

# Thoughts on Establishing Explicit Deposit Insurance System for China's Rural Banks

<sup>1</sup>Nana Zhao

<sup>1</sup>Business School, University of Shanghai For Science and Technology, Shanghai 200093, China

Email: [zhnana2007@126.com](mailto:zhnana2007@126.com)

**Abstract**-Rural banks in China begin to rise gradually all over the country, promoting the healthy development of agriculture, farmer, rural areas and the small and micro enterprises. Due to low credibility, difficulties in absorbing deposits, lower profitability, and system defects, rural banks in China have been developing at a slow pace. To promote the healthy and steady development of China's rural banks, the bank deposit insurance system for rural banks should be established quickly to enhance its credibility, reduce risk, making rural banks serve the agriculture, farmer, rural areas and the small and micro enterprises in a high quality.

**Keywords**-Rural banks; Agriculture, farmer, rural areas; Small and micro enterprises; Explicit deposit insurance system

## 1. Foreword

The CBRC issued *some suggestions on adjusting and relaxing the admission policies of banking institutions in rural areas, supporting the construction of new socialist countryside in a higher quality* on December 20, 2006 to increase the supply of rural financial markets and promote financial diversification in rural areas. Rural banks, loan companies and rural mutual societies are allowed to be established in the rural financial markets by it which indicates China's rural Banks come into being. Rural banks are established at the target that rural banks should serve the agriculture, farmer, rural areas and the small and micro enterprises, promoting the healthy and sustainable development of China's economy.

The State Council Executive meeting was hosted by Premier Wen Jiabao On March 28, 2012, deciding to establish the Wenzhou finance integrated reform experimental zone. One of the most important tasks of Wenzhou comprehensive financial reform is to speed up the development of new types of financial organizations, encourage and support the private capital's participation

in local financial institutions reform, which promises their establishment or equity participation in new financial institutions such as village banks, loan companies, rural credit unions, transform eligible loan companies into rural Banks, which will promote the development of rural Banks undoubtedly. Due to the low credibility and small size, limited capitals, difficulties in collecting deposits and weak anti-risk capacity have always been the general problems among the rural banks in China. Establishing deposit insurance system for China's village banks is particularly essential to help village banks improve credibility and increase depositors' confidence in them.

## 2. Situation of China's rural banks and difficulties among them

The first village bank in China, Sichuan Yilonghuimin village bank was established on March 1, 2007. The CBRC planned to set up 1,027 village banks between the year 2009 and 2011. However, only 726 rural banks had been established by the end of 2011(Zhengzhi, 2012).

Many factors are responsible for the slow development of village banks in China.

According to the research on China's first foreign-owned village bank, Project group of PBC branch in Suizhou City (2009) found that higher operating costs, difficulties in profitability, weak financial strength, limited role in agriculture, unsmooth channel of payment and clearing, business development difficulties were the main problems of rural banks in China at this stage. He Yingyuan(2012) started from the four field of new-type rural financial institution's micro-foundations and designed a evaluation system measuring its vulnerability, established the evaluation model of new-type rural financial institution's vulnerability after which tested the vulnerability of 9 village banks in Hunan province. The results showed that village banks behaved the most poorly in terms of liquidity providing and asset pricing. How to improve the credibility to settle issues on collecting deposits and develop new business for different objects became the key to remove the vulnerability of village banks. Wang Qiong (2012) cited a game model and analyzed the relationships between related government departments and existing banks, existing banks and existing banks, village banks and farmers respectively. The result suggested that it is the inadequate incentives of bank regulators putting on existing banks to establish village banks, imperfect operation Principles, underdeveloped rural financial markets and low income level of farmers that led to this situation. Chen Yongfu (2012) insisted that the reasonable distribution of shares which made rural banks cannot take advantages completely, unsound regulatory policies which bring a high operating costs, inadequate depth into rural financial market, making it deviate from purpose, low social awareness which caused insufficient capital, imperfect service conditions, bringing business difficulties were to blame for the issues among village banks in China.

### **3. Significance of establishing obvious deposit insurance system for village Banks in China**

Explicit deposit insurance system means that the structure, setting and operation of deposit insurance system are provided by law. While explicit regulations for banks and other deposit-taking financial institutions to implement deposit insurance are not legal for implicit deposit insurance system. When banks collapse or bankrupt, some assistance will be provided by state to protect the interests of depositors. Liu Zhaona (2009) insisted that implicit deposit insurance system had been carried out in China. Compared with the implicit deposit insurance system, explicit deposit insurance system, explicit deposit insurance system is more significant in protecting the interests of depositors, risk reduction of village banks, decreasing the exit costs of problem banks, maintaining financial market order, etc.

#### **3.1. Safeguard for village banks to reduce risks**

#### **and develop at a sustained and healthy pace**

Once systemic risk occurs among the whole market, the rural banks will be the first to be destroyed due to the limited size of the rural Bank and weak anti-risk capacity. In addition, village Banks have been facing non-systemic risks because of its own characteristics. According to deposit insurance system, funding assistance will be provided by deposit insurance agency to banks in trouble or deposit insurance agency pay to depositors directly to help it out of the woods when banks get into bankruptcy. Furthermore, it can improve the credibility of village banks, increasing depositors' confidence in village banks. In this way, it will be more easily for rural banks to absorb deposits and improve profits.

#### **3.2. Perfecting the financial system and providing the basis for the establishment of overall deposit insurance system in China**

Nowadays, deposit insurance system has been established by more than 70 countries around the world. The deposit insurance system has played an important role in protecting the interests of depositors, enhancing the anti-risks ability of financial institutions, and maintaining financial market stability. Under the background of international financial crisis, it is essential to establish the deposit insurance system to maintain the financial order. Faced with the increasingly complex and competitive international financial environment, establishing deposit insurance system is an inevitable choice for China to maintain steady development of financial institutions. To some extent, establishing deposit insurance system for village banks in China will provide a foundation to the overall deposit insurance system.

#### **3.3. Protecting the interests of small savers and providing an effective settlement approach for village banks exiting the financial market**

Village banks is established mainly to serve the agriculture, farmer, rural areas and the small and micro enterprises, depending small savers are the main objects of village banks. When rural banks are at the risks of bankruptcy, the deposit insurance agency will provide financial assistance to protect the interests of small depositors. Once the village banks are insolvent and collapse, the deposit insurance agency will liquidate these banks, making the inefficient banks exit financial market smoothly to maintain the stability of the financial system.

### **4. Feasibility of establishing deposit insurance system in China**

Based on the experience of establishing deposit insurance system in foreign countries, Qin Zhen (2002) found that, this following qualifications, including clear ownership of economic entity, bank marketization, diversified financial institutions, legal system of economic management are needed to establish deposit insurance system. Considering the condition of village banks in China and the financial environment, it is feasible to establish deposit insurance system for rural banks.

#### **4.1. Clear property rights and market-oriented operation**

Village banks is founded to serve the agriculture, farmer, rural areas and the small and micro enterprises by domestic and foreign financial institutions, domestic non-funded financial bodies corporate, of natural persons in the territory legally as level corporate. At the same time, rural banks operate autonomously and finance independently that makes its position is determined in financial market.

#### **4.2. Sound supervision and management system of village banks**

A scientific and effective financial supervision system is essential to make sure the effective deposit insurance. Along with the deepening of China's financial reform, China has established a relatively complete system of finance supervision and management. Banking, securities, insurance are supervised and managed by China Banking Regulatory Commission, Securities Regulatory Commission, and Insurance regulatory Commission respectively. Based on the precautionary principle, CBRC explores the regulatory approach gradually that is appropriate to village banks. A comprehensive monitoring system offers village banks a solid foundation.

#### **4.3. Strengthening the construction of legal system of economic management**

China has been on reform of economy legal system to making it in line with economic development. To speed up the establishment of deposit insurance system in China, the government has paid much attention to legal system. Now, a preliminary framework of Deposit insurance system has formed, providing the legal basis for the establishment of deposit insurance system.

In addition, Gao Wei (2012) noted that even it fails to establish village banks deposit insurance system, that will bring less possibility to raise systemic risk due to its

limited scale and small impact on the whole finance system.

### **5. Structure of the village bank deposit insurance system in China**

#### **5.1. Organization and target functions**

Currently, deposit insurance organization is divided into three types. It is established by the government or the government and the banking established together. The interbank can also establish jointly under the support of government. Given to the current situation of village banks in China, the deposit insurance system should be established by banking supervision department and managed based on the administrative division. Banking supervision department can get the information at the first time, improve the effectiveness of decision-making. Besides, the banking information can be transmitted quickly between banking institutions, avoiding the supervision lag.

According to the function of deposit insurance system, it can be divided into single function deposit insurance system and comprehensive function deposit insurance system. Single function refers to a deposit insurance institution simply receiving and managing insurance. Besides the function of deposit insurance, comprehensive function deposit insurance system need to regulate and rescue insured financial institutions, clear and settling the bankrupt banks. At present, single function deposit insurance system is carried out in Japan. Single function deposit insurance system is inferior to comprehensive function deposit insurance system in maintain financial system stability. Therefore, comprehensive function deposit insurance system should be implemented in China. The deposit insurance institution should be responsible for the village Bank's credit, risk level, the implementation of the policies and regulations. In addition, once a village bank insolvency and bankrupt, the deposit insurance institution need to take it over or start on clearing and pay to depositors.

#### **5.2. Mobilization and application of insurance money**

Based on the special nature of rural banks, the government should increase policy supports to rural banks deposit insurance. Because of limited financial capacity, rural banks cannot provide comprehensive insurance money. Therefore, part of the insurance money should be supplied by government, the rest of insurance fund by village banks.

To get the preservation and appreciation of the deposit insurance money, Deposit Insurance Fund should be set up by government. According to the Fund, assets are

managed professionally. It is also an effective way to reduce risks and improve the efficiency of the deposit insurance money.

### 5.3. Insurance Approach

Deposit insurance can be divided into mandatory and voluntary, the combination of mandatory and voluntary. A bank has the right to decide to insure or not when the deposit insurance is voluntary. Countries like France, Germany, and Italy are taking voluntary insurance. Compulsory insurance refers deposit-taking financial institutions must join in the deposit insurance, which is required by law. Compulsory insurance is carried out in United Kingdom, Japan, Canada and other countries. While the combination of mandatory and voluntary insurance is practiced in United States. Compared with the implicit deposit insurance system, explicit deposit insurance system has advantages in avoiding moral hazard and adverse selection.

Taking characteristics of rural banks and the finance situation in China into consideration, the combination of mandatory and voluntary insurance is a better choice. On the one hand, rural banks have a small profit margin due to its small scale, weak ability to absorb deposits, social responsibility, etc. It is possible for village banks to expand their business and engage in high-risk activities to pursue maximize profit, ignoring the interests of depositors. On the other hand, some rural banks held by state-owned banks rely on the national credit to some extent. These banks are less likely to collapse and will not join in deposit insurance to save costs which may result in adverse selection. Compulsory insurance is beneficial to unified banking supervision and management. Banking supervision department can keep abreast of rural banks, reducing the risk of bankruptcy.

### 5.4. Insurance coverage

Residents' savings is the primary protection objective. Difficulty in financing has been an urgent issue for medium and small micro-enterprise. Deposits of small and micro-enterprises should be protected to promote the sustainable and healthy development of small and micro-enterprises. However, criteria for small and micro enterprises in China are not unified, which brings problems to deposit insurance of small and micro enterprises. Therefore, national authorities should divide business types in detail and define the small and micro enterprises. Some industrial and commercial units and individual clients should be classified into small micro enterprises.

Liu Cuicui (2010) emphasized that interbank deposits and government deposits are closely associated with banks. Once they were covered by deposit insurance, the financial market may lose its

constraint validity. Therefore, interbank deposits and government deposits should not be in the deposit insurance coverage. Meanwhile, foreign currency deposit should be excluded due to the frequent change of exchange rate that makes it difficult to determine the level of insurance.

### 5.5. Insurance amounts

Deposit insurance can be divided into full insurance and limited insurance. Full insurance may result in moral hazard in deposit-taking financial institutions, which will be detrimental to depositors. Considering characteristics of village banks and the situation of rural areas in China, insurance amount can be determined based on the level of deposit. Under a certain level of deposit, full insurance is feasible, proportional insurance for the part beyond the certain deposit amount. And insurance amount cannot outnumber the top amount. In this way, we can protect the interests of small depositors. Interests of large clients can also be maintained to some extent. Xu Feng (2006) emphasized that a clients should be required to get the insurance for only one of his accounts, preventing a client divides deposits into several accounts to get the full insurance.

### 5.6. Premium rate

Premium rate refers that Insurance rate is charged based on the deposits of the insured bank. The charging of premium increases the operating costs of village Banks, coupled with the small size, difficulties in gathering deposits, weak profitability, serving agriculture, farmer, rural areas and the small and micro enterprises. Too high premium rate may overload village Banks, making profitability weakens further. Therefore, the premium rate should not be too high. At the same time, differentiate premium rates between small and micro-enterprises and residents' savings deposits, lower premium rate for residents' savings deposits to protect the interests of residents. In addition, adopt dynamic management of deposit insurance rates, adjusting the premium rate correspondingly according to the different clients and the changing economic environment.

## 6. Conclusions

It is necessary and feasible to establish village banks deposit insurance system in China. Deposit insurance system has big significance on maintaining stability of rural banks. If not designed properly, it will bring the opposite effect. Therefore, the insurance approach, coverage, amount must be determined based on the characteristics of rural banks and the specific financial environment in China to promote the development of village banks. After establishing village banks deposit insurance system, village banks can serve the agriculture, farmer, rural

areas and the small and micro enterprises in a higher quality, making the economy of China develops in a sustainable way.

## References

- [1] Zhengzhi, Village banks establishment slowing, opening to private capital further, 21st Century Business Herald, 2012-2-21(009).
- [2] Project group of PBC branch in Suizhou City, Village banks operating difficulties and sustainable development—Research on China's first foreign-funded rural bank, Wuhan Finance, 2009:48-49.
- [3] He Yingyuan, He Zheng, Vulnerability testing survey of new rural financial institutions based on the functional perspective, Journal of Central South University (Social Sciences Edition), 2012, 18(1): 121-125.
- [4] Wang Qiong, Analysis of difficulties of village banks establishing on a large scale, Cooperation in Economy and Science and Technology, 2012(435): 70-72.
- [5] Chen Yongfu, Thinking on problems existing in rural Banks, Financial Times, 2012-3-15(012).
- [6] Liu Zhaona, Research on Chinese construction of explicit deposit insurance system, Nanjing Agricultural University, 2009(12): 15-18.
- [7] Qin Zhen, The study on establishing of deposit insurance system in China. Jiangxi University of Finance and Economics, 2002(04): 20-23.
- [8] Gao Wei, Establishing the deposit insurance system in the pilot, Shanghai Securities News, 2012-3-23(0A1).
- [9] Liu Cuicui, Establishment of deposit insurance system in China, Northwest University, 2010(06): 27-31.
- [10] Xu Feng, Study on the establishment of deposit insurance system in China through international comparison, Capital University of Economics and Business, 2006(03): 33-35.

## Vitae

Zhao Nana born in 1989 in JiNing, China, is learning at University of Shanghai For Science and Technology as a graduate. She majors in finance.

Dr. Xu Xuejun, was born in 1968 in LuoYang, China. He works as a master instructor and vice director of MBA Education Center at University of Shanghai For Science and Technology. His research interest includes financial management, strategic planning and operation management.