collect the premium and other commissions and make payments on behalf of the insurance companies and other financial institutions; to do other business approved by PBC.

In its Chapter IV, “The Regulation” defined the operational management of UCCs as follows:

- a) The total amount of its own capital plus the accumulated profit of the UCC shall not be less than 5 per cent of its total assets.
- b) The total loans granted by the UCC shall not exceed 80 per cent of its total deposits plus its own capital.
- c) The total amount of fixed asset loans granted by the UCC should not exceed 30 per cent of its total loans.

- d) The maximum amount of a single loan to collectively owned enterprises and contracted small-sized state-owned enterprises granted by the UCC shall not exceed 50 per cent of its own capital; the maximum amount of a single loan to individual businessmen granted by the UCC shall not exceed 10 per cent of its own capital.
- e) The total amount of the fixed assets of the UCC shall not exceed 20 per cent of its own capital plus its accumulated profit.

From the provisions mentioned above, the procedures relevant to asset and liability management were formulated a long time ago, but the authorities were unable to be put them into force. However, in practice, these provisions led to some improvement in the operations and management of UCCs and to a strengthening in the supervision of PBC over UCCs.

According to “The Regulation”, in case of a temporary fund shortage, UCCs may solve the problem through the inter-bank market, or may apply for short-term financing from PBC which shall not be used for fixed asset lending to their customers.

UCCs shall abide by the principle named “planning the credit issued to customers according to the deposit they have taken and seek the self-balancing of funds”. The interest rate paid by UCCs shall be subject to the level set by PBC; the lending rate charged by UCCs may float on the basis of the authorised lending rate, but the floating margin shall be set by PBC. The interest rate for inter-bank lending or borrowing shall be decided by mutual negotiation.

UCCs shall open an account and deposit reserves in the PBC’s local branch. The required reserve ratio shall be stipulated by the PBC. If they have difficulties in opening an account with PBC, they may open an account in the specialised banks.

UCCs may participate in the intra-city settlement of negotiable instruments. The inter-city settlements among UCCs may be done by mutual agreement between each other. The specialised banks will support them in opening accounts, settlements and the supply of cash.

The practice relating to financial management, employees' salaries, and welfare in UCCs shall refer to the practice in collectively owned enterprises. The distribution of the profits shall be no less than 50 per cent for the mutual fund, the rest for the welfare fund, bonus and dividends. In addition 70 per cent of the mutual fund shall be contributed to the credit fund, and 30 per cent to the development fund. The total amount of dividends and bonus shall not exceed 15 per cent of equity.

“The Regulation” also defines the procedures of capital raising, submission to the credit plan, cash plan, financial statements, and the provision for bad debt reserves.

3. Strengthening the Regulation

a. A Supplementary Circular

The People's Bank of China issued "The supplementary circular on the issues relating to the implementation of 'the regulation on UCCs'", in October 1988, representing a relatively clear solution to the problems reported by the different localities. The main contents of the circular refer to five elements.

- i)* UCCs can only do the business specified in "The Regulation"; shall not enlarge their scope of business without authorisation, nor absorb deposits from and grant loans to the large and medium-sized enterprises, nor conduct business relating to investment and leasing.
- ii)* UCCs shall devote themselves to the implementation of the asset-liability ratio management system. The local branch of PBC shall set a time limit to UCCs which have not met the requirements.
- iii)* The interest payments for the subsidized deposit by UCCs shall be borne by themselves.
- iv)* The provisions on the discipline of not establishing new financial institutions during the rectification period specified in the Document n° 66/1988 of the State Council shall be applied to UCCs and the Federal Urban Credit Unions.

b. The announcement on Strengthening the Fund Management of UCCs

Overheated growth of credit issued by UCCs characterised the first half of 1989, i.e. by the end of June, the lending granted by most UCCs had reached 86.4 per cent of their credit ceilings. Some UCCs even exceeded their credit ceilings. The PBC issued "The Announcement on Strengthening the Fund Management of UCCs" (*Bank Document n° 269/1994*) in September, 1989. The key points of this are: 1) The total amount of loans issued by UCCs must not exceed the credit ceilings set by PBC. 2) The headquarters of PBC will not upgrade the credit ceilings of UCCs; UCCs which have reached their credit ceiling have to withdraw existing lending to grant new loans; if they are long in position, they could lend out to local branches of the Industrial and Commercial Bank of China (ICBC), the Agricultural Bank of China (ABC) and the Bank of China (BOC), and the maturity could be extended to four months. 3) The local branches of PBC in provinces, autonomous regions, municipalities directly under the central government and cities which practise separate planning and budgets, have the authority to upgrade or downgrade the credit ceilings of UCCs located in their areas, if they view it necessary. 4) UCCs shall strictly keep from borrowing from specialised banks. 5) All the local branches of PBC shall review

comprehensively the reserve deposited by UCCs with PBC and set a time limit to UCCs which have not deposited or deposited less than the required reserves to make up for the differentials and penalise them accordingly.

c. The Announcement on Further Rectification of UCCs

In December 1989, in order to solve the problems which needed a prompt solution, the People's Bank of China issued "The Announcement on Further Rectification of UCCs" (*Bank Document n° 346/1989*). The problems delineated in the announcement include: the new establishment of UCCs increased too fast to fit into market capacities; the local government and specialised banks in some areas intervened in the operation of UCCs so frequently that the autonomy of UCCs was impaired; some UCCs were seriously short of own-capital, and had difficulties in self-balancing their funds. As a result the proportion of borrowing in these UCCs was very high; a few UCCs collected deposits from and granted loans to some customers who were not entitled to such loans, exceeded the credit ceilings for fixed asset loans or raised the lending rate without authority, and paid or charged extra fees and commissions to their customers.

In order to ensure the healthy development of UCCs, and to implement a series of Decisions and Announcements relevant to the rectification made by the State Council and the Communist Party, the People's Bank of China stipulated the following requirements to UCCs:

- i)* No new UCC shall be licensed during the rectification period. The UCCs which meet one of the following conditions shall be merged or liquidated within a limited period: the UCCs whose establishment was not approved by the PBC; the UCCs which are seriously short of own-capital and which have illegal sources of funds; the loss-making UCCs; the UCCs which conduct business illegally and do not amend their behaviour; the UCCs which are sponsored by the specialized banks, local governments, other government agencies and individuals; the subsidiaries of UCCs.
- ii)* UCCs shall only do business within the authorised area and must do the following: the deposits collected from the customers which are not entitled to do it have to be returned; all the fiscal deposits have to be transferred to the account with the PBC; all the practices violating the regulations on interbank borrowing and lending shall be corrected within a limited period; all the loans granted exceeding the credit ceilings shall be withdrawn within a limited period; they have to stop absorbing deposits from, granting loans to and do the settlements for, the small-sized state owned enterprises which are under the leasing contract, and return and withdraw the deposits and loans made in the past.

- iii) UCCs shall strictly implement the interest rate policy set by PBC and abide by the accounting procedures formulated by the state.
- iv) No full-time officials in government agencies (including specialised banks) shall hold a position in UCCs. The officials who are also part-time employees of UCCs shall be treated in the light of the relevant regulations issued by the State Council and central and local governments.
- v) UCCs shall raise their capital from urban collectively owned enterprises, private enterprises, individual businessmen and citizens. The specialised banks, state owned enterprises, and other government agencies shall not invest in UCCs; if they have contributed to the capital of UCCs, they shall withdraw or transfer their investments.
- vi) All the local authorities shall be prepared to comply with the restructuring of debts and credits and other asset clearance of UCCs and other follow-ups. The local branches of the PBC shall monitor, supervise and check the acceptance of the required work.

Improvements in the supervision of UCCs' fund and operational management by the PBC played a central role in rationalising the development of UCCs.

C. The Strategy for the Reform of the Urban Co-operative Financial System

Given the well-known difficulties of excessive regional and sectoral specialisation faced by urban credit co-operatives, the authorities have taken new measures to improve the prudential management of these institutions. However, by themselves prudential ratios cannot eliminate the risks faced by UCCs and a deeper effort at reorganising and rationalising the credit co-operative system has been undertaken.

1. New Procedures for Asset-Liability Management

In a bid to strengthen the capacity of UCCs in self-restraint and self-development under the new financial system, and ensure the healthy development of UCCs, the National Financial Working Conference decided in 1994 that the procedures of management of the asset-liability ratio would be applied to UCCs as of that year. This decision was of great significance in improvement of the quality of the credit and assets of UCCs and their management.

In May 1994, the People's Bank of China stipulated "The Announcement on Assets-Liability Ratio Management of UCCs", and promulgated "The Interim Procedures on the Management of the Asset-Liability Ratio by UCCs"

(hereafter “The Procedures”). “The Procedures” are formulated in terms of international practice and Chinese characteristics, and are in accordance with the ratios for commercial banks with the purpose of promoting favourable competition among various financial institutions. “The Procedures” include six aspects and ten ratios:

i) Capital Adequacy

Total capital shall amount to at least 8 per cent of adjusted total assets. The kernel capital shall be no less than 50 per cent of total capital. If the subsidiary capital is larger than the core capital, the differential shall not be taken into account in the total capital.

ii) Deposit-Loan Ratio

The ratio of various loans to deposits shall not exceed 70 per cent. The ratio of balance of borrowing to balance of all the deposits shall not be higher than 4 per cent.

iii) Index for Lending Directions

The loans granted by UCCs to collectively owned enterprises, individual businessmen and small-sized state-owned enterprise which are under the leasing contract, shall not amount to less than 70 per cent of total credits.

iv) Liquidity Ratio

The ratio of total liquid assets to total liquid liabilities shall not be lower than 25 per cent. The ratio of outstanding mid- and long-term loans with maturity longer than one year to the outstanding deposits, shall not exceed 30 per cent. The ratio of the sum of the deposits with the PBC (excluding the required reserves), the deposits with banks and cash balances to the total outstanding deposits shall not be lower than 5 per cent.

v) Risk Control Ratio

The outstanding loans to a single enterprise shall not take more than 50 per cent of total capital of the UCC. The ratio of the outstanding loans granted to a single individual businessman or citizen to the total capital shall not exceed 10 per cent.

The ratio of the outstanding overdue loans to the total outstanding loans shall not be more than 15 per cent, of which, the call loans shall not exceed 5 per cent of the outstanding total loans.

vi) Profitability Ratio

The ratio of annual profits to total assets shall not be less than 1 per cent. The ratio of annual profits to the total capital shall not be lower than 15 per cent.

In order to ensure the smooth transition from credit ceiling to asset-liability ratio management, the target for the deposit-lending ratio attached to UCCs could be realised on a step-by-step basis. On average, this ratio should have been 65 per cent in 1994 on a nation-wide level. According to the regulation formulated by the PBC, the deposit-lending ratio may be overruled by the indices of capital adequacy and asset liquidity. All UCCs which have not met the required capital adequacy and asset liquidity ratios, shall restructure their total assets and their composition.

The People's Bank of China shall be the authorised organisation to supervise the implementation of the asset-liability ratio management system. The legal entity of UCCs at each level shall be a basic examining unit to monitor its implementation of "The Procedures". The local branches in provinces, autonomous regions, municipalities directly under the central government and cities which practice separate planning and budgets, may add to the examining indicators and implement directives to UCCs at each level on the basis of "The Procedures".

2. Standardise UCCs

In order to fit in with the structure of the socialist market economy in which various economic forms co-exist, and to accelerate the development of the medium and small-sized enterprises at the local level, the authorities decided that urban co-operative financial institutions will coexist with urban co-operative banks. Thus, the People's Bank of China will revise "The Regulation on the Management over UCCs". We shall use "New Regulation" to refer to the revised regulation in the following.

The "New Regulation" differs from the regulation promulgated in 1988 on the following aspects:

- a) *Scope of business.* The "New Regulation" stipulates that UCCs may collect the deposits from and grant loans to medium and small-sized enterprises and individual businessmen, and do the settlements for them. In order to reflect the co-operative feature of UCCs, the "New Regulation" emphasises that UCCs shall mainly provide credit services to their members. The People's Bank of China may formulate accordingly the relevant ratios to supervise the operation of UCCs.

In view of the current situation and the future development of UCCs, the “New Regulation” allows UCCs to offer urban individual savings deposit services.

- b) *Risk management.* The “New Regulation” selects three relatively stable ratios among the relevant indices mentioned above, i.e. capital adequacy, single customer credit, and asset liquidity, to measure the prudential management of UCCs in the future.
- c) *The Federal Urban Credit Union.* The function of the Federal Urban Credit Union differs not only from the function of UCCs, but from the urban co-operative banks, and will not be replaced by the latter at an experimental stage. So the People’s Bank of China revises the existing “Regulation on the Federal Urban Credit Union”, which will be automatically void after the establishment of the urban co-operative bank in the whole of China.
- d) *Financial management.* UCCs shall draw required surplus mutual fund and arbitrary surplus mutual funds from their profits. The ratio of the required surplus mutual funds to the arbitrary surplus mutual fund shall be 50 per cent; the rest shall be reserved for the beneficial fund and dividends. A part of the profit after tax earned by UCCs shall be reserved as undistributed profit for future use when they face losses.

3. Establish Urban Co-operative Banks

In order to implement the decision of the third session of the 14th central committee, to improve China’s financial system, and accelerate local economic development, the State Council decided to establish urban co-operative banks as of 1995.

The urban co-operative bank will be a shareholding commercial bank which is sponsored by the UCCs located in the municipalities, the collectively owned enterprises, shareholding companies, private enterprises, individual businessmen, urban citizens, and local finance bureaux. Its main objective is to provide financial services for the medium and small-sized urban enterprises, and to raise funds for local economic development.

In the process of the establishment of the urban co-operative bank, the UCCs which are located in the municipalities enjoy the option of either to become the subsidiaries of the urban co-operative bank giving up their legal entity, or to invest in the urban co-operative bank as the legal entity.

Before establishing the urban co-operative bank, the local authority shall review the current structure of the assets, operations, and the components of the shareholders of the local UCCs. The accounting house designated by the PBC shall evaluate the balance sheet of UCCs to disclose their assets

and liabilities. UCCs shall hold a meeting of the shareholding representatives to decide whether to become the subsidiary of the urban co-operative bank or the shareholder as the legal entity.

The ownership of the properties of UCCs which will become the subsidiary of the urban co-operative bank shall be defined according to the actual capital investment of the shareholders. The mutual accumulation by the former UCCs shall not be transferred or divided among shareholders. The shareholders of the former UCCs who are legal entity will automatically become shareholders of the urban co-operative bank; the individual shareholders of the former UCCs may be shareholders of the urban co-operative bank; their contribution to the capital of UCCs may be returned or transferred to the co-operative bank. The existing creditors and debtors of the former UCCs will automatically become the creditors and debtors of the urban co-operative bank. UCCs which invest in the urban co-operative bank as the legal entity will be standardised in terms of the new “Regulation on UCCs”, and will formulate their working plan to meet the requirements within two years.

In the light of the “Decision on Financial System Reform by the State Council”, the People’s Bank of China will promulgate the “Regulation on Urban Co-operative Banks”, and the revised “Regulation on UCCs” mentioned above. On the basis of these two regulations, the PBC started to establish the urban co-operative bank on a trial basis in 1995.

The “Regulation on Urban Co-operative Banks” is a normative document on the reform of urban co-operative banks. It stipulates the urban co-operative bank’s nature, function, organisational structure, shareholder structure, capital requirement, scope of business, asset-liability ratio, supervision and its relationship with UCCs.

a. The Nature of the Urban Co-operative Bank and its Organisational Structure

The urban co-operative bank is a shareholding commercial bank. The major differences with the other shareholding commercial banks are in the nature of the shareholders and the scope of business, i.e. the shareholders of the urban co-operative bank are the local governments, urban credit co-operatives, collectively owned enterprises, private enterprises and shareholding corporations; the customers of the urban co-operative bank are the medium and small-sized enterprises. The purpose of the establishment of the urban co-operative bank is to rectify the local financial order, encourage the motivation for setting up local financial institutions, and improve services for local economic development.

The urban co-operative bank shall open branches and subsidiaries in accordance with the needs of its development.

b. The Structure of the Shareholders of the Urban Co-operative Bank

The capital of the urban co-operative bank shall be contributed by the urban credit co-operatives, collectively owned enterprise, private enterprises, shareholding corporations, individual businessmen, urban citizens and local finance authorities. The proportion of the local finance authority shall not exceed 30 per cent; the proportion of the individual businessmen and citizens shall not be higher than 10 per cent. In order to diversify the shareholders, the regulation stipulates that the maximum share of each shareholder, i.e. the proportion invested by a single individual, shall not exceed 35 per cent; the proportion taken by a single legal entity shall not exceed 2 per cent.

c. Capital Requirement of the Urban Co-operative Bank

In order to enhance the capacity of the urban co-operative bank to bear risks, and to standardise its management, the regulation defines that total paid-up capital of the urban co-operative bank shall be 100 million yuan all over the country.

d. Scope of Business of the Urban Co-operative Bank

The business of such a bank is:

1) to provide deposit services to urban medium and small-sized enterprises; 2) to grant short-term loans to urban medium and small-sized enterprises; 3) to provide the services relevant to settlement, remittance and currency exchange; 4) to collect deposits from individual urban citizens; 5) to participate in the granting of syndicated loans; 6) to receive the remittance and make payments on behalf of financial institutions, and be the agent of insurance companies; 7) to sell or purchase government bonds and financial bonds; 8) to invest in financial institutions to a limited proportion; 9) to deal with other business approved by the People's Bank of China.

e. The Asset-Liability Ratios of the Urban Co-operative Bank

1) The ratio of the loan to a single customer to total capital shall not exceed 15 per cent; 2) the urban co-operative bank shall formulate approval procedures and reporting systems for loans of large amounts; 3) the ratio of liquid assets to total assets shall not be less than 25 per cent. The ratio of total capital to risky assets shall not be lower than 8 per cent.

f. The Supervision over the Urban Co-operative Bank

The urban co-operative bank shall be supervised by the People's Bank of China. As a shareholding commercial bank, the urban co-operative bank shall set up a Board of Directors and a Steering Committee to monitor the internal management and implement internal control.

g. The Relationships between the Urban Co-operative Bank and the Urban Credit Co-operatives

The urban credit co-operatives shall invest in the urban co-operative bank; the component of the capital of the urban co-operative bank shall include the contribution by the urban credit co-operatives.

The urban co-operative bank will replace the Federal Urban Credit Union for the supervision and monitoring of UCCs. After the authorisation of the PBC, the urban co-operative bank shall supervise and examine the implementation of the accounting standards, credit procedures, statistics reporting system, and safety requirements formulated by the PBC; and shall co-ordinate and support UCCs in fund raising, settlements or payments, and staff training.

Conclusion

Credit expansion by credit co-operatives may be viewed as a source of difficulty for monetary control. While such credit expansion is subject to ceilings set by the comprehensive credit plan¹ compliance with the plan may have proved much more difficult to monitor. Thus UCCs would represent an important source of faster than planned credit expansion. However, this assertion should be qualified since the loans of UCCs have represented only a fraction of the deposits they collect. Of course this does not imply that UCCs have not participated during certain periods in "excessive" credit expansion. These excesses have led the authorities to try to enforce existing regulations and to reinforce them. Furthermore they recently designed asset liability ratios as an alternative form of management to the credit ceilings. The current strategy for reforming the urban co-operative financial system has consisted both in standardising UCCs and in merging some of them into new urban co-operative banks.

Note

1. See for instance Girardin (1997) or Montes-Negret (1995).

IV. A SURVEY OF CHINESE URBAN CREDIT CO-OPERATIVES

Given the lack of first hand data on Chinese urban credit co-operatives, a survey was made among eight cities in three regions with different levels of development, selecting some 57 UCCs, in order to study the structure of their balance sheet, their management structure and financial performance or solvency. We first examine in a descriptive way the main lessons which can be drawn from the survey. In order to go a step further, and isolate the relationships between these different characteristics of the sample UCCs, we also implement a principal component analysis. We then isolate the main underlying problems raised by UCCs and consider directions for their further reform.

A. Descriptive Analysis

1. The Characteristics of the Sample UCCs

A survey of Urban Credit Co-operatives in China was conducted by selecting them randomly in representative regions, chosen because of their diverse level of development, and representative cities, chosen because of their differing sizes. We thus selected 57 UCCs from eight cities across China (see Table 4. 2). A questionnaire was sent to the relevant local branches of PBC, with answers established on the basis of annual reports that UCCs are required to submit.

In the following, all data are collected from these sample UCCs unless otherwise specified. It refers to 1994.

Since the start of the reforms and the opening to the outside world, while China's economy as a whole developed rapidly, differences of economic development among regions widened. Three types of development zones have been formed: one is the developed zone which is composed mainly of coastal provinces in the south-east of China. In this region, the economy is outward-oriented, developed and with deep commercialisation and monetisation. The various economic indices of this zone, including population, land area, aggregate agricultural output, aggregate industrial output, retail

sales and foreign investment as a share of the total in the whole country, are given in Table 4.1. Another one is the developing zone which mainly contains inland provinces in the middle of China. Economic development in this region is just average, falling behind the coastal areas in the south-east of China and it still keeps parts of a planned economy. The third one is the under-developed zone which mostly includes north-western parts of China. This region is relatively isolated and under-developed. The market-oriented economy has just started there.

Table 4.1. **Major Characteristics of Selected Regions as National Share**
(in percent)

	Southern-Eastern	Middle	Western
Population	48	34.1	17.2
Land area	30.7	41.4	28
Agricultural output	57.2	31.7	12.3
Industrial output	71.1	20.7	9.4
Retail sales	62.7	25.2	12.1
Foreign investment	88.6	8.0	3.4

Source: Statistical Yearbook of China, 1995

Table 4.2. **Distribution of Sample²**

	Eastern China	Middle China	Western China
Large cities	9 from Guangzhou (F)	9 from Wuhan (G)	9 from Chengdu (H)
Medium-sized cities	6 from Jinan (C)	6 from Changsha (D)	6 from Xining (E)
Small cities	6 from Changzhou (A)	6 from Kaifeng (B)	

²Number of UCCs in the sample: 57. The letters will be used in section B below.

We selected large, medium and small-sized cities in the above three regions (Table 4.2). We did not choose small-sized cities in the western zone because the number of UCCs in these cities is rather small. We took

nine UCCs in the large-sized cities, and six UCCs in the medium and small-sized cities respectively as random samples. Altogether, the 57 UCCs included in our sample investigation, register 1 per cent of all UCCs across China.

Table 4.3. **Equity Structure of Sample UCCs** (average)
(unit: RMB thousand)

EQUITY SHARES				
Paid-up Capital	Legal entity holders' equity	Number of shareholders*	Maximum amount	Minimum amount
301	161	50	30	1.3
Registered Capital	Individual shareholders' equity	Number of shareholders*	Maximum amount	Minimum amount
202	91.3	270	2.1	0.08

* simple numbers

2. The Structure of their Balance Sheet

a. Non-State Owned Shareholding Structure

China's four specialised commercial banks are solely owned by the state¹. UCCs' share-holding structure is absolutely different from that of the commercial banks. By the end of 1994, owner's equities of UCCs amounted to RMB 16.2 billion, without any equity investment from any level of government budgets.

The equity structure of sample UCCs (Tables 4.3 and 4.4) shows that they share the following characteristics which distinguish them from commercial banks and are of great significance to their management structure.

First, diversification of shareholders. The 56 sample UCCs are owned by 18,257 shareholders of which, 2,859 are legal entities, and 15,398 are individuals. The average number of legal entity and individual shareholders per UCC is 50 and 270 respectively.

Second, diversification of shareholding structure. The equity structure of the sample UCCs shows that, on average, collectively-owned enterprises (legal entities) account for 29.7 per cent of total equity; private enterprises for 10.6 per cent; self-employed persons (individuals) for 5.9 per cent; residents (individuals) for 21.8 per cent; staff (individuals) for 10.2 per cent; communities (legal entity) for 9.2 per cent; and others for 12.6 per cent.

Table 4.4. **Shareholders' Structure of Sample UCCs**
(unit: RMB thousand and %)

	Collective entities	Private entities	Individual-run enterprises	Individual residents	Staff	Community	Others	Total
average	502	17.9	100	369	172	156	214	
%	29.7	10.6	5.9	21.8	10.2	9.2	12.6	100

Third, conditions of equity control. Because the shareholders are diversified, the maximum amount of equity owned by a single legal entity is 300 thousand yuan or 10 per cent of the average paid-up capital. The maximum amount of equity owned by an individual is RMB 21 000 or 0.7 per cent of the average paid-up capital. However, the overall equity structure shows that every UCC has an average of 50 legal entity shareholders holding equity of RMB 1.61 million and 270 individual shareholders holding RMB 913 000. The major shareholders are mainly legal entities. In that sense, UCCs are generally controlled by legal entities.

The equity structure of sample UCCs shows that they do not follow the structure stipulated by the People's Bank of China which provides that neither individual shares (including shares held by private enterprises, self-employed persons and urban residents) nor collectively-owned shares should exceed 30 per cent of total equity. Indeed, the equity structure of sample UCCs manifested in Table 4.3 indicates that the shares owned by collective enterprises and communities amount to 38.9 per cent and individual shares to 48.5 per cent, both of which are far more than the ratio stipulated by the PBC. With regard to these data, we can conclude that the equity structure of UCCs apparently gives a predominance to individuals.

b. Non-State-Owned Nature of the Borrowers

The borrowers of UCCs are generally non-state-owned enterprises. The credit structure of the sample UCCs shows that 31 UCCs lend to state-owned enterprises, accounting for an average of 21.2 per cent of their respective aggregate credit; 57 lend to collectively-owned enterprises, averaging 61.7 per cent of their lending; 14 lend to private enterprises, registering an average of 2.9 per cent of their aggregate loans; 44 lend to self-employed persons, or an average of 5 per cent of their aggregate lending; 47 lend to other borrowers, accounting for an average of 30.0 per cent of the aggregate lending. No credit is offered to individual residents. Among the 31 UCCs for which data are available, credit to state-owned enterprises exceed 50 per cent of the total credit in 5 UCCs (with the highest proportion of 87 per cent);

in three UCCs, credit to state-owned enterprises account for 30-50 per cent; the figure runs from 10 per cent to 30 per cent in nine UCCs and in 14 UCCs the proportions are below 10 per cent.

Analysing the balance sheets of sample UCCs, we can presume that 30 per cent of the total loans, which are listed under “other loans”, possibly include many loans to state-owned enterprises. Among the 16 UCCs for which the ratio of other loans over total loans exceeds 30 per cent, 11 did not report their loans to state-owned enterprises. UCCs are prohibited from providing loans to state-owned enterprises. However, since state-owned enterprises tend to be less risky, it is understandable that UCCs are willing to provide credit to these enterprises. Accordingly, we can presume that UCCs actually provide credit to them but they would rather list such credits under “other loans” than report them explicitly. Based on the above presumption, loans provided to non-state-owned sector by UCCs are believed to be more than 70 per cent, but lower than 78.8 per cent in our sample of UCCs.

c. An Analysis of Business Scale

Since all UCCs in China are single-office entities, and branching is not allowed, their business scale is limited. In the sample UCCs, the largest asset is RMB 490.56 million and the smallest RMB 9.84 million. Their asset scale distribution is shown in Table 4.5.

Table 4.5. **Asset scale distribution of sample UCCs**

	Number of UCCs	Percentage
RMB 200 million	8	14
RMB 100-200 million	13	23
RMB 70-100 million	13	23
RMB 40-70 million	8	14
less than RMB 40 million	15	26

3. Their Management Structure and Economic Efficiency

a. Involvement of Legal Entities in the Management

In the analysis of UCCs’ management structure, it is important to look at the institutions to which they are attached, which is a unique mechanism in China. We saw earlier that the major shareholders of UCCs are legal entities.

In most cases, UCCs are attached to a legal entity (one of the largest shareholders). Usually, this entity has the authority to appoint the general manager (i.e. representative of the legal entity) so as to de facto control the management of the UCC. However, with the diversification of shareholders and the development of UCCs, these entities lost some of their influence on UCCs and the latter became more and more independent in their decision-making process. The authority of these entities currently manifests itself only in the collection of management fees. In other words, UCCs buy back part of their autonomy with management fees.

On the other hand, with the evolution of UCCs' management structure, more and more UCCs chose to attach themselves to the community board or the urban credit co-operative union instead of to a legal entity or a commercial bank branch. The sample shows that most UCCs are attached to a community board or a urban credit co-operative union, that rarely interfere with the business of UCCs.

b. Relationship between UCCs and Local Governments

Generally, UCCs have little to do with provincial governments. They are more or less related to the municipal governments of their residing cities. Nonetheless, the municipal governments rarely interfere with the business of UCCs because there are quite a number of UCCs in a city (usually more than 20) while the municipal government does not have an institution adapted to this task. In cities with urban credit co-operative unions, UCCs are managed and co-ordinated by such unions, which, accordingly, are supervised by the local branches of the Central Bank.

Nevertheless, this does not mean that UCCs are absolutely free of interference from the municipal governments in their business. The municipal governments may direct, explicitly or implicitly, UCCs to provide financial assistance for infrastructure projects, disaster relief or to local enterprises in need of credit. It comes handy for the municipal government to ask the urban credit co-operative union to provide syndicated loans to finance large projects. In these cases, UCCs will have to offer some credit. Usually, the municipal governments give far less directives to lend to UCCs than to state-owned commercial bank branches, because of the moderate size of UCCs. Another reason is that UCCs are local financial institutions and their loans are confined to the local enterprises anyway while the state-owned commercial banks are national banks whose credit plans are subject to the guidance of their headquarters. Local governments encourage the commercial bank branches to lend to local enterprises for the benefit of local economic development.

In general, from the decision-making point of view, local governments rarely interfere in the management structure of UCCs. On the contrary, local governments are inclined to assist UCCs since the latter play a positive role in the promotion of the local economy through tax and credit.

c. Council and General Manager of UCCs

The council of a UCC is usually composed of large shareholders and specially invited personnel. The sample UCCs indicate that the number of council members range from one-fifth to one-tenth of the total shareholders. The specially invited personnel are usually former managers of financial institutions and other members of the council are legal entity shareholders. Although the members of the council are elected by the general meeting of shareholders, the general meeting has little binding effect on the council since the council members hold a large amount of shares (not necessarily more than 51 per cent). The chairman of the council plays a key role in the council. The council meets once or twice a year to decide on important issues (such as dividend and profit allocation).

The general manager plays a significant role in the operation of UCCs. Though the general manager is appointed by the council, more often than not, he is actually nominated by the largest shareholder. Therefore, the general manager, as the representative of the legal entity, is vital in the management structure of UCCs.

The management structure of UCCs has a clear-cut structure and few layers. On the one hand, the general manager is directly involved in the lending business. Some large loans are subject to personal examination and approval by the general manager. On the other hand, information on the performance of UCCs is transparent to the council and most of the shareholders. The council and shareholders are well informed of the performance of the general manager. Under these circumstances, insider control and information asymmetry can be avoided. This management structure is better than that of state-owned commercial bank branches.

Given the management structure and business scale of UCCs, the qualification of the general manager is of great importance to their efficiency. In the sample, general managers of 36 UCCs (67 per cent of the sample) are at least graduates of higher education, general managers of 40 UCCs (70 per cent of the sample) are below the age of 55. Most of them are experienced in financial industry.

Asset security ratio = $[A - (B + C + D + E)] / A \times 100$

Loan quality = $(B + C) / \text{Outstanding loans}$

Capital risk ratio = $(B + C) / \text{Capital}$

with A = Total assets; B = Outstanding bad loans; C = Outstanding over- due loans; D = Interest receivables; and E = Other receivables.

d. Risk Analysis

The quality of risky assets of UCCs is generally better than that of state-owned commercial banks. According to the data collected from the sample, the total assets of the 57 UCCs are RMB 6,130.50 million, registering an average of RMB 107.55 million per UCC. The three asset quality indices are: the average asset security ratio reaching 92 per cent; the average credit quality index, 11.2 per cent; and the average capital risk ratio, 81.9 per cent. These three indices are defined as follows:

Non-performing loans account for 4.7 per cent of the credit that the sample UCCs grant, well below the 20 per cent (official figure) of the state-owned commercial banks. The assets of UCCs are liquid with an average liquidity ratio of 64.5 per cent. UCCs have adequate reserves, with a free reserve ratio of 28.7 per cent. In addition, the capital adequacy ratio (ratio of capital over risk-adjusted assets) averages 11.7 per cent.

By contrast, the state-owned commercial banks have two main features. First, they have a high ratio of non-performing loans. Such loans account for approximately 20 per cent of their total credit (official figure). Second, they suffer from some deficiency in their development. The equity of the four commercial banks increased at an annual average rate of 13 per cent from 1985 to 1994, which was lower than the growth of their outstanding loans over the same period.

The asset quality of UCCs seems at first inspection closely related to the economic development of the cities where UCCs operate, while the inherent factors come only second. Among the cities where samples are selected, cities with non-performing loan ratios below 3 per cent are Chengdu (1.3 per cent), Wuhan (2.1 per cent), Changzhou (2.4 per cent) and Guangzhou (2.8 per cent), which are three large cities, and a small city with a developed economy. Cities with non-performing loan ratios of 3 to 10 per cent are Jinan (4.6 per cent) and Changsha (7.1 per cent) which are two medium-sized cities whose economy is not well developed. Two small cities with an underdeveloped economy have non-performing loan ratios exceeding 10 per cent: Kaifeng (17.6 per cent) and Xining (19.1 per cent).

As we mentioned earlier in this chapter, we selected samples from the eastern, middle and western regions of China. Nevertheless, taking as a criterion the credit quality of UCCs, it seems at first sight that the economic development of different cities tends to have more influence on the operation of UCCs than the location of the city. The large-sized cities (e.g. Guangzhou, Wuhan and Chengdu) in the eastern, middle and western regions have a developed economy and UCCs in these cities operate well on this criterion. By comparison though, Jinan is in the eastern region and Changsha is not far from Guangdong. UCCs in these cities do not have a good performance in terms of loan quality since the level of economic development in these cities is only average.

Besides, the analysis shows that experience of UCCs' managers plays a more effective role in their operation than their academic qualifications do. In cities with a developed economy such as Guangzhou and Changzhou, the representatives of UCCs as legal entities are young and well educated. However, the asset quality of these UCCs is not as good as that of UCCs in Wuhan and Chengdu, whose legal entity representatives are older and not equally well educated. The situation is similar in Jinan and Changsha. In Changsha, the general managers of two of the sample UCCs are graduates with associates while two of UCCs in Jinan are headed by general managers who graduated from a vocational school. The difference is apparent. Nevertheless, with more experienced staff, UCCs in Jinan enjoy better asset quality than those in Changsha.

e. Analysis of Earnings

The earnings of the sample UCCs show that most UCCs are profitable. The 57 sample UCCs have an average earnings-asset ratio of 2.6 per cent. One (or 1.8 per cent) of the sample has a negative earnings-ratio; 33 UCCs, or 57.9 per cent of the sample, have earnings-asset ratios ranging from 0 per cent to 2 per cent; 19 UCCs or 33.3 per cent of the sample have an earnings-asset ratio of the order of 2 to 5 per cent and 4 of the sample, i.e. 7 per cent, have an earnings-asset ratio in excess of 5 per cent.

The average ratio of earnings on capital of the 56 sample UCCs is 32.4 per cent. More precisely, 18, or 32.1 per cent, of the sample have an earnings-capital ratio below 10 per cent (among which, one has a negative ratio); 23.2 per cent of the sample, or 13 UCCs, have earnings-capital ratios running from 10 per cent to 30 per cent; 16, or 28.6 per cent, of the sample have earnings-capital ratios of 30 to 60 per cent and 9, or 16.1 per cent, have a earnings-capital ratio in excess of 60 per cent.

By contrast, specialised banks are characterised, at a national level, by low and declining earnings. Their earnings in 1994 were RMB 16.6 billion. With total assets of RMB 580 million, this implies an earning asset ratio of

0.29 per cent. In 1994, the outstanding credits of the four state-owned commercial banks increased by 28.4 per cent compared with that of 1992 while earnings declined by 51.8 per cent over the same period.

B. Principal Component Analysis

In order to get a deeper understanding of the relationships between the different characteristics of UCCs, we use a principal component analysis to classify them on the basis of a number of criteria: i.e. the extent they lend to and borrow from collectively-owned or state-owned-enterprises (SOEs), their profitability and the quality of their loan portfolio.

Box 1: The Principles of Principal Component Analysis

The basis of principal components analysis is to 'explain' as much of the total variance of the variables retained in terms of a small number of synthetic variables called principal components. The latter are simply linear combinations of the actual variables once standardized. Thus, if we have K variables (X_1, X_2, \dots, X_K), the method determines K principal components (F_1, F_2, \dots, F_K) as linear combinations of the standardized variables (Z_1, Z_2, \dots, Z_K). Z is defined as follows: $Z = (X - \bar{X}) / s(X)$, where \bar{X} is the mean of X , and $s(X)$ its standard deviation. The principal components are given by:

$$F_k = a_{k1} Z_1 + a_{k2} Z_2 + \dots + a_{kK} Z_K \quad \text{for } k = 1, 2, \dots, K$$

Given that each variable is standardized, its mean is zero and its variance equal to one. The total variance is therefore equal to the number of variables (K). The principal components are determined such that the first explains the maximum proportion of the total variance, the second the next highest proportion and so on. The method will yield as many principal components as there are basic variables.

The usefulness of the method (see box) lies in the fact that a large part of the total variance can be explained by a small number of components, thereby reducing the dimension of the problem. The observations, in our case the 57 UCCs, can then be presented graphically in terms of the first few principal components rather than examining $1/2K(K - 1)$ pairwise scatter plots of the observations in terms of the original variables. Of particular interest in the case of UCCs is that they are based in eight different cities and, given the above observations, it will be interesting to see whether UCCs in a particular region are relatively homogeneous with respect to the variables used. Finally, in order to interpret what the principal components represent,

we note that the sign and absolute size of the coefficients or 'loadings' are critical. These attribute positive and negative values to the principal components for different observations, depending on the values of the standardized variables (Z). In this way, observations are separated along axes and often form fairly distinct groups.

1. The Relationship between Deposit and Loan Structure

We examine as a preliminary approach the deposit and loan structure of UCCs according to where deposits emanate from and to whom loans are granted. We use the following four variables:

depcol: the percentage of total deposits emanating from collectively-owned enterprises

loancol: the percentage of total loans granted to collectively-owned enterprises

depstate: the percentage of total deposits collected from state-owned enterprises

loanstate: the percentage of total loans granted to state-owned enterprises

We also weigh each observation according to the size of total assets in order to avoid outliers having too much influence on the estimated coefficients.

This preliminary analysis reveals that the first two components of the four available 'explain' more than 80 per cent of the total variance (Table 4.6), and so our graphical analysis can be conducted in two dimensions (Figure 1). The coefficients on the first principal component provide a clear opposition of UCCs that deal with collectively-owned enterprises which have negative values, and those that loan to SOEs which have positive values. Thus cities A, B, C and, to a lesser extent, H tend mainly to lend to and collect deposits from collectively-owned enterprises while D, E and G (i.e. one city with an average level and one with a higher level of development) deal mainly with state-owned enterprises. City F shows no clear separation. The coefficients on the second principal component give high positive values to UCCs that collect deposits mainly from collectively-owned enterprises and grant loans to state-owned enterprises. Negative values are attributed to UCCs that do the opposite. Positive values are found for UCCs in cities A and D, and negative values for UCCs in cities C, G and B. UCCs in the other cities are more heterogeneous in terms of the second principal component.

**Figure 1: Preliminary Principal Component Analysis:
First Two principal Components (F1 and F2)**

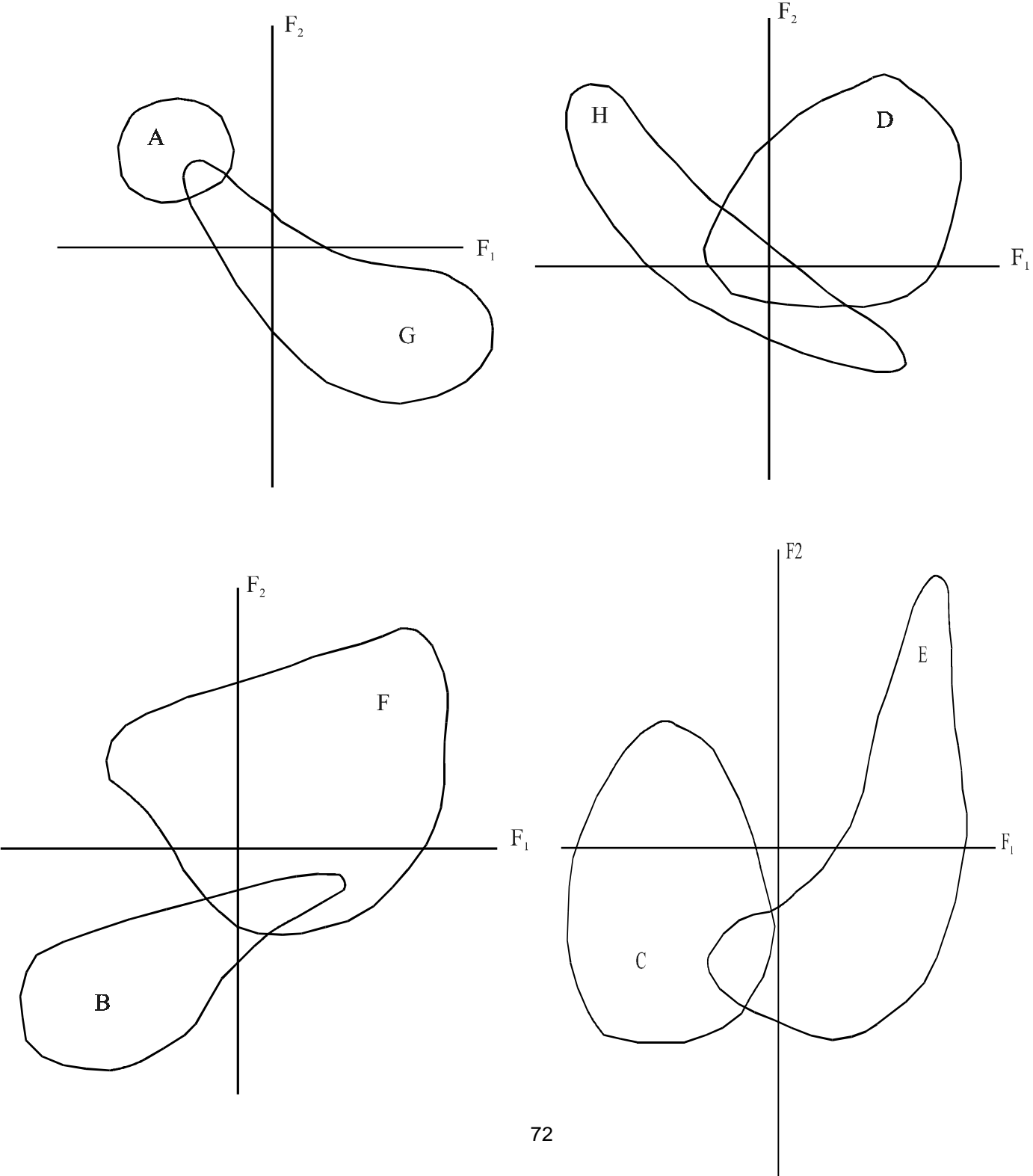


Table 4.6. **Principal component analysis: relationship between deposit and loan structure**

	Principal Components	
	First	Second
	(F1)	(F2)
Deposits from collectives	-0.32	0.88
Loans to collectives	-0.57	-0.18
Deposits from SOEs	0.48	-0.12
Loans to SOEs	0.57	0.41
Cumulative variance	0.52	0.75

The preliminary principal component analysis is thus particularly useful in that it points to a clear separation of cities in terms of whether they deal more with state-owned or collectively-owned enterprises (along the first axis) and the extent to and direction in which they tend to fulfill a function of financial intermediation between the two types of enterprise (along the second axis). UCCs in different cities are found to be relatively homogeneous in the main.

2. The Inclusion of Performance Indicators

The preliminary analysis was undertaken mainly in terms of institutional features of the UCCs - their specialisation and the predominant form of their intermediation. In order to extend this, we now include two further variables reflecting the financial situation of UCCs. The first is an indicator of the quality of the loans that the UCC makes (*loanqual*) and is measured as the percentage of bad loans to total loans. The higher the value of this ratio, the lower the quality of loans. The second additional variable is an indicator of the profitability of the UCC (*rateprof*) which is measured as the rate of profit on capital.

As a technical matter, it should be noted that the addition of basic variables in a principal component analysis will tend to cloud the relatively clear distinctions made earlier. There is 50 per cent more variance to be explained and there will be six principal components instead of four. Furthermore the percentage of the variance explained by the first two principal components will decrease.

Not unsurprisingly, the first principal component is very similar to that found in the earlier analysis. The highest coefficients are found on the original four variables and are of the same order (Table 4.7). However, high positive values of the principal components which were attributed to UCCs dealing mainly with state-owned enterprises (in terms of both deposits and loans) are also associated with UCCs that have a preponderance of bad loans and

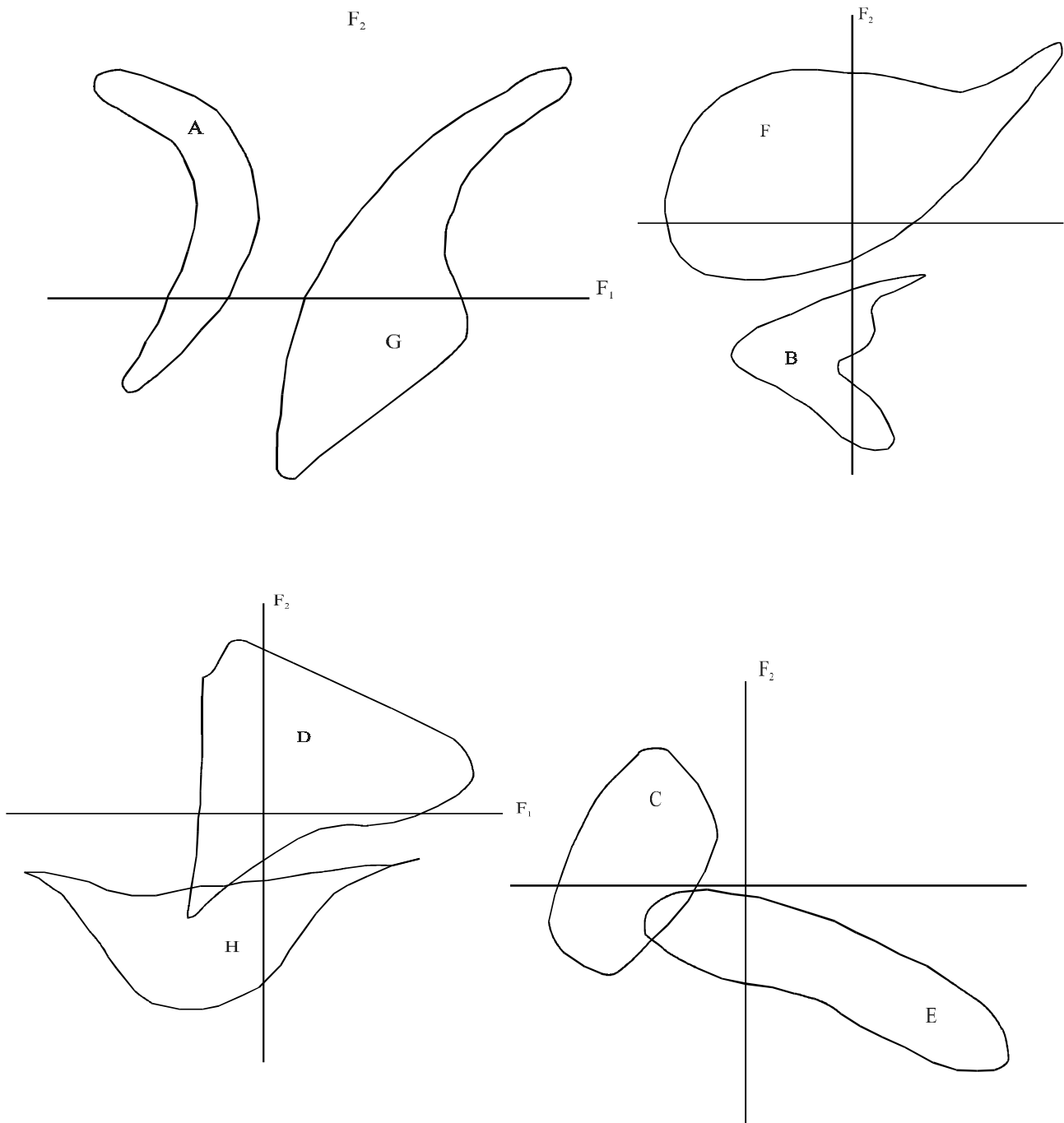
a low rate of profit. The opposite is true for UCCs dealing mainly with collectively-owned enterprises. The main difference is that the first principal component explains only 37 per cent of the total variance compared to 57 per cent in the preliminary analysis. The configuration of UCCs by city along the axis defined by the first principal component is similar, though slightly less distinctive, than that found earlier (Figures 3 and 4).

Table 4.7. **Principal component analysis: Relationship between asset structure and financial indicators**

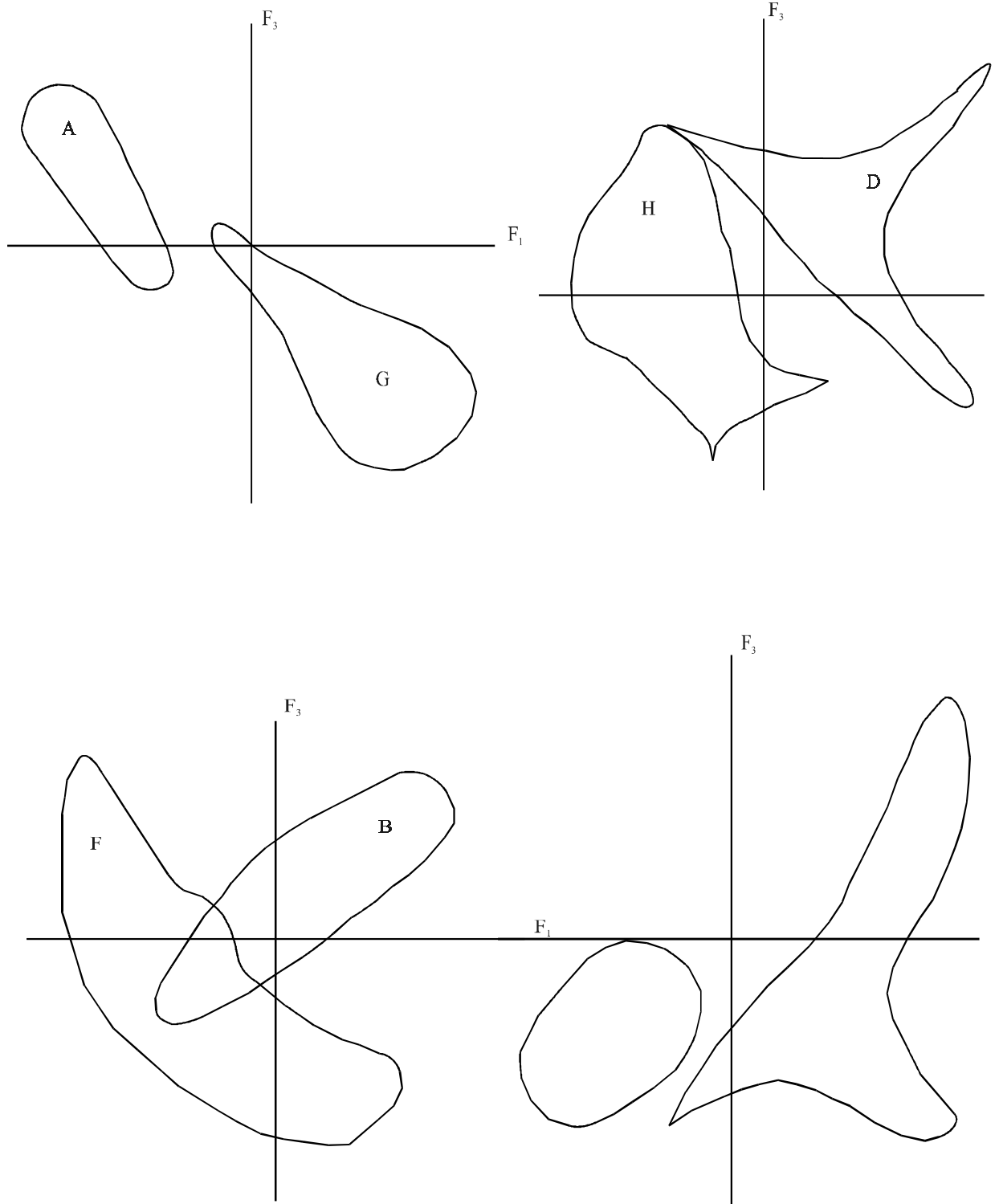
	Principal Components		
	First (F1)	Second (F2)	Third (F3)
Deposits from collectives	-0.35	0.32	0.46
Loans to collectives	-0.53	-0.24	-0.26
Deposits from SOEs	0.45	0.14	-0.52
Loans to SOEs	0.52	0.37	0.24
Loan quality	0.26	-0.52	0.61
Profit rate	-0.20	0.64	0.14
Cumulative variance	0.36	0.59	0.74

Interestingly the second principal component is quite different from that found in the preliminary analysis. The financial variables dominate the others, attributing high positive values to UCCs with a high quality of loans (a low value for the variable *loanqual*) and a high rate of profit. While of much less importance, higher values are also attributed to UCCs with a high proportion of loans to state-owned enterprises and a high proportion of deposits from collectively-owned enterprises. Thus, UCCs with high values for this principal component are profitable, well-managed, intermediaries intermediating mainly from collective to state-owned enterprises, and tend to be found in cities A, D, F and G (located in highly or mildly developed areas). Those with very low values for the second principal component are B, E and H, (from underdeveloped regions) and the latter form more homogeneous groups than the former along the second axis. This principal component shows the extent to which UCCs are profitable by keeping bad loans to a minimum, which appears to be associated with allocating deposits from collectively-owned enterprises as loans to state-owned enterprises. Together, the first two principal components 'explain' nearly 60 per cent of the total variance.

**Figure 2: Second Principal Component Analysis:
First Two Principal Components (F1 and F2)**



**Figure 3: Second Principal Component Analysis:
First and Third Principal Components (F1 and F3)**



The combination of the classification given by the first two principal components (Figure 2) generates a rather clear division between four types of cities. The first have UCCs with good financial performance associated with intermediation from collectively-owned to state-owned enterprises. They are then subdivided between the cities where UCCs mostly intermediate among collective enterprises (cities A, C and F from Eastern China) which enjoy a better financial performance than those which intermediate among SOEs (cities D, G, from middle China, and F). The second, opposite category, includes cities where UCCs have a poor financial performance and intermediate from SOEs to collectively-owned enterprises. The subdivision is then the same as for the first category with now cities B and H (from middle and Western China) characterised by the predominance of UCCs intermediating between collective enterprises having a better financial performance than UCCs located in cities E (Western China) and G which UCC's intermediate between SOEs. This implies that the level of development of the region in which they are located matters more for the financial performance of UCCs than the size of the city in which they operate. Indeed, the better performing ones are located in the most developed regions (eastern and middle of China) while moving westwards tends to imply a deterioration in financial performance.

The addition of the third principal component increases the proportion explained to 74 per cent. The third principal component is in fact similar to the second in the preliminary analysis except that the most prominent variable in terms of the size of its coefficient is *loanqual*, the proportion of bad loans. That is high values of this principal component are attributed to UCCs which have high proportions of deposits from collectively-owned enterprises and low proportions from state-owned enterprises, and where the loans made are of poor quality. A high proportion of loans to state-owned enterprises also leads to a positive value for this principal component but it is not one of the prominent variables. Low values for this principal component are found for UCCs in the cities C and G, and high values for cities A, D and H. However, in each city there are exceptions and there is more heterogeneity among cities than for the first two principal components (Figure 3).

C. Problems and Direction of Reforms

1 . Underlying Problems

a. Supervision of UCCs

Though there are PBC branches in almost all cities, it is difficult for the bank to carry out regular supervision of each UCC, for instance of their capital adequacy, liquidity ratio, line of business, level of interest rates and

risk management. It is almost impossible for the PBC to be informed of their regular financial performance. The off-site examination is largely entrusted to the credit co-operative union. In cities without a credit co-operative union, supervision is much less stringent. Even in cities that do have credit co-operative unions, the unions, for some reason, do not promptly report non-compliance or improper risk assumed by UCCs.

Given the huge number of UCCs, the deficiency of the Central Bank's supervision on UCCs is apparent, with an associated risk of potential crisis. In recent years, there have been a few cases of insolvent UCCs. Though the number of crises is small, the potential risk is always there.

b. Business Scale and Risk

It is true that the average level of assets of UCCs is small, but their ratios of earnings over assets and over capital are higher than those of other financial institutions in China (e.g. state-owned commercial banks, trust and investment companies and rural credit co-operatives). As far as economies of scale are concerned, the scale of UCCs is consistent with the urban economic development in China, which is related to the system characteristics of UCCs. For example, UCCs have a well-defined equity, a rational internal management structure, an awareness of competition, a profit orientation and a binding budget. However, there are some factors which cannot be compared. For instance, the state-owned commercial banks had to provide policy loans and are levied with heavier tax rates and rural credit co-operatives have to provide agricultural loans which are highly risky.

Theoretically, financial institutions with small assets are risky. This is evidenced by the recent crisis of saving and loans associations caused by huge losses in the United States. However, it is premature to predict that such a crisis will occur among UCCs. In China, the risk comes from the asset structure rather than the size of assets. As long as the loans are adequately diversified and have a short-term maturity, (unlike the savings and loans associations in the United States which lent heavily to the real estate industry), risks can be avoided. However, UCCs undoubtedly suffer from risks linked with geographic specialisation. They indeed try to diversify in as much as a large part of their assets is made of loans on the inter-bank market partly to state owned banks. The prevailing view among the authorities is thus that the risks on assets of UCCs are low because they do not lend heavily to state-owned enterprises or to the real estate industry. UCCs thus benefit from the fact that as long as the general economy does not encounter a serious crisis or recession, the urban small and medium-sized enterprises will continue to operate properly and keep a good debt-service record. The difficulty raised by such an argument has to do with the inefficiency and the high risks which are characteristic features of the state-owned banks. Lending

on the interbank market may thus not be an adequate means for UCCs to diversify their risks and may on the contrary magnify them, since this implies that they become subject to the much more serious risks faced by state-owned banks (SOBs) which hold a substantial portfolio of non performing loans granted to SOEs.

c. Underlying Problems in the Operation of UCCs

Unallocated Public Accumulation Funds

Because of the ceiling imposed by the government on dividends, most UCCs have accumulated large amounts of public funds. The average amount of the accumulation of public funds for the sample is RMB 1.84 million, accounting for 80 per cent of the average registered capital (RMB 2.30 million). Since it is provided that the public accumulation funds shall not be distributed to the shareholders, the way in which the public accumulation funds is handled will remain a problem.

Inter-city Settlement

Intra-city settlement of cheques of customers of UCCs is convenient, but if the customers make a payment with their cheques in other cities, the inter-city settlement becomes difficult. Currently two approaches are applied: in several cities, UCCs form a multilateral network of mutual correspondence to clear and settle the cheques of UCCs. Since there are a large number of cities in China, this approach only solves the problem of inter-city settlement for a few cities. It is not very convenient and involves settlement risks. Another common approach is for UCCs to make use of the national settlement network of state-owned commercial banks. This requires every UCC to open a deposit account with the local branch of the state-owned commercial bank and drafts can be issued under that account to facilitate inter-city settlement. This approach is convenient, but UCCs have to deposit large amounts of funds for settlement. In addition, this is dependent on the efficiency of the settlement of commercial banks.

Incompliance with Regulations

Because of the deficiency in the supervision of UCCs by the Central Bank, there have been cases of incompliance of UCCs; for instance, the involvement in inter-bank lending exceeding the authorised ratio, granting medium and long-term loans above the regulated ceiling, taking large deposits of state-owned enterprises, raising interest rates and engaging in securities transactions as brokers. The incompliance with regulations of UCCs contributed to the financial disorder.

2. Direction for Further Reform of UCCs

a. Should UCCs Similar to Small-Sized Commercial Banks Persist?

This is the most controversial question involved in the reform plan of UCCs. As far as their functions are concerned, UCCs in China are in fact individual small-sized commercial banks with single entities. There is no difference between UCCs and commercial banks in the equity structure, management structure and line of business. The only difference is that the asset scale of UCCs is smaller. Those who dispute the adequacy of the current UCC system emphasise the evidence that a payment risk certainly exists regularly in a large number of UCCs similar to small-sized commercial banks. Since it is impossible for the Central Bank to carry out regular supervision of these UCCs, their lack of compliance will occur widely. Reforms of the current UCC system seem imperative because it is the large number of depositors who will ultimately assume the risk.

Since UCCs have come to be commercial banks in a true sense, the depositors should assume the possible risk. The smaller the commercial bank is, the weaker its capability to undertake risk. In addition, less capable persons and even so-called 'saboteurs' do exist among the managers of UCCs. Therefore, there are risks that several UCCs might go bankrupt. Moreover, the deposit insurance system has not been established in China, which implies that China is unable to take such huge risks.

The line of business of small-sized UCCs is not different from that of medium-sized commercial banks. While the latter can provide all the business which UCCs can offer, they have less payment risk and provide a better ground for regular supervision. Therefore, it is believed that unification of individual UCCs can offer a reduction in payment risk and allow more convenient regular supervision. The transition of individual UCCs into medium-sized commercial banks (i.e. City Co-operative Commercial Banks, hereafter referred to as CCCBs) will not bring about any shortage in the financial service sector.

b. Transition of UCCs into CCCB

Transition of UCCs to CCCB has been chosen to be the way to reform the current UCC system in China. That is, the existing UCCs in the medium and large-sized cities will be transformed into a CCCB as a single legal entity and become branches of the new banks. So far, this measure has been taken in Beijing, Shanghai, Guangzhou, Shenzhen and Shijiazhuang. According to the regulation stipulated by the State Council, the capital of a

CCCB should not be less than RMB 100 million. CCCBs currently being established in the above five cities all have capital amounting to more than RMB 1 billion.

- i) CCCBs are commercial banks with a shareholding system, but which have different rules and business from general commercial banks.

For the purpose of providing better services to the medium and small-sized enterprises in cities, the total amount of capital of a CCCB is composed of equity investment from various enterprises, self-employed persons, urban residents and local government budgets, of which, the various enterprises include state-owned enterprises, enterprises with shareholding system, collectively-owned enterprises and private enterprises. Their equity investment should conform to the regulations concerning the equity investment in financial institutions stipulated by the PBC. Equity investments by local government budgets should not exceed 30 per cent of the registered capital.

- ii) In a CCCB with legal entity status, all the shareholders enjoy equal rights and equal dividends. UCCs will become branches of a CCCB and be deprived of their legal entity status after they join the CCCB. Former shareholders of UCCs will become the shareholders of the CCCB.
- iii) Only one CCCB is allowed to be set up in a city if it has a similar line of business to that of the commercial bank, which is stipulated in the Commercial Bank Law.
- iv) The PBC is responsible for the regulation and supervision of CCCBs. All CCCBs should be authorised by the PBC and the eligibility of their chairmen, vice-chairmen of the board, presidents and vice-presidents should be reviewed by the Central Bank. The PBC undertakes regular supervision of their business.
- v) Settlements of CCCBs will directly join the inter-bank settlement network organised by the PBC, which will alleviate the difficulty currently existing in the inter-city settlement of UCCs.

c. Are Co-operative Financial Institutions Necessary in Cities?

The existing UCCs were not established as co-operative institutions of self-employed persons from the start. However, the high level of monopoly and inflexible management of the state-owned banks contributed to a large extent to their establishment. Accordingly, the initiators of UCCs are mainly state-owned legal entities and UCCs have become subordinated to community governments, state-owned enterprises and some other organisations and agencies. Since the PBC has authorised UCCs to practise the same scope of business as that of commercial banks, it is possible to restructure these UCCs into medium-sized commercial banks.

It becomes questionable whether these UCCs will continue to provide financial services to self-employed persons and individually-run enterprises after they are restructured to CCCBs. Several factors are at stake, including:

- i) Local governments will have 30 per cent equity investment. As a result, they will utilise CCCBs for administering the local economy and monitor them to provide financial services to key projects and medium and large-sized enterprises.
- ii) Compared with community co-operative financial institutions, commercial banks have higher management costs involving credit examination. As a result, they will not provide loans to those self-employed persons or small-scale private enterprises who require only thousands or tens of thousands yuans in most cases. If there are no such formal financial institutions to serve these small amounts of credit demands, those customers will have to turn to individual creditors, with an adverse impact on financial stability. Therefore, it is necessary to establish several UCCs of community co-operative characteristics after the existing UCCs are restructured.

d. UCCs with Community Co-operative Characteristics

In accordance with the reform plans, UCCs similar to small-sized commercial banks will no longer exist in those cities where CCCBs are set up. However, only UCCs of community co-operative characteristics are allowed to be established. These kinds of UCCs have the following features:

- i) They are co-operatives. Their business aims at providing financial services to their members and to help them to raise funds.
- ii) They put more emphasis on public accumulation in profit allocation. This kind of accumulation will not be divided among shareholders because of the high risk involved with providing services to self-employed persons and medium and small-sized enterprises.
- iii) Membership is introduced for these UCCs to promote public participation, public ownership, public management and public supervision.
- iv) The concept of community is introduced. For metropolitan cities, “community” indicates each street (board) in these cities and for other provincial capital cities and medium and small-sized cities, “community” refers to their administrative district (government).
- v) Business is mainly open to their members, including deposit-taking, credit-lending, instruments-discounting for UCCs’ members and savings-taking for individuals of the city.
- vi) Their settlement will be handled through commercial banks.

- vii) They will implement self-disciplined management through restoring co-operative structures. The PBC will carry out its supervision through unions of these UCCs.

e. Assessment of the Current Reform Plan

According to the current reform plan, the scenario for the urban co-operative credit system in China in the next few years will be as follows: there will only be UCCs of community co-operative characteristics in those cities where CCCBs are established. There will be UCCs similar to small-scale commercial banks in those cities where no CCCB has been set up. These three types of financial institutions will co-exist for a couple of years all over the country. Under the above-mentioned arrangement, CCCBs are actually local commercial banks with powerful strength, large amounts of assets and great support from local governments. They will directly compete with state-owned commercial banks in the local financial industry. UCCs of community co-operative characteristics aim at serving their members and small-sized customers of the community with small business scale and relatively low risk.

The current reform plan undoubtedly represents an important step in the right direction. By consolidating existing UCCs and establishing a pyramid structure not unlike previous experiences in other major Asian countries, it will contribute to the diversification of assets which is crucial in order to reduce the excessive regional specialisation that is typical of credit co-operatives. However, to be truly successful, such a programme should be accompanied by a deep reform of the state-owned banks which currently suffer from serious inefficiencies². Such a reform³ would enable credit co-operatives to diversify their assets efficiently in another way by lending to SOBs. The current split of such banks into commercial and development arms is the first stage of such a reform but does not deal with the endemic problem associated with the stock of non-performing loans.

Conclusion

In this survey it seems that sample UCCs do not as a rule comply with many existing regulations. Thus their equity structure gives a predominance to individuals, and to collective enterprises, in excess of what is stipulated by existing regulations. Besides, even though UCCs are prohibited from granting loans to state-owned enterprises, such loans represent 20 to 30 per cent of credits granted by UCCs. However, this is understandable in as much as state-owned enterprises tend to be less risky. Besides, the financial performance of our sample UCCs is much better than the national

performance of state-owned banks. Their share of non performing loans is four times smaller and their ratio of earnings over assets ten times bigger than those of the latter.

We selected samples from the eastern, middle and western regions of China. Taking as a criterion the share of non-performing loans granted, a descriptive analysis would imply that the economic development of different cities tends to have more influence on the operation of UCCs than the region in which they are located. However, a principal component analysis shows that there tends to be a separation of UCCs according to the level of development of the region in which they operate, rather than to the size of the city in which they are located. In highly and mildly developed regions, i.e. the eastern and middle parts of China, UCCs are profitable and have a low proportion of non-performing loans while they, to some extent, collect deposits from collectives and lend to SOEs. In the western part of China, composed of less developed regions, UCCs do to some extent the opposite type of intermediation and have a poor financial performance. The fact that UCCs do the rest of their intermediation between collective enterprises rather than between SOEs improves their financial performance in both cases. Actually the more developed the region (i.e. the more to the east) the lower the share of intermediation between SOEs. This analysis implies that it is only in these regions that it seems rational for UCCs to side-step regulations in order to grant loans to SOEs. The SOEs which borrow from them may be keen at servicing their debts in order to keep their reputation and may divert funds to put UCCs first on the list among creditors.

As far as their functions are concerned, many UCCs in China are in fact individual small-sized commercial banks with single entities. Apart from the scale of assets, there is no difference between UCCs and commercial banks, and payment risk certainly exists regularly in a large number of UCCs similar to small-sized commercial banks. Since it is impossible for the Central Bank to carry out regular supervision over these UCCs, their lack of compliance will occur widely. A transformation of such UCCs into regular banks seems imperative because without more regulation it is the large number of depositors who will ultimately assume the risks. This implies that UCCs should be merged into City Co-operative Commercial banks in medium and large-sized cities.

However, it becomes questionable whether these new banks, located in such cities, will continue to provide financial services to self-employed persons and individually-run enterprises because they will have higher management cost involving credit examination. Therefore, in these cities, it is necessary to establish several UCCs of community co-operative characteristics after the existing UCCs are restructured. In smaller cities, where no merging of UCCs into CCCBs occurs, UCCs should be transformed into small-scale commercial banks in order to be better regulated.

Notes

1. The Bank of Communications is also controlled by the state. "Controlled" here refers to equity investment of central and local governments, or direct holding by the state in the true sense. This kind of equity is different from the equity investment of the state-owned enterprises (i.e. legal entities).
2. See Girardin (1997).
3. See Girardin (1997).

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