



# Report and Recommendation of the President to the Board of Directors

---

Project Number: 47046-002  
October 2015

## Proposed Loan People's Republic of China: Gansu Featured Agriculture and Financial Services System Development Project

Distribution of this document is restricted until it has been approved by the Board of Directors. Following such approval, ADB will disclose the document to the public in accordance with ADB's Public Communications Policy 2011.

Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 30 September 2015)

Currency unit	–	yuan (CNY)
CNY1.00	=	\$0.1572
\$1.00	=	CNY6.3620

## ABBREVIATIONS

ADB	–	Asian Development Bank
ASMEs	–	agricultural small and medium-sized enterprises
BAAH	–	Bureau of Agriculture and Animal Husbandry
EIRR	–	economic internal rate of return
ESMS	–	environmental and social management system
GPG	–	Gansu Provincial Government
PAM	–	project administration manual
PMO	–	project management office
PRC	–	People's Republic of China
RFSP	–	rural financial service provider

## GLOSSARY

Featured agriculture	–	All possible agricultural products that are geographically adapted to the project area and that have potential for high market value, including various types of cash and tree crops and livestock products.
Production base	–	A large-scale farming area devoted to a certain type of crop or livestock, often applying uniform technology and practice.

## NOTE

In this report, “\$” refers to US dollars

<b>Vice-President</b>	S. Groff, Operations Group 2
<b>Director General</b>	A. Konishi, East Asia Department (EARD)
<b>Director</b>	Q. Zhang, Environment, Natural Resources and Agriculture Division, EARD
<b>Team leader</b>	Y. Jiang, Senior Economist, Economic Research and Regional Cooperation Department
<b>Deputy team leader</b>	F. Wang, Senior Project Officer (Financial Management), EARD
<b>Team members</b>	E. Arcillas, Senior Operations Assistant, EARD M. Bezuijen, Environment Specialist, EARD C. Carreon, Project Officer, EARD F. Connell, Principal Counsel, Office of the General Counsel S. M. Lee, Financial Sector Specialist, EARD M. Vorpahl, Senior Social Development Specialist, EARD
<b>Peer reviewers</b>	M. Katagami, Senior Natural Resources and Agriculture Specialist, Sustainable Development and Climate Change Department M. Ozaki, Financial Sector Specialist (Rural and Microfinance), South Asia Department

In preparing any country program or strategy, financing any project, or by making any designation of or reference to a particular territory or geographic area in this document, the Asian Development Bank does not intend to make any judgments as to the legal or other status of any territory or area.

## CONTENTS

	Page
PROJECT AT A GLANCE	
I. THE PROPOSAL	1
II. THE PROJECT	1
A. Rationale	1
B. Impact and Outcome	3
C. Outputs	3
D. Investment and Financing Plans	5
E. Implementation Arrangements	7
III. DUE DILIGENCE	8
A. Technical	8
B. Economic and Financial	8
C. Governance	8
D. Poverty and Social	9
E. Safeguards	9
F. Risks and Mitigating Measures	10
IV. ASSURANCES	10
V. RECOMMENDATION	10
APPENDIXES	
1. Design and Monitoring Framework	11
2. List of Linked Documents	14

## PROJECT AT A GLANCE

1. Basic Data		Project Number: 47046-002	
Project Name	Gansu Featured Agriculture and Financial Services System Development Project	Department /Division	EARD/EAER
Country Borrower	China, People's Republic of China, People's Republic of	Executing Agency	Gansu Provincial Government
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Agriculture, natural resources and rural development Finance	Agricultural production		56.82
	Agro-industry, marketing, and trade		33.87
	Inclusive finance		9.31
	Total		100.00
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project	Medium
Environmentally sustainable growth (ESG)	Natural resources conservation		
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Client relations, network, and partnership development to partnership driver of change	Effective gender mainstreaming (EGM)	✓
Knowledge solutions (KNS)	Institutional development		
Partnerships (PAR)	Pilot-testing innovation and learning		
Private sector development (PSD)	Commercial cofinancing		
	Private Sector		
	Promotion of private sector investment		
5. Poverty Targeting		Location Impact	
Project directly targets poverty	No	Rural	High
6. Risk Categorization:	Complex		
7. Safeguard Categorization	Environment: FI Involuntary Resettlement: FI-C Indigenous Peoples: FI		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		100.00	
Sovereign Project loan: Ordinary capital resources		100.00	
Cofinancing		0.00	
None		0.00	
Counterpart		100.00	
Others		100.00	
Total		200.00	
9. Effective Development Cooperation			
Use of country procurement systems		No	
Use of country public financial management systems		Yes	

## **I. THE PROPOSAL**

1. I submit for your approval the following report and recommendation on a proposed loan to the People's Republic of China (PRC) for the Gansu Featured Agriculture and Financial Services System Development Project.<sup>1</sup>

2. The proposed project aims to support the production and access to market of featured agricultural products in the southeastern Gansu Province. The project will also help develop the rural financial service system, which plays a key role in agricultural development. The project proposes to adopt the financial intermediation loan (FIL) modality, which through establishing partnerships with local commercial banks, can promote the development of the agriculture and rural finance sectors in a market-oriented approach. The project is expected to help increase the income of farmer households as well as other rural residents in the project area.<sup>2</sup>

## **II. THE PROJECT**

### **A. Rationale**

3. While the PRC has achieved remarkable economic growth since the late 1970s, rural development remains an important challenge. Rural poverty is more pervasive and persistent in the western and inland provinces than the more advanced coastal regions. Some key policy challenges include how to (i) restructure and modernize the agriculture sector toward sustainable and faster productivity growth, (ii) diversify agriculture production and create modern agricultural value chains that allow for the professionalization of farmers and support rural income growth, (iii) reform rural institutions and improve the financial institutions serving the rural sector, and (iv) protect land and water resources for food security and environmental sustainability.

4. The project area covers 11 counties in the southeastern Gansu, which have enormous demand and potential for modern agricultural development. The project area is located in one of 14 areas of national focus for poverty reduction designated in the Outline for Development-Oriented Poverty Reduction for China's Rural Areas, 2011–2020. Most people in the project area depend on agriculture and livestock, and are poor and vulnerable. The average rural per capita net income in 2013 was CNY4,122—81% of the provincial average and 46% of the national average. All the farms are very small, averaging about 2.5 *mu* per capita or 0.17 hectare.<sup>3</sup> About 51% of household income in the project area is from farming and livestock, and rural unemployment and underemployment are significant. Grain crop production, which accounts for about 59% of the total sown area and 33% of household income, is mainly based on small-scale and fragmented household operations with limited productive assets at the household level. Grain crop production usually only generates marginal profit, if any, since input costs have increased more than grain prices.<sup>4</sup>

5. Alternatives to grain crops include a number of cash and tree crops that are suitable in the arid and semiarid climatic and soil conditions of the project area. These include various types of vegetables such as potatoes, edible lilies, eggplants, peppers, tomatoes, and celery;

---

<sup>1</sup> The design and monitoring framework is in Appendix 1.

<sup>2</sup> The Asian Development Bank (ADB) provided project preparatory technical assistance for Preparing the Gansu Featured Agriculture and Financial Services System Development Project (TA 8417-PRC).

<sup>3</sup> A *mu* is a Chinese unit of measurement (1 *mu* = 666.67 square meters).

<sup>4</sup> Data in this section come from government statistic data provided by the provincial project management office (PMO) unless otherwise indicated.

medicinal plants such as angelica and Asia bell; and tree crops such as apples and pears. These cash crops, often referred to as featured agriculture, have potential for higher market value if produced efficiently on scale and with improved quality. The government has tried to promote restructuring of the sector by increasing the proportion of featured agriculture activities, mainly through financial and technical assistance to farmers and farmer cooperatives to develop large-scale production bases for these crops. The production base approach is also desirable to promote the application of environment-friendly measures such as climate-smart agriculture practices and water efficiency techniques. However, progress has been slow because of the limited financial and technical resources available to the government and farmers.

6. Livestock production, such as sheep, dairy cow, cattle, and pig rearing, is also part of the featured agriculture and has been another main source of income for farmer households in the project area, contributing 17.6% to total household income. However, livestock and associated income growth is severely constrained by the limited scale of production and traditional technologies applied. Establishing specialized livestock farms with up-to-date technologies has become a priority for livestock development. The Gansu Provincial 12th Five-Year Plan for Animal Husbandry particularly encourages the establishment of production bases for standardized livestock farming to enhance productivity and quality of livestock sector.

7. Farmers also need to access broad markets and understand consumer demands to diversify into higher-value crops and livestock. The challenges of smallholder farmers in this regard are characterized by the small quantity and moderate or poor quality of products brought to the market. As a result, 70%–80% of vegetables produced in Gansu Province are marketed through local brokers, who go from village to village to collect the products after they have obtained contracts from the big buyers. Low levels of organization and weak marketing capacity of individual farmers give brokers strong bargaining power. Brokers thus earn a big share of profits in the supply chain when dealing with farmers at the farm gate. Although farmer cooperatives and agricultural small and medium-sized enterprises (ASMEs) have played an increasing role in linking farmers to markets, they are still at an early stage of development in the project area.<sup>5</sup> They are generally small in scale, having limited capacity to develop a value chain or to service their members, have weak governance, and face difficulties obtaining credit. External assistance is needed for them to (i) expand operations with diversified business models; (ii) enhance capacity for grading, processing, packing, storing, and marketing; and (iii) strengthen governance and management. This would also make them more bankable.

8. Strong rural financial markets and institutions with sizable outreach is another key factor to develop featured agriculture. Although 67 traditional financial institutions or branches, mainly rural credit cooperatives and commercial banks, are present in the project counties, they fail to meet the demand, especially that of smallholder farmers and ASMEs, because both their priorities and expertise focus on industrial and commercial lending.<sup>6</sup> Following recent policies for rural financial market development, rural financial service providers (RFSPs) have emerged. These include some 53 microcredit companies, six village and township banks, and 384 rural mutual cooperatives that were in the project counties by 2014. The RFSPs are generally smaller, better appreciating the potential of agricultural projects, and more accustomed to dealing with small customers. As a result, relatively small loans to agriculture have increased. However, the RFSPs are still at an early stage of development and are either prohibited by law or constrained

---

<sup>5</sup> Agricultural small and medium-sized enterprises are those with annual sales revenue below or equal to CNY200 million, which follows the PRC's national standard issued in 2011.

<sup>6</sup> Data source: China Banking Regulatory Commission.

by their short history to take deposits from the public. In addition, they are also short on capable staff and physical and technical capacity to provide more services for rural customers.

9. Previous experience of the Asian Development Bank (ADB) and other development partners in the sector in the PRC indicates that the government is generally constrained by its capacity and often assumes large credit risks acting as direct lender to agricultural borrowers. To address the issue, the project, whose target subborrowers are all from the private sector with demand for small and short-term (1–3 years) credit, proposes to adopt the financial intermediation loan modality. Active rural financial market reform since the 1990s has led to the rise of many local commercial banks in the PRC. Some of them have properly aligned interest and capacity in agricultural finance as well as sound governance and incentive systems, and thus can serve as good financial intermediaries to onlend to farmers, cooperatives, ASMEs, and RFSPs. Through partnerships with local commercial banks and careful implementation, the project could (i) eliminate government exposure to agricultural borrowers by onlending through financial intermediaries that are better positioned to assess and assume sub-borrower credit risk, (ii) use loan resources more efficiently by revolving loan proceeds, and (iii) mobilize additional funding resources from financial intermediaries to support agriculture.

10. The project will assist the project counties in (i) developing market-oriented production of locally featured cash crops, tree crops, and livestock products; (ii) improving market linkages for featured agricultural products by supporting profitable and promising farmer cooperatives and ASMEs; and (iii) enhancing rural financial services with increased funding, service capacity, and technical skills. The project is fully aligned with the government's agricultural development strategies and policies in the western regions, which encourage farmers to organize themselves for specialized production and call for transforming fragmented production to economic scale market-oriented production through land transfer, growth of farmer cooperatives and agro-enterprises, and enhanced rural financial services. The project is also in line with the upcoming ADB country partnership strategy for the PRC, 2016–2020, which identifies inclusive growth as one of its three pillars, supported by boosting rural livelihoods and improving access to finance, and with ADB's strategic priorities of the Midterm Review of Strategy 2020.<sup>7</sup>

## **B. Impact and Outcome**

11. The impact will be increased income of rural residents in Gansu Province, which is in line with the upcoming 13th Five Year Plan of Gansu Province, 2016–2020. The outcome will be more productive, market-oriented agricultural activities in 11 project counties.

## **C. Outputs**

12. **Output 1: Inclusive and environment-friendly featured agricultural production bases developed.** This output aims to address low agricultural productivity and value addition caused by fragmented production by (i) developing commercial production bases to gain economy of scale, and (ii) improving the quality of products for locally featured cash and tree crops and livestock. The production bases will be developed by farmers, farmer cooperatives, or ASMEs in various models, which will organize or engage individual farmers into more efficient and market-oriented production activities. Capacity development will be also conducted for farmers, technicians, and other stakeholders in developing the production bases.

---

<sup>7</sup> ADB. 2014. *Midterm Review of Strategy 2020: Meeting the Challenges of a Transforming Asia and Pacific*. Manila.

13. **Output 2: Farmer cooperatives and agricultural enterprises financed and strengthened.** This output will improve the value chain for locally featured agricultural products with good market potential to link farmers to profitable markets. The project will support farmer cooperatives and ASMEs in (i) business development or expansion through the acquisition of packing, grading, and processing equipment; transportation, technical equipment; and building storage; (ii) market development, including information access, sales promotion, and building marketing networks; (iii) branding, including certification and trademark registration for featured products; and (iv) capacity development for the managers and key staff of cooperatives and ASMEs on business and financial management, storing and processing techniques, branding and market development, and establishing and implementing governance rules and regulations.

14. **Output 3: Rural financial service system developed and enhanced.** This output aims to promote the financial viability, coverage, and sustainability of the rural financial service system. The project will (i) onlend part of the loan proceeds to RFSPs to expand their funding resources. The RFSPs will use the loan proceeds to lend to farmers, farmer cooperatives, and ASMEs following agreed eligibility criteria of sub-borrowers; (ii) establish grassroots financial service units such as village offices to extend rural financial service coverage; (iii) develop or pilot test innovative financial services and products, such as credit rating, bank–insurance cooperation, and lending with new types of collateral; and (iv) provide capacity development for loan officers and rural financial professionals to improve their lending skills to serve rural customers.

15. **Output 4: Capacity for project implementation and management strengthened.** To ensure the successful implementation of the project, the following activities will be supported under this output: (i) strengthening the management capacity of staff at provincial and county project management offices (PMOs); (ii) acquiring office equipment to enhance the physical capacity of provincial and county PMOs; (iii) holding project management workshops; (iv) project monitoring and evaluation, including guiding and supporting the implementation of the environmental and social management systems (ESMSs); (v) knowledge management; and (vi) ensuring financial capacity for daily operations of provincial and county PMOs.

16. **Special features.** The project design embodies the following innovative features:

- (i) **Promoting agricultural development with a systematic and market-oriented approach.** The project attempts to address challenges of agricultural development and rural income growth by improving productivity, market connectivity, and access to finance. Besides engaging farmers in more productive agricultural activities via production base development, the project will strengthen linkages between farmer producers and markets through cooperatives and ASMEs, and promote continuous financial support to agriculture and rural residents in the long term. Moreover, with partnership between the government and financial intermediaries, loan resources could be allocated in a more market-oriented manner to support sustainable agricultural projects. The government, through its extensive agricultural administrative and technical systems, could help identify and develop subprojects with significant market potential and apply environmentally sound practices. The financial intermediaries' screening, monitoring, and management of subloans will help ensure the subprojects are financially viable and sustainable.
- (ii) **Supporting a dynamic and competitive rural financial market.** A dynamic and competitive rural financial market is important to meet growing demand for rural financial services, in which RFSPs could play a significant role. Under the existing policy framework, commercial banks, especially those large- or medium-



sized, could lend to RFSPs to increase their capital capacity and support RFSPs through knowledge sharing. This market link is currently missing. The project will help build such linkages, as financial intermediaries will onlend the loan proceeds to RFSPs together with their own resources and provide training to RFSP staff. This will be on a pilot scale, but could generate a large demonstration effect.

- (iii) **Partnership with local banks.** Three local commercial banks—the Bank of Lanzhou, the Bank of Gansu, and the Yuzhong Shanghai Pudong Development Rural Bank—are identified as project financial intermediaries. As small to medium-sized banks, they share the project's goals of promoting local agriculture and rural finance development in the project area. The financial intermediaries will onlend the majority of loan proceeds to targeted sub-borrowers for agricultural production base development under output 1 and business development or expansion under output 2, and onlend to RFSPs under output 3. They will also contribute about \$68.58 million as counterpart funds to be onlent to the targeted sub-borrowers of the project, applying the same requirements and eligibility, and to strengthen rural financial services in the project area.

## D. Investment and Financing Plans

17. The project is estimated to cost \$200 million (Table 1) based on the projected first batch of subprojects.<sup>8</sup>

**Table 1: Project Investment Plan – First Batch of Subprojects**  
(\$ million)

Item	Amount <sup>a</sup>
<b>A. Base Cost<sup>b</sup></b>	
1. Inclusive and environment-friendly featured agricultural production bases developed	72.77
2. Farmer cooperatives and agricultural enterprises financed and strengthened	72.19
3. Rural financial service system developed and enhanced	27.88
4. Capacity for project implementation and management strengthened	5.88
<b>Subtotal (A)</b>	<b>178.72</b>
<b>B. Contingencies<sup>c</sup></b>	<b>13.61</b>
<b>C. Financial Charges During Implementation<sup>d</sup></b>	<b>7.67</b>
<b>Total Project Cost (A+B+C)</b>	<b>200.00</b>

<sup>a</sup> Includes taxes and duties of \$9.77 million, to be financed by the beneficiaries, government, and Asian Development Bank (ADB) loan resources. The following principles were followed to determine the amount of taxes and duties to be financed by ADB: (i) the amount is within reasonable country thresholds, (ii) the amount does not represent an excessive share of the project investment plan, (iii) taxes and duties apply only to ADB-financed expenditures, and (iv) financing of taxes and duties is material and relevant to the success of the project.

<sup>b</sup> In December 2014 prices.

<sup>c</sup> Physical contingencies are computed at 5% for works and goods. Price contingencies are computed using domestic inflation rates: 3.0% for 2015 onward; and foreign inflation rates: 1.0% for 2015 and 1.4% for 2016 onward.

<sup>d</sup> Includes interest and a commitment charge to be capitalized under the ADB loan. Interest during construction for the ADB loan has been computed at the 5-year US dollar fixed swap rate plus a spread of 0.50% and a maturity premium of 0%. Commitment charge is 0.15% per year to be charged on the undisbursed loan amount.

Source: ADB estimates.

<sup>8</sup> The first batch refers to subprojects financed by loan proceeds initially disbursed by ADB and financial intermediaries' own funds during the loan implementation period. The first batch of subprojects under outputs 1 and 2 will be selected from a long list of subprojects proposed and updated by the government. Appendix 1 of the Project Administration Manual (PAM) [accessible from the list of linked documents in Appendix 2] describes the selection and approval procedures for these subprojects. Financial intermediaries will revolve the ADB loan proceeds to make them available for the subsequent subprojects. For these subprojects, as well as loans made by the financial intermediaries to RFSPs and by RFSPs to sub-borrowers under output 3, financial intermediaries and RFSPs will adopt the eligibility criteria in screening the sub-borrowers, which are described in Appendix 2 of PAM.

18. The government has requested a loan of \$100 million from ADB's ordinary capital resources to help finance the project. The loan will have a 15-year term, including a grace period of 9 years, a straight-line repayment option, an annual interest rate determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, a commitment charge of 0.15% per year, and such other terms and conditions set forth in the draft loan and project agreements. The longer grace period is essential to make the full loan principal available to maximize project benefits. Based on this, the average loan maturity is 12.25 years and the maturity premium payable to ADB is zero per annum. The ADB loan will also finance taxes and duties for eligible ADB-financed expenditures, and transportation and insurance costs included in the base cost to ensure smooth project implementation. Interest during construction and commitment charges will be capitalized. The loan will finance 50% of the project cost.

19. The financial intermediaries need to contribute an equivalent of \$68.58 million, or 34.3% of the project cost, from their own resources to the project. The counterpart funds from the financial intermediaries will (i) finance a subset of subprojects for the first batch under outputs 1 and 2;<sup>9</sup> (ii) be onlent to RFSPs together with ADB funds; and (iii) expand rural finance service units, develop innovative financial services, and strengthen the capacity of rural loan officers of financial intermediaries and RFSPs. Subproject beneficiaries under outputs 1 and 2 are expected to contribute an equivalent of \$24.67 million in equity, or 12.3% of the project cost, in kind and in cash. The rest of the project cost, about \$6.75 million equivalent or 3.4% of the total cost, will be financed by the Gansu Provincial Government (GPG).

20. The financing plan is in Table 2. GPG has assured ADB that any additional counterpart funding required for any shortfall of funds or cost overruns for the nonfinancial intermediary part of the project will be provided.<sup>10</sup>

**Table 2: Financing Plan (First Batch)**

<b>Source</b>	<b>Amount (\$ million)</b>	<b>Share of Total (%)</b>
Asian Development Bank		
Ordinary capital resources	100.00	50.0
Financial intermediaries	68.58	34.3
Beneficiaries	24.67	12.3
Gansu Provincial Government	6.75	3.4
<b>Total</b>	<b>200.00</b>	<b>100.0</b>

Source: Asian Development Bank estimates.

21. The Government of the PRC will be the borrower of the loan and will relend it to GPG, which will relend the loan to the participating county governments. For loan proceeds to be onlent to sub-borrowers and RFSPs by financial intermediaries, each county government will relend to the financial intermediary assigned to the county in US dollars on the same terms and conditions as those of the ADB loan. The relending agreement between the government and financial intermediary will cover, among others, repayment schedule, risk management, financial intermediaries' counterpart funds, and monitoring and reporting.

22. The subloans from financial intermediaries to farmers, cooperatives, and ASMEs will be in local currency; interest rates will be set taking into account the cost of the ADB loan, financial

<sup>9</sup> Same terms and conditions as ADB-funded subprojects, including environmental and social management system requirements, apply to these subloans except for the interest cap (para. 22).

<sup>10</sup> The government or financial intermediaries will not cover any shortfall or cost overrun for subprojects. The financial intermediaries will require the sub-borrowers to provide counterpart and overrun or shortfall funding.

intermediaries' operational costs, costs to cover credit and exchange risk, and a reasonable profit margin for financial intermediaries, subject to a maximum ceiling.<sup>11</sup> The current ceiling of subloan interest rates (6.5%) is within prevailing market rates in the project area (6.5%–12.0%) and entails a spread for financial intermediaries equivalent to that of their other funding resources.<sup>12</sup> Subloan tenors will generally be coordinated with subproject needs. For loan proceeds to be relent to RFSPs and onlent by RFSPs to sub-borrowers, no ceiling is applied on the interest rates.

## E. Implementation Arrangements

23. GPG, acting through Gansu Department of Finance, will be the executing agency. The bureaus of agriculture and animal husbandry (BAAHs) in the project counties and the three financial intermediaries will be the implementing agencies. The provincial PMO has been established within the provincial Department of Agriculture and Animal Husbandry, and the county PMO has been established within each BAAH.

24. The implementation arrangements are summarized in Table 3 and described in detail in the project administration manual (PAM).

**Table 3: Implementation Arrangements<sup>a</sup>**

Aspects	Arrangements
Implementation period	January 2016–December 2020
Estimated completion date	31 December 2020
Estimated loan closing date	30 June 2021
<b>Management</b>	
(i) Oversight body	The Foreign Capital Management Committee of GPG will be the project leading group acting through its office at Gansu's Department of Finance to supervise and coordinate the project activities. The committee is chaired by a vice governor and consists of all relevant government agencies.
(ii) Executing agency	GPG, acting through Gansu's Department of Finance
(iii) Key implementing agencies	BAAHs of Hezheng, Huan, Jingchuan, Jishishan, Kongtong, Lingtai, Lintao, Min, Yongjing, Yuzhong, and Zhenyuan counties of Gansu Province, and three financial intermediaries (Bank of Gansu, Bank of Lanzhou, and Yuzhong Shanghai Pudong Development Rural Bank)
(iv) Implementation unit	BAAHs, county branches of financial intermediaries, RFSPs, and sub-borrowers in the project counties
Procurement	Procurement will be undertaken in accordance with ADB's Procurement Guidelines (2015, as amended from time to time). For subprojects funded with subloans made by financial intermediaries and RFSPs, procurement will be undertaken by the sub-borrowers in accordance with established private sector or commercial practices acceptable to ADB.
	Shopping                      35 contracts                      \$830,040
Consulting services	Project implementation consultants will be hired using government counterpart funds following the People's Republic of China's public bidding procedure.
Retroactive financing and/or advance contracting	GPG, BAAHs, and financial intermediaries have requested advance contracting and retroactive financing to enable early commencement of procurement of goods and training by the government and sub-loans by financial intermediaries. The details of activities to be financed and their justification will be set out in a written request to ADB. The executing and implementing agencies have been advised that (i) approval of advance contracting and retroactive financing does not commit ADB to finance the

<sup>11</sup> Financial intermediaries have agreed with the government that (i) when ADB's loan interest rate is below or equal to 2%, the ceiling is 6.5%; and (ii) the ceiling will be increased by 0.5 percentage points if ADB's interest rate exceeds 2% and by another 0.5 percentage points each time ADB's interest rate increases 0.5 percentage points thereafter. For instance, if ADB's loan interest rate falls in 2+~2.5%, the ceiling is 7%, and so on.

<sup>12</sup> The information is based on the reports by the provincial PMO, financial intermediaries, and project preparatory technical assistance team.

Aspects	Arrangements
	project, and (ii) retroactive financing may only apply up to 20% of the amount of ADB loan in respect of expenditures incurred before loan effectiveness, but not earlier than 12 months before the date of the loan agreement. All advance contracting and retroactive financing will be undertaken in conformity with ADB's Procurement Guidelines (2015, as amended from time to time) and Guidelines on the Use of Consultants (2013, as amended from time to time). The issuance of invitations for bids, bidding documents, bid evaluations, recommendation of contract awards, and subloan contracts under advance contracting and retroactive financing will be subject to ADB approval. An environmental and social management system should be established by financial intermediaries and approved by ADB before financial intermediaries start to review subloan applications.
Disbursement	The loan proceeds will be disbursed in accordance with ADB's <i>Loan Disbursement Handbook</i> (2015, as amended from time to time) and detailed arrangements agreed between the government and ADB. A statement of expenditure procedure will be used for subloans up to the free limits of \$100,000 for farmers and \$1 million for farmer cooperatives and agricultural small and medium-sized enterprises. Subloans exceeding the free limits will require ADB's prior approval.

ADB = Asian Development Bank, BAAH = bureau of agriculture and animal husbandry, GPG = Gansu Provincial Government, RFSP = rural financial service provider.

<sup>a</sup> The project implementation period extends beyond the loan completion date because of the financial intermediation loan modality, which will revolve loan proceeds to finance new subprojects.

Sources: Asian Development Bank and Gansu Provincial Government.

### III. DUE DILIGENCE

#### A. Technical

25. The project is located in an arid region subject to drought. A climate risk vulnerability assessment indicates potential temperature increases, and precipitation variation could adversely affect the success of the subprojects. To mitigate these risks, all relevant subprojects are required to adopt climate-smart farming and water-efficient practices as project objectives stated in the design and monitoring framework, and subject to a procedural step in the ESMS.

#### B. Economic and Financial

26. Financial and economic analysis was carried out for 13 types of agriculture production bases, 12 representative ASMEs, 11 farmer cooperatives, and the project as a whole. Financial analysis indicates that the financial internal rates of return of the production bases are 13.2%–29.3%, and the financial internal rates of return of the ASME and farmer cooperative subprojects are 16.3%–27.2%, which are all well above the estimated weighted average cost of capital of 3.4%. Economic analysis shows that the economic internal rates of return (EIRRs) of the agricultural production bases are 15.1%–49.0%, the EIRRs of the ASME and cooperative subprojects are 11.2%–26.9%, and the EIRR for the whole project is estimated to be 15.8%.

#### C. Governance

27. GPG has extensive experience in administering projects financed by multilateral institutions, including ADB and the World Bank. Gansu's Department of Finance, which will operate and manage the imprest account, has sufficient experience in administering projects financed by ADB. Although the provincial PMO and BAAHs have the financial management capacity, they lack experience in managing or implementing ADB projects. The three financial intermediary banks have rigorous internal control and risk control systems. The employees

generally have a good educational background and receive training periodically. Their financial management capacity is sufficient to participate in the project.<sup>13</sup> The financial management assessment concluded that the overall premitigation financial management risk is moderate. Capacity building will be conducted and project implementation consultants will be engaged to implement the project in line with ADB policies and procedures. The financial management risks and mitigation measures will be reviewed and updated during project implementation.

28. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and GPG. The specific policy requirements and supplementary measures are described in the PAM.

## **D. Poverty and Social**

29. The project is categorized effective gender mainstreaming. A social and gender action plan has been developed, which will guide GPG, the BAAHs, and financial intermediaries to screen and enhance subproject proposals to ensure they provide social benefits, and contribute to improved gender equality in the project area. Overall, the project is expected to benefit over 27,000 rural households in the first batch of subprojects to be completed over the first 5 years of project implementation through various training programs, organizing for more efficient production, on- and off-farm employment, and income-generating transactions such as land use right transfer on a voluntary basis. Among the beneficiaries, 30% are expected to be poor, and 30% or more to be women (depending on the activities). At least 50% of signees of subloan contracts will include women. Since the loan proceeds will be revolved, more rural households will further benefit from the project. The project will also make more credit available to rural communities in the project area by providing funding to RFSPs.

## **E. Safeguards**

30. The project is classified FI for environment, involuntary resettlement, and indigenous peoples. An ESMS document will be prepared by each financial intermediary bank and RFSPs based on the agreed ESMS template prepared with GPG and the financial intermediaries, and approved by ADB before the first disbursement to the financial intermediaries.<sup>14</sup> Safeguard-related eligibility criteria are defined in the template ESMS, which exclude any subproject that (i) should be categorized category A for environment or indigenous peoples, (ii) involves involuntary land acquisition and resettlement (category A or B), or (iii) involves activities in the prohibited investment activities list of ADB's Safeguard Policy Statement (2009) and other activities listed in the ESMS. The financial intermediaries and RFSPs are responsible for implementing the ESMS under the supervision of the provincial PMO. The provincial PMO will engage project implementation consultants to provide assistance and training to the staff of financial intermediaries and RFSPs for ESMS implementation. The ESMS template was formulated based on consultations with local people. The ethnic minority development plan and ESMS (including the ethnic minorities planning framework) were disclosed on ADB's website on 8 June 2015. The relevant BAAH or financial intermediaries will ensure adequate consultation and disclosure have been done prior to subproject approval.

<sup>13</sup> Due Diligence of Financial Intermediaries (accessible from the list of linked documents in Appendix 2).

<sup>14</sup> Financial Intermediary: Environmental and Social Management System Arrangement (accessible from the list of linked documents in Appendix 2).

## F. Risks and Mitigating Measures

31. Major risks and mitigating measures are summarized in Table 4 and described in detail in the risk assessment and risk management plan.<sup>15</sup> Risk assessment for the overall project is medium and the integrated benefits and impacts are expected to outweigh the costs.

**Table 4: Summary of Risks and Mitigating Measures**

<b>Risks</b>	<b>Mitigating Measures</b>
Financial intermediaries' unwillingness to lend to some sub-borrowers in the long list proposed by the government	The government will try to identify financially viable subprojects and financially healthy sub-borrowers. The long list of proposed subprojects will be updated by the government and financial intermediaries annually. The government will provide capacity building to potential sub-borrowers to enhance their creditworthiness to meet financial intermediaries' requirements. Restrictions on maximum subloan size and average subloan size to be included in the relending agreement. Remedial measures will be included in the relending agreement to address of nonperformance of financial intermediaries.
Financial intermediaries are unwilling to lend to RFSPs because of perceived high risk	The government will help financial intermediaries to identify well-managed RFSPs with missions aligned to project objectives and willing to be fully involved. Financial intermediaries provide operational and management capacity building to potential RFSPs. Financial intermediaries learn RFSPs' credit rating technology from ongoing Asian Development Bank technical assistance. <sup>a</sup>
Weak financial management and governance of cooperatives and ASMEs	The government will provide ASMEs and cooperatives with training on financial management and accounting, the People's Republic of China's Law on Specialized Farmers Cooperatives (2006) and specific financial and accounting regulations. Sound financial management and governance can make ASMEs and cooperatives more bankable.

ASMEs = agricultural small and medium-sized enterprises, RFSP = rural financial service provider.

<sup>a</sup> ADB. 2013. *Technical Assistance to the People's Republic of China for Credit and Social Rating System Development for Microcredit Companies*. Manila.

Source: Asian Development Bank.

## IV. ASSURANCES

32. The government and GPG have assured ADB that implementation of the project shall conform to all applicable ADB policies including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the PAM and loan documents. The government and GPG have agreed with ADB on certain covenants for the project, which are set forth in the loan agreement and project agreement.

## V. RECOMMENDATION

33. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the loan of \$100,000,000 to the People's Republic of China for the Gansu Featured Agriculture and Financial Services System Development Project, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility; for a term of 15 years, including a grace period of 9 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft loan and project agreements presented to the Board.

Takehiko Nakao  
President

22 October 2015

<sup>15</sup> Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

## DESIGN AND MONITORING FRAMEWORK

### Impact of the Project is Aligned with

Income of rural residents in Gansu Province increased (The upcoming 13th Five Year Plan of Gansu Province, 2016–2020)

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
<b>Outcome</b> More productive, market-oriented agricultural activities in 11 project counties enhanced	<b>By 2020<sup>a</sup> (first-batch subprojects<sup>b</sup>):</b> a. Sales of featured agriculture in project area reach CNY968 million (2014 baseline: CNY 745 million) b. Sales of rural farm product marketed through project-supported farmer cooperatives and ASMEs increase by 50% (2014 baseline: 0) c. Financial intermediaries' lending to farmers, farmer cooperatives, and ASMEs with their own resources increases by 50% (2014 baseline: 0)	a. Annual statistics of the Department of Agriculture and Animal Husbandry b. Project completion report by provincial PMOs c. Official banking statistics from the People's Bank of China	Natural disaster and market fluctuations increase agricultural production costs significantly  Slowdown of the economy reduces overall demand growth for featured agricultural products
<b>Outputs</b> 1. Inclusive and environment-friendly featured agricultural production bases developed	<b>By 2020 (first-batch subprojects) 2014 baseline</b> 1a. At least 145 featured agricultural production bases developed (2014 baseline: 0) 1b. Each production base applies at least one water-saving and/or climate-smart farming practice (2014 baseline: 0) 1c. 50% of financial intermediary loans to individual farmer households with women's signature (2014 baseline: 0) 1d. 30% of beneficiaries of the production base development are from poor households (2014 baseline: 0) 1e. At least 20,000 farmers trained in the development and management of featured agricultural bases and cooperatives and ASMEs, with women trainees not less than 50% and the poor not less than 30% (2014 baseline: 0) 1f. At least 450 technical agents trained with up-to-date knowledge and technologies on featured agriculture, with women not less than 30% (2014 baseline: 0) 1g. At least 50 persons from two or more departments trained in	1a–b., 1d. Semiannual project progress reports by provincial PMO  1c. Project financial statements by provincial PMO  1e–g. Training workshop registration documents by provincial and county PMOs	Financial intermediaries are unwilling to lend to sub-borrowers in the long list proposed by the government  Weak financial management and governance of cooperatives and ASMEs  Financial intermediaries are unwilling to lend to RFSPs because of perceived high risk  Market demands decrease for some featured agriculture products  Animal diseases occur and spread

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
	water conservation and resource monitoring, with women not less than 30% (2014 baseline: 0)		
2. Farmer cooperatives and agricultural enterprises financed and strengthened	2a. At least 217 farmer cooperatives and ASMEs supported with subprojects to enhance business and with capacity building on governance, branding, and market development (2014 baseline: 0) 2b. At least 33 ASMEs and 45 farmer cooperatives obtain product certification (2014 baseline: 0)	2a–b. Semiannual project progress reports by provincial PMO	
3. Rural financial service system developed and enhanced	3a. Each financial intermediary makes loan to at least one RFSP (baseline: 0) 3b. At least 29 grassroots financial service units built by financial intermediaries, with women staff recruited by these units not less than 30% (2014 baseline: 0) 3c. 270 staff of financial intermediaries and 35 staff of RFSPs trained, with women not less than 30% (2014 baseline: 0)	3a–b. Semiannual project progress reports by provincial PMO  3c. Training workshop registration documents by financial intermediaries	
4. Capacity for project implementation and management strengthened	4a. At least 76 PMO staff trained in project management, financial management, and implementation of ESMS, EMDP and SGAP, and monitoring and evaluation, with women not less than 35% (2014 baseline: 0) 4b. ESMS implementation mechanism is established with relevant staff trained within the financial intermediaries and RFSPs (2014 baseline: 0)	4a–b. Semiannual project progress reports by provincial PMO  4a–b. Asian Development Bank's annual review missions	
<b>Key Activities with Milestones</b>  <b>1. Inclusive and environment-friendly featured agricultural production bases developed</b> 1.1 Prepare initial long list of subprojects and provide to financial intermediaries by Q4 2015 (provincial and county PMOs) 1.2 Establish ESMS and screen subprojects for safeguard issues accordingly by Q4 2015 (financial intermediaries) 1.3 Receive subloans from financial intermediaries to develop production bases from 2016 up to 2020 (farmers, farmer cooperatives, and ASMEs) 1.4 Provide capacity building for farmers from 2016 to 2020 (county PMOs)  <b>2. Farmer cooperatives and agricultural enterprises financed and strengthened</b> 2.1 Prepare initial long list of farmer cooperatives and ASMEs to be supported by Q4 2015 (provincial and county PMOs)			



<p>2.2 Screen long list in accordance with ESMS and provide subloans to farmer cooperatives and ASMEs from 2015 up to 2020 (financial intermediaries)</p> <p>2.3 Provide capacity building for farmer cooperatives and ASMEs from 2015 up to 2020 (county PMOs)</p> <p>2.4 Obtain product certification by 2020 (at least 33 ASMEs and 45 farmer cooperatives)</p> <p><b>3. Rural financial service system developed and enhanced</b></p> <p>3.1 Identify RFSPs satisfying eligibility criteria for relending, and government, financial intermediaries, and RFSPs reach agreement on relending terms, eligibility criteria of sub-borrowers, and safeguards by Q2 2016 (financial intermediaries)</p> <p>3.2 Disburse loan proceeds to financial intermediaries for onlending to selected RFSPs with established ESMS. RFSPs onlend to farmers, ASMEs, and farmer cooperatives from 2015 up to 2020</p> <p>3.3 Establish at least 29 grassroots financial service units by 2020 (financial intermediaries)</p> <p>3.4 Organize training for at least 300 loan officers and staff of financial intermediaries and RFSPs by 2020 (financial intermediaries)</p> <p>3.5 Develop or pilot innovative rural financial services and/or products from 2015 to 2020 (financial intermediaries)</p> <p><b>4. Capacity for project implementation and management strengthened</b></p> <p>4.1 Provide training to staff from provincial and county PMOs, BAAHs, and financial intermediaries on project implementation covering financial management, implementation of ESMS, EMDP, SGAP, and project monitoring and evaluation by Q2 2016</p>
<p><b>Inputs</b></p> <p>Asian Development Bank: \$100.00 million</p> <p>Financial intermediaries: \$68.58 million</p> <p>Beneficiaries: \$24.67 million</p> <p>Government: \$6.75 million</p>
<p><b>Assumptions for Partner Financing</b></p> <p>Not applicable.</p>

ASMEs = agricultural small and medium-sized enterprises, BAAH = bureau of agriculture and animal husbandry, EMDP = ethnic minority development plan, ESMS = environmental and social management system, PMO = project management office, Q = quarter, RFSP = rural financial service provider, SGAP = social and gender action plan.

<sup>a</sup> The three indicators measure how much more production, marketing and credit will be achieved by the project, respectively. Farmers are direct participants of production and marketing and direct recipients of credit.

<sup>b</sup> The first batch refers to subprojects financed by loan proceeds initially disbursed by the Asian Development Bank and financial intermediaries' own funds during the loan implementation period.

Source: Asian Development Bank.

### **LIST OF LINKED DOCUMENTS**

<http://adb.org/Documents/RRPs/?id=47046-002-3>

1. Loan Agreement
2. Project Agreement
3. Sector Assessment (Summary): Agriculture, Natural Resources and Rural Development
4. Project Administration Manual
5. Contribution to the ADB Results Framework
6. Development Coordination
7. Financial Analysis
8. Economic Analysis
9. Country Economic Indicators
10. Summary Poverty Reduction and Social Strategy
11. Gender Action Plan: Social and Gender Action Plan
12. Indigenous Peoples Plan: Ethnic Minority Development Plan
13. Financial Intermediary: Environmental and Social Management System Arrangement
14. Risk Assessment and Risk Management Plan

### **Supplementary Documents**

15. Due Diligence of Financial Intermediaries
16. Financial Management Assessment