Financing Constraints, Policy Guarantee and Rural Homestead Mortgage Transfer

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Abstract

This paper has a good analysis of the request for the rural modernization development and the current contradiction between supply and demand for rural finance, thereby to point out the necessity of the homestead mortgage transfer. Then, as far as the risk the stakeholder faces in the process of transfer is concerned, it is envisioned in this paper that the government is interposed to improve such transfer process by establishing the operation mechanism for mortgage transfer with the involvement of government, thus to contribute the most to alleviate financing dilemma in the peasant households and develop the agricultural modernization.

Keywords: Rural Homestead, Mortgage Transfer, Complete Information Dynamic Game, Pareto Efficiency.

1. INTRODUCTION

In recent years, China has made great efforts to support the agricultural development. Today, China has witnessed a constant improvement in the agricultural modernization, which attributes to government's increasingly aggressive efforts. But beyond that, this also indirectly contributes to an ever-increasing demand of farmers for financing, while a string of issues such as shortage of farmers' effective collateral, mismatch between supply and demand in rural finance. For the rural households, these will be greatly alleviated if homesteads, as the most valuable assets in their hands, can act as collaterals, in other words, the policy that the households get loans against homestead mortgage is obviously conducive to the removal of financing constraints. In the current laws, however, there are some stipulations and restrictions on the transfer of the right to the use of homesteads in rural areas. For the government, therefore, how to actively involve in it matters it greatly. Eventually, the homestead transfer will achieve the Pareto improvement (Cheng and Wang, 2015) in a certain sense, and the increase of farmers’ income and the development of rural economy reaches a win-win situation.

2. CHALLENGES IN THE HOMESTEAD MORTGAGE TRANSFER

Homestead is a featured concept of China's rural land system. Its right to the use is freely assigned to the peasant households by the collective as a kind of social security benefit granted by the country for the purpose of guaranteeing peasant's survival. At this stage, China's rural medical care, pension, living security systems have not yet been improved, once the homestead mortgage transfer policy is developed, the original hidden problems will emerge one by one, and many stakeholders will suffer more from these.

2.1 Impact on peasants

For peasants, they may face the danger of losing their lands, houses and occupations, and exile into the "landless, unemployed and low-insured" "marginal men" between urban and rural areas (Yuan et al., 2015). They will also suffer from a loss of family income at a peril of homelessness and even social marginalization.

2.2 Impact on government

For the government, the homestead mortgage transfer will lead to a series of policies and legal risks. As far as the policy risk is concerned, "the market economy theory says that the ownership is the precondition of commodity exchange and mortgage guarantee. The contractual lands and homesteads should belong to the mortgage of ownership"(Liang, 2014). In the case when the ownership of homestead is assigned to the collective, peasants can
only mortgage it to the rural financial institutions by virtue of their right to the use of it, which, in fact, implies that the collective land is taken as collateral to exchange the development funds for individuals. For this reason, the rural monetary institutions are generally reluctant to offer farmers with mortgage loans whose risk can only be assumed by the government; in the case of legal risks, the pilot projects on the homestead mortgage transfer are developing in various districts in China at this stage, which obviously violates China's "Guarantee Law". To a certain extent, the violation of the current law in our country attributes to the conflict against its articles.

2.3. Impact on banks

(1) The collateral is hardly registered. Once a farmer is unaffordable to repay a loan in due time, the bank cannot cover the deficit by mortgage realization. The bank's NPL ratio will hike up to make the bank plunge into liquidity risk.

(2) The sharp devaluation of collateral transfers risk to the bank during the life of mortgage. Agricultural production is always susceptible to natural and anthropogenic factors, which has resulted in a very unstable income for farmers, thus directly determining the length of the repayment period. Consequently, banks are exposed to great credit risk.

(3) Currently, most of the laws and regulations on the circulation of rural homesteads in our country are exercised strictly and prudently. Once some issues such as transfer and auction of bank collateral occur, it cannot be freely transferred due to restriction of relevant laws.

Government involvement helps the bank profit the most because the bank faces a dilemma when government interposes. On the one hand, starting from the "three principles" and the business target of commercial banks, farmers are not the target audiences for whom they issue the loans; On the other hand, under the central government's policy, banks have to make a concession to offer rural households with loans, which directly causes a low cost-benefit for banks. After the government makes intervention, the government set up a policy guarantee company which tenders guarantee for the farmers. When the farmer operates the trade successively, the bank not only can take the repayment but also earn the interest from it. While the farmer bankrupts and is insolvent to repay the bank, then the policy guarantee institutions that government has established will disburse it instead. It could be said that it is an optimal decision for banks to offer loans provided that the government makes guarantees.

3. FEASIBILITY ANALYSIS OF GOVERNMENT'S POLICY GUARANTEE

The fundamental purpose of the homestead mortgage transfer is to eliminate farmers' financing constraints. Whether the banks and other financial institutions can offer loans voluntarily is the key to solve this problem. Government policy guarantees can be introduced to well urge banks to offer loans. The above conclusion can be demonstrated by the game theory. First, the two sides of the game are farmers and rural financial institutions; secondly, the following assumptions should be made:

Hypothesis 1: Both rural households and financial institutions are the rational subjects in a perfectly competitive market. As a complete information dynamic game between both, the rural financial institutions should act as pioneer to decide whether or not the loan is issued. If they refuse to issue it, then the returns of both sides are all zero.

Hypothesis 2: Farmer B takes out a loan from the rural financial institution A at an annual interest rate of r, within a term of t, and on a principal P (after t years it will be calculated by simple interest). Farmers receive loan funds and employ them for investment management, assume that the profit they get is R, and R > P (1 + r) × t.

The government-guaranteed homestead mortgage allows the rural financial institutions to get compensation from the government when the rural household becomes insolvent at maturity, thus mitigating the liquidity risk in rural financial institutions. It is now supposed that the government has sufficient funds for compensation, and that A takes N to get repayment amount from the government (borne by farmers). If B cannot repay it in due time, A benefits $P \times r \times t$ from mortgage realization, B gets profit R-N; if A chooses not to realize the security, the proceeds earned is -P, while B profits R. Game analysis is shown as below:
When the game goes to the third stage, A, from a rational economic perspective, must choose the optimal strategy - guarantee realization, so as to profit $P \times r \times t$. However, we can learn from the inverse induction that the choice of A in the third stage determines that B will choose the optimal strategy in the second stage of the game - repayments of the loans and thus get the yield R. Similarly, the choice of game B in the second stage determines that A will choose the optimal strategy in the first stage - issuing loans and thus profit $P \times r \times t$. “After the government guarantee is considered, the end result of the game is that, A chooses to issue loans, B chooses to repay loans, and A chooses to realize the collateral. It is obvious that after the guarantee restriction is additive, B will repay the loans on schedule. The economic combination of optimal strategies is reached” (Zhang, 2009). As a result, the security guarantee the government offers for the households can not only reduces the financial risks of banks and improves the loan issuance rate of banks and other financial institutions, but also provide financing channels for farmers, so as to achieve a win-win situation.

4. OPERATION MECHANISM OF HOMESTEAD MORTGAGE TRANSFER UNDER THE POLICY GUARANTEE

Today, the rural land management in China is extremely decentralized with complex and changeable property relations and restricted equity transactions, which leads to such fact that the development of rural land property mortgage loans in China cannot be achieved simply by market mechanism. Therefore, in order to make sure the rural land not only continues to provide a social security, but also play a financing function as an effective collateral. In doing so, it is necessary for us to introduce a policy leading mechanism. Specifically speaking, this mechanism means that the government interposes to set up a policy guarantee company which tenders the guarantee for households and gives credit enhancement to help them get loans from the financial institutions, provided that the peasant households mortgage the homestead right of use to the guarantee company. In addition, it is worth noting that farmers should not mortgage it without the consent of the rural collective organizations. In the event of a credit default, the government will first repay the loan instead to allow the bank shied away credit risk. Afterwards, the government can obtain advanced payment loans from rural collective organizations in return of the homesteads, avoiding the transfer of homesteads outside the rural collectives and mitigating the risk of farmers’ land loss. The capitals of rural collective organizations mainly come from some peasant households who have an intention for homestead mortgage and jointly contribute capitals voluntarily to set up the risk funds. The specific operation process is shown below:

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**Figure 1.** Benefit game between rural household and financial institution under policy guarantee (Guan and Huang, 2013)
As shown in Figure 2, the above transfer process is composed of four parts:

1. The policy guarantee companies established by the state provide guarantee to farmers with insufficient credit standing under the support of the government in order to reduce the credit risk caused by the asymmetric information to banks and other financial institutions so as to lead the bank’s capital investment.

2. The financial institutions such as banks offer loans to peasant households on the premise of government guarantee to alleviate the capital imbalance between supply and demand in rural areas.

3. The peasant households have pledged the homestead right of the use to the policy guarantee company which can offer guarantee for them. After the peasants have achieved the credit enhancement, they get loans from the banks.

4. Before the mortgage guarantee occurs, the rural collective organizations raise the capitals from farmers to set up the risk funds. In the case of breach of contract, the rural collective organizations pay back the government’s advanced payment funds by using the risk funds in return that the homesteads are collected into collectives to avoid their transfer to outside of rural collectives, thus reducing the risk of farmers’ land loss.

Once this guidance mechanism gets a trouble-free operation, farmers, banks and the government all reap benefit from it. For farmers, the introduction of government policy guarantee mechanism makes it possible to mortgage the homestead for financing, in order to solve the financing difficulties and other issues, and better develop modernized agriculture, improve peasants’ living standards; for banks, the government provides guarantee for the farmers, which not only improves the credit standing of farmers, but also reduces the possibility of bank risk, i.e., liquidity risk, credit risk, etc.; for the government, the inclusive finance, agriculture modernization have always been the focuses, the introduction of a mechanism not only increases the channels for financing of rural households, but also expands the coverage of rural financial services to a certain extent.

5. POLICY SUGGESTIONS

5.1 Improve the homestead mortgage valuation system

To ensure the smooth implementation of the operation mechanism for the homestead mortgage transfers under policy guarantees, most of all we should address the value assessment of homesteads. First, refer to the standard land price system of urban land use rights to establish the value evaluation mechanism of rural land property. Second, accelerate the construction of land market transaction price system to realize the market-oriented mechanism of homestead mortgage value and market price. Finally, build up physical market for auctioning and transferring collaterals in order to achieve transfer realization, thus to reduce the financial risks.
5.2 Set up a corresponding risk compensation funds, maintain the persistence of policy guarantees

The reason why banks and other financial institutions take the lead to provide financial services is that, on the one hand, there are some inherent defects in rural property rights in our country; on the other hand, in relation to other industries, banks face a higher risk of agricultural production than the proceeds, so that such financial markets should develop far more policies than other markets with which requires government to intervene. For the sake of risk dispersion, the government can charge certain premium against guarantee offered for the farmers to set up a risk compensation funds. In the case that the farmer is solvent to repay the mortgage loan, the government can give the financial institutions a proper compensation through the risk funds to share risks with banks and peasants, further facilitating the sustainability of the policy guarantee.

5.3 Have a universal education on farmers with homestead mortgage relevant knowledge, mobilize their enthusiasm for involvement.

Today, the farmer households lack of reasonable cognition about the mortgaged homestead transfer. Although the government involvement has aroused the enthusiasm of the farmers for mortgage loans to a certain extent, they dare not to try it. On the one hand, it is certain that the peasant households concern their own employment and high risk of homestead loans when they decide whether the homesteads are taken as collaterals; on the other hand, the financial institutions consider their own business objectives, and always have doubts about the value of homestead mortgages, while the stance in lending is not clear. Therefore, in order to ensure a smooth implementation of homestead mortgage, the government must give the farmers a tranquilizer to explain them the benefits and the losses involved in the process of farmers' homestead mortgage in detail, so as to relive their unnecessary concerns, encourage them to choose homestead mortgage to access financing without prejudice of the their basic living standards.

5.4 Establish urban and rural integrated social security system, weaken the social security function of land

Currently, the maximum subsistence guarantee of peasants is still dependent on lands. However, when their homesteads undergo mortgage transfer, peasants are bound to face the risk of losing their lands. Once peasants lose homesteads, "they are no longer peasants in a pure sense on the one hand, and on the other hand, they cannot be accepted by the city. Then they become marginal groups in the city without minimum living guarantee as urban residents have." (Gao and Li, 2009) Therefore, in order to ensure the smooth implementation of the homestead mortgage transfer, it is imperative to improve the various types of social security schemes that cover medical treatment, endowment insurance, and minimum living standards. Only in this way can we alleviate the worries of farmers about homestead mortgage and reduce their dependence on lands.

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