Using the Framework of the Community Reinvestment Act to Support Rural Communities in China

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The Chinese economic success story has become a globally envied phenomenon. Rapid growth has raised living standards, reduced poverty rates, and created jobs. But as cities have prospered, the progress of rural China has remained stagnant. In recent years, the Chinese government has undertaken steps to spur growth and productivity in its underdeveloped rural areas, referred to by the Chinese as "counties." In particular, the Chinese central bank, the People's Bank of China, is now looking abroad for ways to increase access to capital in underserved areas. In India, they looked at the role of microfinance. In the United States, they took a close look at the Community Reinvestment Act (CRA), the over 30-year-old U.S. banking law that requires banks to reinvest in communities where they take deposits. The Xi'an branch of the People's Bank of China reached out to the Federal Reserve Banks of Boston and San Francisco to learn more and engage in a dialogue about how CRA might be applied in China. The discussion was a study in contrast, but also uncovered some surprising areas of commonality.

Urban and Rural Inequality: The Role of Lending

China experienced a high average annual GDP growth from 1978 to 2010. Much of this growth has taken place along China's coastal region and in its cities. Construction cranes have become the native birds of Chinese cities, especially in coastal cities such as Shanghai, Tianjin, Dalian, Shenzhen, and Guangzhou. The story of Chinese growth, however, is primarily an urban one. The picture in, and plight of, rural China is quite different. Home to 60 percent of China's population, China's rural areas remain impoverished. Income gaps between city and country are staggering, as urban residents earn 3.3 times more than their rural counterparts.[2]

One contributing factor to this disparity is the lack of access to credit and capital for Chinese farmers and for other small enterprises. Despite its population and the presence of rural "small towns" with upwards of several hundred thousand people, there is a dearth of lending in county areas. According to one source, rural areas are home to fewer than one-sixth

1 The views in this article do not represent those of the Federal Reserve Bank of Boston, nor the Federal Reserve Board of Governors, nor the People's Bank of China. The author acknowledges the information provided by Sun Tianqi, Director of Financial Research at the Xi'an branch, and thanks him accordingly. However, the article expresses solely the views of Prabal Chakrabarti, and any statements, opinions, or errors are his.

2 Andrew Jacobs, "China's Army of Graduates is Struggling," *New York Times*, p. A1, December 12, 2010.

of all bank branches, and lending per capita in rural areas is one-tenth that of Chinese cities.[3] Five large banks dominate China's banking system, and their activity is concentrated in cities. Currently, few banks serve the rural market, such as rural credit cooperatives.

Rural unemployment has remained stubbornly high, and while the government has promoted entrepreneurship, it is hard for the population to obtain loans. Many individuals turn to family and friends, or to pawnshops or private moneylenders who charge exorbitant rates of interest. Some underground lenders charge interest rates of 200-300 percent.[4]

As noted, Chinese banking officials have looked to microfinance for solutions. The People's Bank of China recently announced a microfinance initiative in rural China. They also instituted other reforms with the Agricultural Bank of China, created a new Postal Savings Bank to lend to farmers and rural enterprises, and started a pilot project that allowed individuals to set up privately owned credit cooperatives.[5]

Bridge to the Community Reinvestment Act

Recognizing that lack of credit was a common problem, Chinese banking officials began searching for comparative examples to address rural access to capital. Sun Tianqi, Director of the Financial Research Division of the Xi'an branch of the People's Bank of China, first contacted the Boston and San Francisco Banks in mid-2009 to request permission to translate their joint publication Revisiting the CRA: The Future of the Community Reinvestment Act.[6] Sun was aware of the CRA as a possible model, having been an active reader of Federal Reserve publications on its websites. In particular, Sun was motivated by the act's stipulations that banks lend in areas where they take deposits, and he believed the act would shed light on how to regulate this desired behavior in China.

Based in a booming city of 8 million people, the Xi'an branch might, at first glance, be a surprising place to look at lack of access to capital. But like the San Francisco Federal Reserve district, Xi'an branch covers a massive geographic area, making up one-third of the territory in China, including five provinces in Northwest China. While Xi'an has become a center for the solar power industry in China, and has certainly partaken in the real estate boom, the wider region is a far cry from the development seen in China's coastal regions.

In early 2010, the Xi'an branch invited the Federal Reserve Banks of Boston and San Francisco to bring a delegation and put together a workshop on CRA on April 19, 2010. The Federal Reserve delegation, led by Sandra Braunstein, Director of Consumer and Community Affairs at the Federal Reserve Board, embarked for China.

3 China Tries to Make Lending Easier In Rural Areas," International Herald Tribune, Business Section, February 19, 2007.

4 "China will legalize private lending to help rural areas," Asia Economic Institute citing People's Bank of China. http://asiaecon.asiaeconomicinstitute.org/special_articles/read_sp/12535/0/56.

5 Ibid.

6 Federal Reserve Banks of Boston and San Francisco, "Revisiting the CRA: The Future of the Community Reinvestment Act" (San Francisco: Federal Reserve Banks of Boston and San Francisco, 2008), available at www.frbsf.org/publications/community/cra/index.html.

The People's Bank of China (PBC) Presents the Chinese Context

Held in the regal setting of the Shangri La Hotel, the workshop audience comprised participants from Chinese regulators and banks and the financial news agency. Representatives spoke from the People's Bank of China's Beijing and Xi'an branches. Audience members included bankers from the county branches of the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Bank of China, and the Construction Bank of China. A representative of the China Banking Regulatory Commission also attended.

The Chinese central bankers began by framing the magnitude of the challenge of spurring development in a county-area population that comprised more than 70 percent of China's population in 2009, and accounted for half of China's gross domestic product.[7] They described the key role finance plays in lending to small- and medium-sized enterprises and providing agricultural loans. However, the underdeveloped financial system and lack of lending institutions, they said, has led to underperformance.

They described a bifurcated system of lending in counties. State-owned commercial banks hold the majority of deposits, yet rural credit cooperatives make most of the loans. Many state-owned banks reported loan-to-deposit ratios of less than 20 percent, while two-thirds of the rural credit co-ops reported loan-to-deposit ratios of more than 60 percent.

The stated causes of low lending were financial, economic, and technical. Notably, Chinese authorities' greater emphasis on reducing risk in banking led to greater centralization and fewer opportunities for local branches to retain deposits and make lending decisions. The exact degree of local versus central decision making was a matter of some debate. The underlying economy in rural areas was also a significant barrier. Lenders perceive small businesses as risky, with uncertain revenue, and farmers are unable to pledge adequate collateral.

Members of the People's Bank of China (PBC), led by Guisheng Liu, president of the Xi'an branch, spoke of their efforts to transform the delivery of financial services in counties. Since 2005, the central government advocated for increased lending. China announced new policies to encourage financial institutions to reinvest deposits at certain shares. The Ministry of Finance is now providing incentives in the form of subsidies to "innovative rural finance institutions" with a bonus for better-than-average growth.[8]

Throughout, PBC staff had a desire for a more market-driven approach to serving the credit needs of the county population, while accepting that bank funds would continue to flow to urban centers in search of higher returns. They saw the U.S. experience with CRA as potentially useful in shaping their policy. Moreover, Chinese companies are expected to display corporate social responsibility.[9]

The Chinese audience had several questions upfront. They were interested in learning

7 The share of the Chinese population differs from the 60 percent figure because Chinese counties overlap with, but are not quite the same as, rural areas; they contain some large towns and even small- to mid-sized cities.

8 Presentation by LIU Guisheng, PBC Xi'an Branch, April 19, 2010.

9 During the April 2010 session, the American delegation heard about Chinese companies, like a major soft drink manufacturer, that donated profits for earthquake recovery, which had just occurred in Qinghai in western China.

more about what kinds of institutions were covered, bank compliance, any implications of the subprime crisis, and the then-current proposals for a new consumer agency and changes to consumer regulations. In a familiar note, Chinese farmers, it seemed, had made poor choices owing to a lack of financial literacy, or had fallen prey to aggressive practices by money lenders. This situation could matter even more, as China had recently lifted its ban on private money-lending. Finally, they noted that any CRA-like regime was merely one tool to be coordinated with other rural finance policies and with other antipoverty subsidy policies.

Essential Elements of CRA That Might Apply in China

Making the point that CRA is not a stand-alone regulation and is examined along with other consumer-related rules, Sandra Braunstein provided an overview of the entire consumer regulatory scheme. Braunstein oversees these regulations for the Federal Reserve Board, including the Equal Credit Opportunity Act and the Home Mortgage Disclosure Act. Data are a major tool for the CRA by making volume and terms of lending transparent, and so Braunstein emphasized how CRA examiners use Home Mortgage Disclosure Act Data and small business data. The Chinese audience was quite interested in the data collection and many of the regulatory laws.[10]

Chinese regulators are concerned with the relative financial illiteracy of their rural borrowers, many of whom were getting into deep debt through usurious practices of money lenders. According to People's Bank of China staff, many less-educated rural residents had little understanding of how debilitating the agreements they were entering into might turn out to be. Braunstein covered much of the structure that protects consumers, but also highlighted the efforts by Board staff to test disclosure documentation through focus groups, with the goal of making the fine print on financial forms shorter, consistent, and easier to understand.

As expected, some ideas underpinning the CRA resonated more clearly than others for the Chinese. One element that resonated clearly was the idea that CRA was designed in part to address the exodus of deposits without recycling the money into loans. Among the many measures used by CRA examiners, the loan-to-deposit (LTD) ratio is one measure by which institutions are judged, comparatively and in context, on how well they meet the credit needs of their community. Chinese representatives asked whether a specific LTD ratio was required to meet a threshold for an outstanding rating. The U.S. system relies heavily on examiner judgment rather than prescriptive rules. China was considering establishing a target, such as through a financial incentive. A specific LTD target would not be the goal in the United States, as it would be considered a form of capital allocation.

CRA in the U.S. makes distinctions between size of institution, with greater scope of responsibilities for larger banks. This also resonated with the Chinese, with their recognition of the presence of branches of very large commercial banks and the smaller rural cooperatives.

10 Following the workshop, Sun and his staff translated the *Consumer Regulation Handbook* of the Federal Reserve Board.

Chinese regulators would have to determine whether to set different standards for different institutions (like "subbranches" of a major bank versus incorporated rural credit cooperatives).

Chinese regulators considered the explicit consideration in the CRA of safety and soundness essential. Of concern to China is the continued stability of its commercial and state-owned banks, and the health of its rural credit cooperatives. PBC speakers raised as a concern the dearth of financially viable projects, citing high costs and low returns. With agriculture the main industry, exposure to natural disaster, market risks, and low productivity hamper investments. A relevant issue was the role of CRA and the subprime crisis. But, as I underscored, the subprime crisis was not a failure of safety and soundness of the CRA, given that CRA lending has outperformed non-CRA regulated subprime lending.

One of the fundamental elements of CRA, the underlying concern with race, seemed to translate less well. Richard Walker of the Boston Fed provided the context of CRA as a tool against redlining, and relayed the community history of protest that pushed regulators to implement and enforce CRA. Although the CRA does not explicitly mention race, its origins grew out of racial disparity. This is quite different than the Chinese problem, which is more concerned with unequal growth between rural and urban.

CRA in the United States also relies on a rich network of nonprofit groups and intermediaries, as highlighted by David Erickson, drawing from his book *The Housing Policy Revolution: Networks and Neighborhoods.*[11] While China has rural cooperatives and possible collaboration among banks, it is difficult to imagine the same rich web of private and nonprofit players that partner in the U.S. system. Erickson also highlighted the role of tax credits, such as those for low-income housing and other federal subsidies, which are layered with CRA money to produce targeted outcomes. Yet China also employs industrial zones, so one could envision special treatment for rural areas akin to the U.S. empowerment zones.

Parts of the U.S. system of examination remained difficult to convey to the Chinese participants. For example, the concept of an assessment area, the geographic area used to evaluate a Bank's CRA performance, was difficult to explain.[12] This is, in fact, not surprising, as the assessment area is itself a confusing and much criticized element of the U.S. system. In the United States, examiners do not themselves define assessment areas. Banks self-define them according to a plan they submit to regulators. Chinese officials asked what would and would not constitute an assessment area, and what factors a bank might choose to define their area.

The requirements for an outstanding or satisfactory CRA rating was also difficult to convey. Audience members consistently asked, in general, what loan-to-deposit ratio would suffice to

11 David J. Erickson, *The Housing Policy Revolution: Networks and Neighborhoods* (Washington, DC: Urban Institute Press, 2009).

12 Assessment areas must include geographies where bank has its main office, branches, and deposit –taking ATMs, as well as surrounding geographies where the bank has originated or purchased a substantial share of its loans. It may not reflect illegal discrimination or arbitrarily exclude low and moderate income geographies. (Taken from "A Bankers Quick Reference Guide to CRA," Revisiting the CRA: Perspectives on the Future of the Community Reinvestment Act (Federal Reserve Banks of Boston and San Francisco, 2009)

achieve certain levels. Federal Reserve regulators pointed out that owing to different context and needs, changes in the economic cycle, and a host of other factors, no single ratio is viewed as acceptable or not. Moreover, the host of ratios and factors used, like the share of lending to lower income borrowers, argue against focusing on any single across the board measure.

More broadly, the Chinese perceptively picked up on the troublesome nature of defining "community," for example, in the community development lending test and in the bank obligation to meet the credit needs of their communities. According to Liu Ping, Deputy Director General of the Financial Research Institute of the Beijing Head Office, China itself is struggling to define the "county." For example, when issuing licenses to commercial banks, should Chinese officials request loans be given to high-income individuals living in urban areas within the counties, or should the loans be restricted to low- and moderate-income individuals? The American CRA faces similar questions. Erickson gave the hypothetical example of a luxury hotel being constructed in a low-income area. Should it qualify? The answer? It depends. Perhaps the hotel creates permanent jobs for low- and moderate-income individuals living in close proximity. Once again, the judgment of the examiner comes into play.

China sees lending as the primary driver, yet Liu drew attention to the CRA's service and investment tests as possibly new considerations.[13] She raised several other questions as well, including how to establish the correct incentive and punitive measures and how to establish the corresponding examination and supervision system, which would be coordinated with the China Banking Regulatory Commission.

Implementation may require other steps. For example, Susan Krause-Bell of Promontory Financial Group highlighted the lack of a credit scoring or credit data infrastructure in much of China. She also pointed to the collateral restrictions. Chinese farmers cannot pledge their land as collateral. She highlighted that other gaps in data make it difficult to evaluate risk and structure and price loans. Liu also talked of the underdeveloped credit environment, focusing on reforming the framework for personal insolvency as one way to improve the system.

Efforts Underway in China to Implement a CRA-Like System[14]

As a macro financial regulator, the PBC attaches great importance to balancing urban-rural development and strengthening financial support to county-level financial institutions, advancing financial reform, and improving financial services in rural areas. A brief description of some policies and reforms being considered by the PBC and the Chinese government is below.

13 Presentation of Ms. LIU Ping PBC Beijing Head Office, April 19, 2010.
14 This section draws heavily from material provided by Sun Tianqi, PBC.

Institutional Policies

As noted previously, China has embarked on efforts to support the rural sector for much of the past decade. Rural credit cooperatives are one area of activity. The central banks lend directly to rural credit cooperatives. From 1999 through 2007, the PBC allocated central bank lending in support of agriculture of 128.8 billion yuan ($19.5 billion) which revolved to the accumulated amount of 1.2 trillion yuan ($182 billion). As of September 2010, the outstanding central-bank lending to the Rural Credit Cooperatives (RCC) was 69.1 billion yuan ($10.5 billion). Thanks to central bank lending, RCC's agricultural loans, especially the loans to farmers, grew rapidly, averaging an annual growth rate of 22 and 25 percent, respectively. This rate was 8 and 12 percentage points higher than the growth of loans made by financial institutions in China overall.

The efforts include granting a favorable reserve requirement ratio to the RCCs to help channel more funds to the agricultural sector. At present, the ratio for RCC is 10 percent, 6 percentage points lower than large commercial banks. In particular, RCCs with fewer assets and a high proportion of agriculture-supporting loans enjoy a ratio that is 7 percentage points lower than large banks. It is estimated that the favorable reserve requirement ratio has allowed RCC to maintain 461 billion yuan ($70 billion) worth of funds. A similar policy regarding reserve ratios applies to village and township banks. RCCs also are supported by establishment of a nationwide clearing center for RCCs, which helps them gain access to the Large Value Payment System (LVPS) and local clearing system in a timely manner.

The Agricultural Bank of China is another lever to spur rural access to credit. People's Bank has guided the Agricultural Bank in setting up a special "agriculture-countryside-farmers" department to improve availability of financial services across these three dimensions. Not content to reform existing financial institutions, the People's Bank also looks to create new ones. The bank is undertaking pilot projects of new rural financial institutions, including micro-credit companies, village banks, and rural funding cooperatives to try to establish a multi-tiered rural financial service system.

As noted earlier in the comments of Susan Krause Bell, the data infrastructure is weak. Efforts have been made to advance the development of credit reference system in rural areas and promote the use of bankcards and improve the rural financial environment.

Land Reform

The Chinese are also considering rural land reform. Hernando De Soto and others have made a strong case for the importance of a good title to land.[15] Yet this is not easy in China. According to bank staff, they are working to standardize the transfer of land contracting and associated operation rights, and to reform the institutional arrangements of rural land use. A pilot project has experimented with extending credit against the collateral of rural land

15 See Hernando De Soto, *The Mystery of Capital: Why Capitalism Triumphs In the West and Fails Everywhere Else* (New York: Basic Books, 2000).

contracting and operation rights, as well as rights to use rural housing sites. In principle, this effort shares similar challenges with extending mortgage credit on Native American land in the United States, where ownership and title are also complicated.

Educating the rural population about financial concerns is an important concern, particularly as it relates to private money lenders. Co-sponsored by China Foundation for Development of Financial Education (CFDFE) and the PBC, a "Rural Financial Education" project has been advanced nationwide since 2008. The project is a nonprofit, volunteer effort designed to make basic financial and investment information and education available to the rural public and financial practitioners in rural areas. This project will be conducted for 10 years in 21 provinces in central and western China, and with a goal of reaching 80 million farmers.

A CRA-like Mandate through Incentives

In September 2010, the PBC and the Chinese Banking Regulatory Commission jointly released circular no. 262 entitled, "Issuance of Assessment Methods for Encouraging County-Level Financial Institutions to Use a Certain Proportion of New Deposits in Local Loans (Trial)." The measures recommend that county-level financial institutions should direct any new deposits towards local development. Financial institutions that meet the criteria would enjoy a one-percentage-point reduction in the reserve requirement ratio and also subsidized interest rates on refinancing loans from PBC.

Direct financial incentives from the Ministry of Finance are also available. The incentives are designed to spur financial institutions to increase agricultural loans by applying preferential taxes and fare subsidies.[16] Specifically, if the year-on-year growth rate of outstanding agricultural loans exceeds 15 percent at year's end, the financial institution receives 2 percent of the amount in excess of 15 percent. The amount would be counted as income in that year. This additional income improves its operation and development ability. If growth does not exceed 15 percent, no reward is granted. Both the central and local actors share the incentives. The pilot program was launched in 18 of 34 provinces in China. In 2009 and 2010, the Ministry of Finance has granted rewards of 860 million ($130 million) and 2.08 billion RMB yuan ($315 million) respectively, to county-level financial institutions.

CRA-like Assessment

Based on local conditions, the research department of the PBC's Xi'an branch has made up a "credit + service + macro environment assessment system" (CSE) for county-level financial institutions. Including the macro environment was an idea that emerged from the CRA workshop in Xi'an in April 2010. Under this CSE framework, if the macro environment is poor, a satisfactory rating will be given to the financial institution even if it has a low LTD ratio.

16 The program is called Pilot Operation of Rewarding County-level Financial Institutions Which Realize the Growth of Agricultural Loans since 2008.

Throughout the implementation of these policy reforms and new measures, the People's Bank will need to examine the diversified needs of financial services in rural areas and put in place risk prevention measures. According to PBC staff, the initiative will not operate in isolation, as the Chinese effort will combine both direct and indirect financing, integrate the strengths of the banking, insurance, and securities sectors and feature active participation of private capital.

Conclusion

For the author, one of the most intriguing things about this exchange, beyond the tremendous diligence of the PBC staff to research and prepare for the workshop, was its timing. The current U.S. context contains a great deal of 'China-envy' around its economic growth and infrastructure spending, the Beijing Olympics, and the performance of Chinese students in Shanghai on globally comparative exams. In a country lurching toward economic stability after the financial crisis, we still hear the flawed argument that CRA-regulated lending, rather than gaps in the regulatory system, was to blame. Yet at a time when advocates of CRA in the U.S. have had to play defense, the world's new economic superstar sees it as a model for how to keep growth both sustainable and equitable.

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