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SME financing in China

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Abstract

SMEs have a great contribution in China's economic expansion. However, the financing predicament currently faced by SMEs constitutes a great bottleneck for their development. Banks are reluctant to lend to them, mainly due to the lack of collateral and their poor capability in pricing risk. This is the reason why credit guarantee institutions play a key role in SME financing and the perfection of the credit guarantee system is important for promoting their access to credit. In addition, the lifting of the ceiling on lending rates as well as other steps taken by banking authorities will encourage bank lending to SMEs. Finally, informal finance has a significant part in SME financing.

Résumé

Les PME ont une grande contribution à la croissance chinoise. Pourtant, leur difficulté de financement devient un grand obstacle dans leur développement. Les banques ne veulent pas leur prêter, principalement à cause de manque de collatéraux et la faible compétence des banques pour évaluer le risque de crédit. C'est la raison pour laquelle les organismes de garantie jouent un rôle indispensable dans le financement de PME et le perfectionnement du système de garantie est important pour augmenter leur accès aux crédits. En plus, l'enlèvement du plafond de taux d'intérêt de crédits ainsi que les autres mesures prises par les autorités bancaires vont encourager les prêts bancaires aux PME. Enfin, la finance informelle a une part significative dans le financement de PME.

Key Words: SME financing, credit guarantee, informal finance

JEL Classification: E26, E51, G21, O53

1. Introduction

The scope of private ownership has become substantial, producing well over half of GDP and an overwhelming share of exports-imports. Private companies generate most new jobs and are improving the productivity and profitability of the whole economy. The continued re-orientation of the economy towards the private sector brings considerable gains to real incomes and macro-economic activity. It should be noted that all companies which are controlled neither by state nor by collective shareholders are considered as private companies; 98% of enterprises in non-public sector are SMEs (small and medium sized enterprises), and 98% of SMEs are in non-public sector.

The changes in government policies explain importantly the emergence of a powerful private sector in the economy. In 2005, regulations that prevented privately-owned companies entering a number of sectors of the economy, such as infrastructure, public utilities and financial services were abolished. However, SMEs have always limited access to credits, which hinders heavily their businesses' expansion and thus their healthy development. Why banks are reluctant to lend to them and how they have fallen into financing difficulties? How to resolve their financing problems and who can serve as their main supporters? This paper tries to respond to these questions and to draw the best SME financing service system.

The paper begins by evaluating the position of SMEs in the real economy as a whole and highlighting issues facing SME financing. The following section discusses formal finance's support for SMEs, emphasizing the role of credit guarantee institutions. Ultimately, the paper presents informal finance's development and outlines its influences on SME financing.

2. The private sector—a major driving force in economic expansion

China's private sector has become its main driver of economic growth. In 2005, there were more than 40 million SMEs and sole industrial & commercial proprietorships (*getihu* enterprises), accounting for 99.6% of the total number of enterprises. They were responsible for as much as 59% of GDP. They accounted for 60% of sales value and represented 68.65% of imports & exports. They paid 48.2% of taxes, and occupied more than 75% of employment in urban areas. The regions with which SME cooperate have extended from Hong Kong & Macao to some developed countries, such as United States and Italy.

The growth in private output has been the result of the higher productivity of most companies in this sector. The sharper incentives facing the private sector companies have resulted in them using less capital and labour to produce output than state companies. Overall, the aggregate productivity of private companies in the industrial sector is estimated to be almost twice that of enterprises controlled directly by the state. The profitability of private companies has also risen considerably, and the rate of return on physical assets was double that of state controlled companies in certain provinces in 2005. Such a high level of competitiveness has resulted in the private sector accounting for more than two-thirds of all exports in 2005. While the bulk of these exports are made by foreign-controlled companies, the domestically-owned private sector is increasing its exports, as more small and medium-sized enterprises are granted export licences. (OECD, 2005).

The private sector plays a key role in a largely market-oriented economy owing to the changes in government policies. Government authorities have recognized the importance of the private sector for economic growth and job creation, and have moved to reduce a number of barriers that limit its expansion and to promote its equal treatment with publicly-owned sectors. On February 2005, the State Council issued “Guidelines on Encouraging and Supporting the Development of the Non Public Sector including Individual and Private Enterprises” that include 36 articles for improving the operating environment for private business. The new guidelines give much-improved market access to private companies in many industries that were previously restricted, including those that are dominated by state monopolies and heavily regulated sectors such as public utilities, financial services, social services and national defence. The directives also mandate equal treatment of private and public business, calling for rescinding of rules that discriminate against private companies and direct ministries and local governments to carry out implementation of the new constitutional amendment guaranteeing private property rights. In terms of access to financing, the new guidelines direct financial regulators to expand access to bank, equity and bond financing, through pro-active treatment of private companies under the interest rate liberalisation, and through impartial treatment of private companies in capital market access. A subsequent survey by the All-China Federation of Industry and Commerce showed that entrepreneurs cited the new market entry and financing access articles to be the most important.

3. The difficulty of SMEs to access to credit

3.1 Structure of SME financing and their financing difficulties

According to the survey conducted by State Administration for Industry and Commerce (SAIC) in 2002, the domestic private companies, including the very small companies, have low ratios of liabilities to equity, supporting the view that they had limited access to credit. Indeed over 40% of such companies in the sample had no debt, and financed their activities from internal funds, while the remaining nearly 60% borrowed from banks or informal market (Table 1). The very smallest private industrial companies and private service sector companies rely extensively on informal credit. Bank credit, on the other hand, seems to be more accessible for larger companies. The survey also indicates that over 90% of the private companies had difficulty in obtaining bank credit. Over half of the respondents named their lack of collateral as a major barrier to bank borrowing. Ownership discrimination was cited by one-fifth of respondents followed by insufficient amount of bank loans and too short-term lending as major problems with bank financing. Much fewer firms chose too high interest rates or stringent requirements for credit rating as top reasons for not bank borrowing. While banks tend to lend short-term, the informal markets provide long-term financing. The informal sector also accepts receivables as collateral, which may help explain why some larger firms rely exclusively on the informal market for external finance.

China International Capital Corporation Limited's recent research (2006) indicates that equity and retained earning represent respectively 30% and 26% of capital resources in SMEs. Among external financing channels, equity market's entry threshold is high, venture capital investment system isn't complete, corporate bonds' issuance entry is difficult, so SMEs can't raise capital through capital market effectively. For instance, listing in the stock market in Shenzhen or Shanghai is a privilege of a handful of well-established, large and profitable private companies. Although the establishment of the second board on the Shenzhen market for high-tech SMEs may ease this need somewhat for such companies, for non-high-tech companies financing still remains a major problem. Moreover, bond financing seems to be even less accessible for private companies due to stringent criteria including industrial policy guidelines.

Table 1 – Use of credit by Domestic Private Sector Companies

	Size category (Sales volume, million yuan)						
	0-1	1-3	3-10	10-20	20-50	50+	all
Access to borrowing	Per cent of firms						
Per cent with no credit	54.2	43.4	39.5	36.1	28.6	42.4	41.1
Per cent with credit	45.8	56.6	60.5	63.9	71.4	57.6	58.9
Per cent of firm with bank finance only	13.8	23.3	28.3	34.8	43.7	36.1	29.3
Per cent with informal finance only	20.2	18.3	15.0	11.6	9.6	7.6	14.0
Per cent with bank and informal	11.8	15.0	17.2	17.5	18.0	13.9	15.6
Firms with any borrowing¹	Per cent of equity						
Manufacturing	51.8	32.3	36.5	39.9	36.5	28.9	32.5
Services	43.6	40.9	49.9	30.3	63.8	31.1	39.9
All	47.6	36.9	38.8	36.6	43.8	29.5	34.7
Share of informal borrowing in total borrowing	Per cent of total borrowing						
Manufacturing	23.3	24.3	19.5	26.4	9.4	3.9	17.6
Services	44.2	35.1	8.7	12.1	11.6	8.7	21.4
All	35.7	28.2	15.6	20.9	10.3	6.3	10.9
Pre tax rate of return on equity	6.1	10.6	11.5	15.1	16.6	15.5	14.8
Investment relative to (previous year) equity plus debt minus investment	11.8	19.8	24.8	29.9	32.0	30.6	29.0
Proportion of firms in each size group	14.5	18.7	25.3	12.3	12.6	16.7	100.0

Note: Sample size is 2 460 companies.

Source: the Chinese University of Hong Kong, OECD Economic Surveys: China (2005)

With respect to banks, although lending by State Owned Commercial Banks (SOCB) and other banks to non-state enterprises has been growing rapidly, private enterprises still seem to have less access to credit than State-owned enterprises (SOE). Small and medium sized businesses, which account for more than half of GDP, receive only 16% of total bank loans. Only 30% of credits demanded by SMEs with a good quality have been satisfied. (Economic Daily, 14/06/2006)

Another example. According to Shanghai Branch of CBRC (China Banking Regulatory Commission), up to the end of June 2005, 71 915 small enterprises had obtained credits, which accounted for 28.2% in the total number of small enterprises in Shanghai. There are at least 70% of small enterprises which have never demanded credit, in a conservative estimation. Among

¹ The enterprises, which have less than 1 million yuans of sales volume, have the highest ratio of borrowing to equity, because they have little equity instead of much borrowing.

those which had demanded credit, only 10% of small enterprises failed due to their poor management, 45% were refused because they hadn't acceptable properties as a pledge for banks.

3.2 Why banks are reluctant to grant credit?

Credit demanded by SMEs has the following characteristics: small amount, urgent and frequent demands, in short term. The control cost of such credit is much higher than the one of credit to big enterprises. The smaller scale of SME loans makes banks proportionately more expensive to monitor. Big banks prefer to do business with big enterprises. Yet there are small & medium banks which have much less capital and which grant credits to SMEs with a good quality. These banks are less competitive but know very well SMEs in their regions.

Likewise, poor management, complex related transactions, non transparent accounting and weak anti-risk capability have aggravated their difficulties to get credits from banks. Banks don't want to lend to them owing to information asymmetry and high costs of transaction and control.

Banks' efforts to avoid incurring new non-performing loans reduce the access of SMEs, state owned and non-state, to bank credit, while larger SOEs (State Owned Enterprises) backed by central or local governments are able to get loans largely because of the implicit guarantee that backing confers. Non performing loans granted by big four SOCBs (State owned commercial banks) to SOEs can be written off or transferred to AMCs (Asset Management Corporation). The State has infinite responsibility. But those granted to SMEs can't benefit this advantage. The personnel who grant credits are always responsible for them. Generally, SMEs are considered to have a relatively high default risk. In 2003, average NPL ratio of lending to SMEs in principal commercial banks was 32.11%, 15.7 points more than the average NPL ratio in commercial banks. For this reason, the Big-Four which want to lessen NPL ratio in order to satisfy the regulatory rules defined by CBRC (3%-5%) will be very prudent to SME lending.

Due to high risk in SME lending, banks demand SMEs to put enough properties in pledge, or to look for a guarantee as an indispensable condition to grant credit. Nonetheless, most of SMEs haven't enough acceptable assets as a pledge. This is a great handicap in their financing. So a fully developed credit guarantee system is strongly needed.

The present dependence on collateral and guarantee is indicative of the fact that banks now have limited capabilities to assess, process, and price loans to smaller customers. Improvement of these capabilities is the ultimate key to ensuring adequate access to credit for SMEs and will require substantial upgrading of internal systems for assessing and managing risk and considerable training of staff. However, it is particularly important that lenders have necessary flexibility to charge lending rates that adequately compensate for risks and costs of their loans. The SMEs have a relatively higher business failure rate than larger borrowers. Risks of lending to SMEs are further increased by their relatively poor information systems, which makes it difficult for banks to assess their creditworthiness. Official restrictions on bank's flexibility in setting lending rates were an increasing impediment to SME lending as banks became more conservative in the effort to avoid further non performing loans.

Empirical analyses by MOLNAR and TANAKA (2007) show that private firms have difficulties in obtaining financing from the formal banking system and their access to bank loans depends on their credit history, size and rating that can't easily be manipulated through creative accounting. Loan decisions irrelevant of the financial health of the company may suggest that banks, especially the largest ones, don't have appropriate incentives to develop monitoring and risk pricing skills as they mainly engage in lending to SOEs (i.e. they are not able to distinguish between genuine and manipulated performance indicators). Firms in manufacturing sector are more likely to get loans, probably due to the fact that manufacturing firms are more likely to possess assets that can be used as collateral compared to firms in service industries.

4. Enlarging access to credits for dynamic sectors—Formal finance's support for SME

4.1 Credit guarantee Schemes (CGSs)

As described above, lack of collateral is the chief difficulty in obtaining bank loans for SMEs. Collateral or loan guarantee, or both, have become an essential precondition for most SME lending in China.

Improving financing for SMEs undergoing substantial expansion has become a main concern for government. The central government has taken many steps to improve the flow of credits to SMEs in urban areas. Besides urging banks to penetrate that market, the government has promoted the establishment of credit guarantee schemes for smaller firms. The largest component of such schemes is the government-sponsored credit guarantee institutions established by municipalities and provinces. In addition, there are a smaller number of member-SME-funded mutual guarantee funds and private-sector invested commercial guarantee companies, both forms of which pre-date the establishment of government credit guarantee institutions.

Nearly all provincial governments have established credit guarantee institutions. Following a pilot programme starting in 1998, 30 provinces established credit guarantee institutions. There were more than 20 in 1997, more than 300 in 2000, 848 in 2002 (one third were private credit guarantee institutions), more than 3 500 in 2004 (more than 2 000 were private credit guarantee institutions), and the number of such institutions reached more than 4 000 in 2005, with the amount of loans carrying guarantees amounting to about 400 billion RMB. According to the statistics, there are 1 200 credit guarantee institutions which serve especially for SMEs (for credits and shares issue), which account for 32.28% in all of credit guarantee institutions. (The People's Bank of China & China Finance, 23/01/2006)

The credit guarantee institutions are highly diverse: some are funded from the government budgets, others by fees on participating businesses, or by private investors, or a mixture of these sources. More than 70% of the funds of the institutions originate from non-government sources. In lots of such institutions, the capital invested by private enterprises and individuals is more than 60% (Financial News, 07/09/2005). The organisational form of the institutions varies from public service units, to state or privately controlled shareholding enterprises, to fund management companies. Further, they can be non-profit or profit institutions and their business scope can be limited to guaranteeing firm borrowing or can cover a wider range of activities.

The remainder of this section is organized as follows. 4.1.1 analyses guarantee business operation; 4.1.2 presents the establishment of guarantee system; 4.1.3 discusses risk management

and puts forward some proposals for reform; and finally, 4.1.4 outlines the importance of private credit guarantee institutions' development.

4.1.1 Guarantee contract

The enterprises which demand guarantee should satisfy the following conditions:

- They should register in State Administration for Industry & Commerce.
- They should have been created three years ago at least, and shown good performance in the three previous years.
- The ratio of liabilities to assets can't exceed 70%.
- The domain in which enterprises work should be supported by State (for example, industrial policies, environmental protection policies, etc). If the domains are restricted by State, credit guarantee institutions won't accept their demands.

Generally, credit guarantee institutions charge a price less than a half of bank's lending interest rate². The prices vary across different credit guarantee institutions, amounting to 0.8%-3% of guaranteed credits. In addition to this guarantee price, SMEs should also pay a guarantee fee which is calculated per year and is paid only once³. The guarantee fees vary with credit amounts and the risk level of SME. Guarantee fee rate is defined on the basis of credit risk degree, and it's a floating rate. Guarantee fee rate is limited to 50% of banks' lending rate in the same term at most⁴.

Credit guarantee institutions often demand counter-guarantee as an essential condition for granting the guarantee. There are various forms of counter-guarantee, such as mortgages on land use rights and real estate; means of transportation, equipment, and other movables; cashable

² The floor of bank's lending interest rate is 6.12% for one year. There is no ceiling.

³ For the guarantee in short term (3 months, 6 months), the guarantee fee is calculated per month (annual guarantee fee rate/12).

⁴ Target lending rate (adjusted by the People's Bank of China, effective from August 19, 2006)

Credits in short term

duration<= 6 months: 5.58%

6 months<duration<=1 year: 6.12%

Credits in medium and long term

1 year<duration<=3 years: 6.30%

3 years<duration<=5 years: 6.48%

duration>5 years: 6.84%

saving instrument, actions, bills of exchange; pledges on transferable stocks, patents, and trademarks; the guarantee granted by another person or institution, the enterprise chief's unlimited responsibility, etc.

Most of guaranteed credits are in short term (\leq one year). The guarantee covers normally the principal and the interests, eventually with loss undergone by creditors in certain guarantee contracts. This depends on the negotiation between bank, enterprise and credit guarantee institution. After granting the guarantee, the credit guarantee institutions should control the enterprises continuously.

In case the enterprise can't repay credit to bank on the maturity of contract, the bank will hold caution deposited by credit guarantee institution, which is called "substitutive refunding". If the enterprise has a cash shortage, and she can refund credit later, we call it "temporary relay". In contrast, if the enterprise hasn't the capability to refund it, we call it "default credit". Normally, credit guarantee institutions assume all of implied responsibility, i.e. they refund credits to banks, and then they demand enterprises to refund them. Certain banks give a time limit (for example, 3 months after the expiry of credit contract). If the enterprise can't yet repay credit, the credit guarantee institution will repay it for the enterprise.

The substitutive refunding ratio relies on the credit guarantee institutions' risk management. It can be zero in certain credit guarantee institutions, with contrast that others will go bankrupt owing to only one substitutive refunding. Most of enterprises are responsible for their engagements, and so the substitutive refunding ratio is low.

After refunding credit to the bank, the credit guarantee institution requires the enterprise to repay it, and all of interests (not only those paid to the bank, but also interests for the period after substitutive refunding), eventually with loss and fees for creditor. The interest rate demanded by credit guarantee institution for the period after repayment to bank can be the same as the one demanded by bank, or even higher than the bank's lending interest rate. In case of no refunding, the credit guarantee institution will sell pledges. The pledges are sufficient for refunding credit generally, so the credit guarantee institution has little loss.

The guarantee law (promulgated on June 30, 1995 by permanent committee National People's Congress and effective from October 1, 1995) and the new bankruptcy law (voted in the 23rd meeting of 10th permanent committee National People's Congress on August 27, 2006 and effective from June 1, 2007) protect well-functioning guarantee businesses and priority of guaranteed credits' repayment.

4.1.2 Guarantee system

National Development and Reform Commission is organizing to establish a SME guarantee system. There are "one body, two wings, four levels" in this system: one body is mode body (different resources of capital, market-oriented operation, corporate governance, support for the best); two wings are commercial guarantee institutions and mutual guarantee institutions which are considered as supplementary (agricultural credit guarantee institutions included). There are four levels in credit guarantee system which have different functions-national, provincial, prefectural and county.

According to plan, the county and prefectural credit guarantee institutions give guarantee for SMEs in their proper regions. The provincial credit guarantee institutions grant re-guarantee for these credit guarantee institutions at lower levels, and supervise them with the People's Bank of China. They can also grant guarantee directly to SMEs. The national credit guarantee institutions are being established and will work as guarantors of last resort and grant re-guarantee to the credit guarantee institutions at lower levels.

4.1.3 Risk management

In most of guarantee businesses, the credit guarantee institutions have joint obligation⁵, i.e. banks transfer the whole credit risk to credit guarantee institutions. The only risk for banks is the substitutive refunding risk which comes from credit guarantee institutions. Credit guarantee institutions can also have an ordinary obligation⁶ or assume the risk proportionately with banks

⁵ After the expiry of the contract, the banks can demand enterprises or credit guarantee institutions to repay credits.

⁶ After the expiry of the contract and before trial or arbitration, credit guarantee institutions can refuse to assume guarantee responsibility. After adjudication, banks use properties put in pledge to refund credits. The credit guarantee institutions bear loss with banks proportionately. The proportion is negotiated by them.

together⁷. In a mature credit guarantee system, credit guarantee institutions should assume the risk proportionately with banks. The objective is to avoid moral hazard on any side. Banks or credit guarantee institutions can collude with enterprises to damage another side's interest.

SMEs should put their properties in pledge either in banks or in credit guarantee institutions as an indispensable condition for obtaining credits. The value of properties put in pledge covers the principal and the interests normally.

Credit guarantee institutions should deposit a caution in banks as a basis of cooperation with them, which is also a precaution against risk in banks. If the enterprises can't repay their credits at the term of the contract, banks will hold the caution. The caution rate in banks varies from 10% to 20% of the guaranteed credit amount, i.e. the credit granted by banks can't exceed 10 times the caution deposited by credit guarantee institutions. For example, credit guarantee institution deposit 10 million yuans in a bank, this bank will lend a sum of 100 million yuans in maximum guaranteed by this institution⁸. Certain credit guarantee institutions are demanded a higher caution rate, at around 20%--33%. Others are demanded nothing.

Sometimes, the banks demand also the enterprises to deposit a caution, which differs from the one deposited by credit guarantee institutions. These two cautions can coexist.

The caution deposited by enterprises in credit guarantee institutions serves as a counter-guarantee. Some credit guarantee institutions demand enterprises to pay a caution. Most don't do so. The caution is 2%--10% of guaranteed credit amount. If the enterprise can't repay its credit according to the contract, credit guarantee institutions will hold part of the caution deposited by the enterprise. This part of the caution will increase along with time. Six months later, the credit guarantee institution will hold the whole caution. It's punishment for the enterprise. Enterprises can't require to refund the caution. This punishment differs from the substitutive refunding. The substitutive refunding is done with credit guarantee institutions' ownership, that is the caution deposited in banks by credit guarantee institutions.

⁷ e.g. banks bear 30% of risk.

In general, credit guarantee institutions bear different risks, such as guaranteed enterprises' risk⁹, pledge sale risk, macro-economic risk (law, regulation and policies changes), and operational risk. So strengthening their risk management capability is a very important condition for cooperating with banks, developing their guarantee businesses, and especially for accelerating SMEs' development.

4.1.3.1 “SME credit guarantee institutions’ risk management temporary measures” (26/03/2001, [2001], Ministry of Finance)

These measures take important precautions against risk.

- ✓ Credit guarantee amount for an enterprise shouldn't exceed 10% of credit guarantee institution's equity fund. The total credit guarantee amount shouldn't exceed 5 times of their capital in general, 20 times at most.
- ✓ Counter-guarantee. SMEs' major assets are mortgaged. It can avoid their moral hazard. These assets can be sold if they can't repay their credits in term of contract.
- ✓ Credit guarantee institutions should take out 50% of guarantee fees as *responsibility provision* for their guarantee contracts which haven't expired. They should also take out 1% of guaranteed credits amount (in maximum) and certain percentages of profits after income tax as *risk provision*. These two provisions should be deposited in a special bank account and are considered as the precaution against substitutive refunding later. The ceiling of these two provisions is 10% of guarantee amount in the end of the year.
- ✓ Credit guarantee institutions should deposit 10% of their registered capital in the bank assigned by their governors (local bureaus of Ministry of Finance in provinces) after their creation and for one time definitively. This provision will only be used in refunding their debts in case of their bankruptcy.

⁸ These credits can be granted for different enterprises.

⁹ There are SME with uncertainty surrounding their growth. Their management isn't standardized. They have a relatively weak capability for refunding credit.

- ✓ For the remaining capital, credit guarantee institutions can use 80% at least in bank's deposit, government bonds, financial bonds and major SOEs' bonds (SOE—state owned enterprises), 20% at most in shares and funds with their governors' agreement.

4.1.3.2 Credit Information Registry and Collateral Registry shared in common

There isn't a common information system for credit guarantee institutions. So they can't share enterprises' evaluation. The fact that sometimes they evaluate the same enterprises will raise their costs and information asymmetry risk. In addition, information on the enterprises by different controllers isn't shared as well. Credit Information Registry created by the People's Bank of China is available only in commercial banks' credit departments. State Administration for Industry & Commerce, State Administration of Taxation, and China Customs have their own systems which aren't available for each other.

There appears to be, however, no standard way for a creditor/guarantor to know whether a piece of collateral has already been pledged to another creditor/guarantor. Therefore, in order to increase the utility of collateral for lenders and guarantors, thus allowing them to take greater risks and extend credit to a broader enterprises, national collateral registry should be created that consolidates the site of registration in one institution, makes the information nationally available in an accessible, searchable database, and reduces the costs of collateral registration (in time and money). It is possible that this could be combined with the credit information registry outlined above, to set up such a system overlap.

A credit information system available to all controllers concerned is also needed. Such a publicly shared information system can improve banks' ability to judge and appropriately price credit risks and reduce loan processing times and costs, and can offer similar benefits to potential trade creditors. This well-functioning system will create positive incentives for borrowers to repay loans in a timely manner by enhancing the value of "reputation collateral" derived from timely repayment of all types of credit. This increases the profitability of lending in the long run, which will contribute to building a sounder, competitive SME financial services industry.

4.1.3.3 Risk Compensation Funds

In order to reduce substitutive refunding risk and to have a healthy development for credit guarantee institutions, two solutions are preferable. First, the credit guarantee institutions can cooperate to grant guarantee in common or to give re-guarantee for others, which constitutes a risk-sharing system. Second, a risk compensation fund should be created and credit guarantee institutions' capital should be completed by public finance at the same level. The local governments can draw a part of raised taxes and give them to credit guarantee institutions as external risk compensation in order to encourage their guarantee businesses' development.

A risk compensation rate should be fixed per period. The losses which exceed the capital invested by government finance will be made up by credit guarantee institutions themselves. In order to help the best and to eliminate the worst, it will be ideal if the contribution rate of guarantee revenue to government finance is chosen as the ceiling, and the capital loss rate at normal management level as the floor. This rate can be adjusted according to the financial situation of credit guarantee institutions. Along with credit risk environment's improvement and substitutive refunding ratio's drop, this rate can be reduced, until zero under the condition that capital accumulation need is satisfied.

This risk compensation fund is created for public credit guarantee institutions. They are non-profit institutions. They play an important role in promoting regional economic development. Sometimes even if there would be losses, they will apply state industrial policies and support some enterprises in order to encourage their development. Generally they have few capitals in risk compensation. If their counter-guarantee measures aren't effective, they will bear losses in case of substitutive refunding.

At present, special guarantee funds are created in certain regions. For example, Xi'an high technology zone management committee in Shaanxi province has taken 10 million yuans for the first time as guarantee risk compensation funds in 2006. Shenzhen Branch of Ministry of Finance will put 1 billion yuans for the first time as guarantee risk compensation funds in the 11th five-year plan. Nonetheless, the risk compensation system at national level hasn't yet existed.

4.1.4 Helping private credit guarantee institutions' development

While public credit guarantee institutions function well, private credit guarantee institutions are in bad situation. 90% of them are reported in losses. Because they have little capital and thus few guarantee businesses. Banks aren't willing to cooperate with them. Many of them do other businesses instead of guarantee businesses. In contrast, public credit guarantee institutions are backed by local governments. They have more capital and relatively complete risk compensation system. Banks would like to cooperate with them.

The credit guarantee institutions should have at least 100 million yuans of capital as a necessary condition to cooperate with banks (CBRC, 2006). However, according to a survey, 1 756 credit guarantee institutions have less than 10 million yuans of registered capital, which represent 47.24% in total number of credit guarantee institutions; 1 776 institutions with registered capital between 10 million yuans and 100 million yuans, which account for 47.78% in all of such institutions. So 95% of these institutions have registered capital of less than 100 million yuans. They are short of capital. (China Finance, 23/01/2006)

The private credit guarantee institutions are equally important as public ones. They are complementary. The private credit guarantee institutions' financing difficulty is an indirect factor for the SMEs' financing difficulty. So reinforcing capital of the private credit guarantee institutions and improving their guarantee operations are important for further development of the credit guarantee system and thus for SME financing. Governments are introducing some policies to help their development, such as capital compensation, exemption from taxation¹⁰, etc.

4.2 Credit rating agencies

Credit rating agencies were created twenty years ago. It's until the beginning of this century that credit rating agencies accelerated their development due to the 10th five-year plan for economy and social development. In 2003, the People's Bank of China created a bureau specially for controlling credit rating agencies. In the beginning of 2005, the People's Bank of China

¹⁰ National Economic and Trade Committee had chosen 104 pilot credit guarantee institutions on April and 122 on September 2001. These non-lucrative credit guarantee institutions which serve for SMEs with a price authorized by local governments are exempted from turnover taxes for three years and only for SME guarantee businesses.

assigned 8 provinces as experimental units. They were Shanxi, Shandong, Shanghai, Zhejiang, Hunan, Sichuan, Henan, Anhui, which have different rating methods.

There are five credit rating agencies approved successively by CIRC (China Insurance Regulatory Commission), National Development and Reform Commission, CSRC (China Securities Regulatory Commission). The People's Bank of China is their supervisor.

- China CHENGXIN Credit Management Co., Ltd (10/1992)
- DAGONG GLOBAL Credit Rating Co., Ltd (03/1994)
- China Lianhe Credit Rating Co., Ltd
- Shanghai Far East Credit Rating Co., Ltd (03/1988)
- Shanghai Brilliance Credit Rating & Investors Service Co., Ltd (07/1992)

They are capable in all of types of evaluation: enterprises, corporate bonds, enterprises' convertible bonds, listed societies, banks, trust & investment products, and SMEs.

There are five credit rating agencies which are specialized in evaluating enterprises: SINO-HAWK Credit Rating Co., Ltd, Xiamen Financial Consultation & Appraisal Co., Ltd, Ningbo YUANDONG Real Estate Valuation Co., Ltd, JIANGSU FAR EAST International Appraisal & Consultation Co., Ltd and Hangzhou Credit Rating Co., Ltd. These five credit rating agencies together with five great national credit rating agencies mentioned above are regarded as those which are mainly responsible for evaluating banks' credits to enterprises.

Banks have their proper rating methods of enterprises which are not available to public. The People's Bank of China demands credit rating agencies to evaluate enterprises which constitutes a necessary condition in an examination procedure of credits. Credit rating agencies evaluate enterprises in depth. This evaluation concludes normally four categories of information: general information, enterprises' quality, corporate management and financial situation. The rating is valid for one year. After giving a rating, credit rating agencies should control enterprises continuously.

4.2.1 SME rating and banks' attitude to their ratings (example of Shanghai)

SMEs' evaluation started in the 10th five-year plan. Until now, there has not been a common SME evaluation system and a national evaluation market.

- On February 2000, Shanghai Far East Credit Rating has entered Shanghai small enterprises' services center.
- In 2001, China Lianhe Credit Rating Co., Ltd and Dagong Global Credit Rating Co., Ltd participated in high-technology enterprises' evaluation program in Zhong Guan Cun of Beijing, which was organized by Beijing government and Zhong Guan Cun management commission.
- In 2003, Shanxi, Jilin, Zhejiang, Sichuan and Beijing had been chosen as five pilot units of small enterprises' evaluation. Credit rating agencies are responsible for collecting their information, evaluating them and creating their archives.
- In 2004, China Chengxin Credit Management Co., Ltd, Dagong Global Credit Rating Co., Ltd, China Lianhe Credit Rating Co., Ltd, Shanghai Far East Credit Rating Co., Ltd had been chosen by National Development and Reform Commission to participate in SME pilot units' evaluation in Beijing, Taiyuan (the capital of Shanxi), Taizhou (a city in Zhejiang), Changchun (the capital of Jilin) and Chengdu (the capital of Sichuan).
- On January 2005, Shanghai Branch of the People's bank of China and SME development acceleration bureau appointed 200 SMEs as experimental units of evaluation. Dagong Global Credit Rating Co., Ltd, China Chengxin Credit Management Co., Ltd, Shanghai Brilliance Credit Rating & Investors Service Co., Ltd and Shanghai Far East Credit Rating Co., Ltd were responsible for their evaluation.

In 2005, Shanghai Branch of the People's Bank of China had named four credit rating agencies¹¹ for evaluating 98 small enterprises in this region. In Shanghai, there were more than 360 000 small enterprises. These 98 small enterprises were viewed as pilot units, among which 74 small enterprises had obtained a rating A or even higher. However, these small enterprises obtained little advantage in banks. Banks didn't believe in their ratings given by credit rating agencies, and demanded them to look for credit guarantee institutions' help. Why banks wouldn't believe their ratings? There are mainly two reasons: on the one hand, even if credit rating had a history of twenty years in China, the concrete development started from evaluation of bonds'

¹¹ There were Dagong Global Credit Rating Co., Ltd, China Chengxin Credit Management Co., Ltd, Shanghai Brilliance Credit Rating & Investors Service Co., Ltd and Shanghai Far East Credit Rating Co., Ltd.

issuance in short term in interbank market promoted by the People's Bank of China in 2004. And there is a vicious competition based on price and a monopoly in this market. There isn't effective control in market. These credit rating agencies don't work like the three great international credit rating agencies (Standard & Poor's, Moody's, Fitch), which have collected enterprises' data for more than fifty years and which know very well enterprises and industries to which enterprises belong. On the other hand, according to banks, credit rating agencies haven't a complete evaluation system for SMEs.

Credit rating agencies evaluate small enterprises only for satisfying demand of the People's Bank of China. In addition, evaluation fee is 2 000-3 000 yuans per enterprise, so it's not profitable for them.

4.2.2 Credit guarantee institutions' evaluation

To avoid a transfer of guarantee risk (substitutive refunding risk) to credit risk, the People's bank of China asks credit rating agencies to evaluate credit guarantee institutions. It's an effective means to control credit guarantee institutions and to put them in transparency. This means facilitates cooperation between banks and credit guarantee institutions, and also cooperation among credit guarantee institutions. It improves credit guarantee institutions' internal management so that they could control credit risk with banks effectively. Credit guarantee institutions should be evaluated per year.

4.2.3 Common information system of enterprises for credit guarantee institutions and credit rating agencies

Guarantee industry has high risk due to information asymmetry between credit guarantee institutions and enterprises, and among credit guarantee institutions. Certain enterprises demand guarantee in different credit guarantee institutions at the same time, or put the same property in pledge in different credit guarantee institutions. Likewise, the information system created by the People's Bank of China is available only in banks' credit departments. The mortgaged properties aren't noted in State Administration for Industry & Commerce and in other controllers concerned. So, it will increase risk borne by credit guarantee institutions.

Shanxi Guarantee Association created the first common information system for credit guarantee institutions and credit rating agencies in 2004. This is the first regional system. In this system, enterprises' information is offered by credit guarantee institutions and credit rating agencies which are members of Shanxi Guarantee Association.

4.3 Banks' special measures for supporting SMEs

The government decision on October 2004 to lift the ceiling on lending rates for commercial banks is a very important step toward providing financial institutions with the ability to adequately price risk. Together with the removal of the floor on bank deposit rates, this step represents major progress toward full flexibility for interest rates, although the ceiling on deposit rates and the floor on lending rates remain in place. Banks become more willing to exploit their ability to charge higher rates on riskier loans. According to the governor of CBRC (China Banking Regulatory Commission), Mr. LIU Ming Kang, the interest rate on SME lending can be raised to 15% or even higher. However, rural and urban credit cooperatives were exempted from this liberalisation of interest rate. The ceiling on lending rates still exists (12.834% for credits of one year). These credit cooperatives are main supporters for small enterprises in small cities and counties, and so they need maximum flexibility in setting loan rates for controlling risk.

After freeing the lending rates, CBRC promulgated "Guidelines on banks' lending to small enterprises" (policy banks, commercial banks, rural credit cooperatives mainly, and urban credit cooperatives which have lending businesses to small enterprises) on July 29, 2005. These guidelines demand commercial banks to change their inclination (lending to big enterprises, lending in long term, lending concentration) and to increase lending to small enterprises in order to accelerate their development. Even if they may be intrusive in banks' management (for example, they require all banks to set up a separate business department to undertake small business lending, and to track separately in their accounts the cost and profit of the business), they represent an important milestone in several respects. First, the guidelines stress that achieving commercial sustainability must be a primary goal in undertaking the business, marking a clear departure from China's historically subsidy-oriented approach to promote small business finance. Second, they seek to promote adoption by Chinese banks of the lending techniques employed successfully internationally in small business lending, including an attention to assessing borrower

repayment capacity in terms of available cash flow, with less emphasis on formal collateral, and adopting incentive-based compensation for loan officers, with incentives to be based especially on performance in attracting new clients and in collecting loans. Third, they explicitly recognize the future role of policy banks in lending and providing technical assistance to small and medium sized banks for the purposes of penetrating the small business lending market.

On October 2006, CBRC issued another regulation. “zero risk” assessment and investigation of responsibility were eliminated in lending to small enterprises. Moreover, this guidance simplifies the examination procedure of credits to them, and encourages banks to lend to small enterprises which have a good credit reputation.

Several chinese and foreign banks have taken some special measures to ease SMEs’ access to credits. For example, the Industrial and Commercial Bank of China and the Agricultural Bank of China established special units for credit to small enterprises in pilot regions, Shanghai Pudong Development Bank, China Minsheng Banking Corp. and China Everbright Bank established small & medium-sized customers department or small & medium-sized enterprises servicing center, and some other city commercial banks and rural commercial banks established special units or teams as well.

- **Industrial and Commercial Bank of China**

As the biggest bank in China, Industrial and Commercial Bank of China (ICBC) has introduced ten measures on lending to small enterprises on September 2005. These measures are favourable for small enterprises which work for big and medium sized enterprises and which can put their acceptable and negotiable properties in pledge, or those which work in international trade and are related to big and medium sized enterprises. There is no concern about their ratings. ICBC has been named “small enterprises’ lending bank” by CBRC in 2005.

Beijing Branch of this bank has promised on November 2006, that she will grant new credits of 60 billion yuans to more than 1 000 SMEs in next three years. Up to the end of October 2006, new credits granted to SMEs in ten previous months have exceeded 10 billion yuans for more than 250 SMEs. There were 114 300 accounts of SMEs, around 96.6% of total number of

company accounts. She is in the first place on supporting SMEs compared with her colleagues in this region.

- **China Construction Bank**

On August 2005, China Construction Bank (CCB) and Zhejiang province government reached an agreement “cooperation for supporting SMEs’ development”. Zhejiang Branch of this bank would grant 60 billion yuans of credits to SMEs in next three years. From September 1, 2005, the credits with amount less than 5 million yuans can be examined and granted directly by the sub-branches in cities. SMEs can obtain credits with mortgage or guarantee only in one week. Zhejiang Branch will also grant 30 billion yuans of credits to enterprises and programs in innovation in next three years (September 2006).

- **China Development Bank**

As one of three policy banks, China Development Bank (CDB) makes great efforts to facilitate SME financing. In 2005, CDB established a new business department to provide lines of credits and technical assistance to medium and small sized commercial banks (partner banks) that were interested in establishing new lending departments specializing in Micro, Small and Medium Enterprises finance. CDB cooperates with World Bank and Kreditanstalt für Wiederaufbau Bankengruppe (KfW) and imports international experts on lending to micro and small enterprises. In effect, CDB intends to serve as an anchor to the necessary and planned build-up of similar expertise among a new cadre of Chinese bank managers and lending officers, leveraging upon best practices in small-scale lending that have increasingly been adopted around the world over the last decade. Loans sizes are intended to be quite small relative to what is typically referred to as SME lending in China (where loan sizes above 1 000 000 are often cited). CDB is targeting loan sizes from as low as 100 yuans to a maximum of 500 000 yuans.

On November 2004, CDB had chosen Baotou commercial bank (one city in Nei Mongol province) and Taizhou commercial bank (one city in Zhejiang province) as two experimental units for application of her program heading “small enterprises’ financing and their commercial continuous development”. With foreign expert assistance, newly recruited loan officers are being trained and broader management capacity is being put in place to roll out the business throughout

the branch networks of these partner banks. Once the approach has been tested and refined in these and other pilot partner banks, it will be expanded to all provinces. CDB's stated goal is to be engaged with partner banks in all provinces by 2008.

Up to the end of 2006, CDB had granted credits to more than 68 000 SMEs and sole industrial & commercial proprietorships (*getihu* enterprises), the stock of credits to them was 23.2 billion yuans, which created 590 000 jobs. Credit recover rate (principal and interests included) is always 100% for 13 successive quarters. In addition to direct lending to SMEs, CDB supports also credit guarantee institutions (at all level and with different ownership structure) and enhances their guarantee capability in order to indirectly lead commercial financial institutions to increase their lending to SMEs. Up to the end of 2006, CDB had granted 9.3 billion yuans of credits to 154 credit guarantee institutions. Moreover, CDB had granted re-guarantee to more than 1 000 SMEs.

- **Asian Development Bank**

In 2005, Asian Development Bank granted credits of 32.5 million dollars & 2.5 million euros to Business Development Bank¹² which would be used to increase credits to SMEs. She has also cooperated directly with private enterprises in mainly three forms: direct investment, buying actions, granting guarantee for them. Concerning buying actions, she has to purchase more than 20% of actions in enterprises in order to attract other investors.

4.4 SME Board in Shenzhen Stock Exchange

At present, there are 119 listed SMEs¹³. Their growth is very impressive. Up to the end of January 2007, SMEs have totally issued 16 billion shares (6 billion negotiable shares)¹⁴; market value has reached 277 billion yuans (96 billion yuans for negotiable shares). They have raised capitals of 17.8 billion yuans in 2006, which account for 0.09% of GDP. SMEs in manufacturing sector have a significant part in this market.

¹² A foreign bank which serves mainly for lending to medium enterprises in dollars in Shanghai and in coastal provinces around Shanghai.

¹³ Up to March 3, 2007.

¹⁴ From July 2004 to January 2007.

According to an analysis of annual reports 2006 for 116 enterprises¹⁵ in the end of February 2007, the average income from principal operations is 1 061 310 000 yuans with a growth of 30.13% against 2005. Net profit in 90 enterprises increased, with an average of 60 330 000 yuans and a rising of 25.16%. Return per action reached 0.43 yuans. More than 40 enterprises have a growth rate of net profit higher than the one of income from principal operations. Return on net assets is between 6% and 10% in 33 enterprises, and exceeds 10% in 66 enterprises. There are 6 enterprises which have a return per action more than 1 yuan, 33 with 0.5-1 yuans, 57 with 0.2-0.5 yuans, 20 with less than 0.2 yuans. Only one enterprise is in loss.

Table 2 – SME board per sector

Sector	Number of listed SME (Jan 2007)	PER (price earning ratio) (Jan 2007)	Turnover volume: Share million (2006)	Turnover value: RMB million (2006)
Agriculture	3	47.98	2.27%	4.42%
Mining	0	0	0%	0%
Manufacturing	88	46.02	78.30%	71.95%
-Food & Beverage	2	29.34	0.99	1.25%
-Textiles & Apparel	10	46.49	4.62%	3.14%
-Timber & furnishing	1	26.75	0.60	0.34%
-Paper & Printing	5	34.21	2.72%	2.31%
-Petrochemical	16	36.81	7.78%	7.31%
-Electronic	9	46.37	4.40%	6.47%
-Metal & Non Metal	13	53.17	5.39%	5.39%
-Machinery	19	56.85	7.58%	7.68%
-Pharmaceutical	8	49.35	2.31%	2.60%
-Other	5	58.63	1.18%	1.24%
Utilities	1	32.89	1.72%	1.11%
Construction	3	36.38	2.36%	2.15%
Transportation	2	26.87	3.67%	2.83%
Information & Technology	8	48.49	4.54%	6%
Wholesale & Retail	2	121.77	1.98%	5.95%
Financials	0	0	0%	0%
Real Estate	0	0	0%	0%
Social Services	3	46.6	4.38%	4.89%
Media	0	0	0%	0%
Conglomerates	1	31.02	0.76%	0.70%
Total	111	51.12	29677.52765	307155.4766

Source: CEIC

5. SME financing by informal finance

5.1 China's informal financial markets

¹⁵ There were 116 listed enterprises up to the end of February 2007. There are three enterprises which have just gone public on March 2, 2007.

The growth in informal finance has been stimulated in recent years by the difficulties of SMEs and farmers in getting credits from the formal sector. According to the first nationwide survey on informal finance in 20 provinces driven by Central University of Finance and Economics, at the end of 2003, the size of informal financial sector stood between 740-830 billion yuans or equivalent to 31-35% of corporate borrowing from formal banking sector or 5.5-6.2% GDP in that year. While in absolute terms, Guangdong province and Wenzhou City in Zhejiang province have the largest outstanding stock of informal finance (500 billion and 150 billion yuans respectively), the highest shares of informal finance in total finance are found in northeast provinces such as Heilongjiang and Liaoning, at around 30%. This survey indicates that in less developed western and central provinces, over 40% of SME financing comes from informal sources while in coastal areas, the corresponding share is 30%. Informal finance is particularly important in rural areas, where it supplies the bulk of credits to farmers¹⁶.

Informal lending can take various forms: lending by individual money lenders, enterprise mutual lending networks, pawnshops or underground financial organizations such as ROSCA (Rotating Savings and Credit Association), etc. The customers and hence the type of lending differ between northeast and south. In the south (defined as the south area of the Yangtze River), where the informal finance serves mainly for the dynamic private economy, *qianzhong*, *yinbei*¹⁷ or other informal financial institutions are active. In the northeast, where the private economy is less developed, the most common form is *duifeng*, i.e. re-lending by the enterprises which can obtain credits easily to those which have difficulty of access to credits but which have potential and are in the rising cycle, so mainly by SOEs to members of firm associations. The member pays interest with a rate 1-2 times higher than banks' lending rate on the amount borrowed and 10% of credit as association fee which is a way to address the risk of non-repayment. Members can borrow only once or twice a year, the amount is 0.5-2 million yuans and most loans are for 3 months or 6 months.

¹⁶ In 2001, the agricultural sector received about 5% of total loans from the financial sector, about one third of its contribution to GDP. Rural enterprises received a further 5% of total loans, but again this is below their overall contribution to GDP.

¹⁷ The person who lends his money to the one who needs it, or who is intermediary between the one who has money and the one who needs it.

Informal finance, given its informal nature, is not regulated by the financial regulatory agency. It is important to note, however, that just because it is informal, it is not necessarily illegal. Usury lending is indeed illegal, but informal financial facilities which don't take deposit nor commit abuses appear to have been allowed to operate outside of formal regulation in recognition of the useful role they play. Borrowing by private enterprises from individuals is accepted as long as it is done from specified individuals rather than from the general public, and legal protection is extended up to an interest rate equal to four times the rate charged on comparable bank loans.

5.2 Informal finance's role for SMEs

The research group of Central University of Finance and Economics led by Professor Mr. LI Jian Jun had investigated 2 175 SMEs in 17 provinces¹⁸ and received 1 789 valid questionnaires¹⁹. According to this survey, the informal finance size for SMEs in East is smaller than those in Centre and in West, but the informal finance in East has more support in SMEs' businesses and production (Table 3 and Table 4). This reflects that the informal finance has been mainly used in SMEs' business and development in East, however in Centre and in West, many SMEs have raised illegal funds and worked as the intermediaries for others.

According to empirical analysis by MOLNAR and TANAKA (2007), receivables in firms' balance sheets serve as valuable collateral for their borrowing in informal financial markets. The size of receivables is an important determinant of informal borrowing. Concerning the regional dimension, only in Eastern region where the private sector is the most flourishing, the coefficient on receivables is significant. Within the coastal provinces (such as Jiangsu, Zhejiang and Fujian), the private sector is particularly important and informal financial institutions are widespread. The coefficient on receivables in this region is especially high, indicating that there is an effective market for receivables in these provinces. The results of estimation also suggest that the selectivity due to access to formal financing needs to be taken into account when examining informal borrowing. Moreover, unobserved factors that increase the probability of getting bank

¹⁸ 17 provinces in survey:

East (7) – Shandong, Hebei, Zhejiang, Fujian, Jiangsu, Beijing, Liaoning;

Centre (4) – Hunan, Shanxi, Heilongjiang, Hubei;

West (6) – Sichuan, Shaanxi, Guizhou, Qinghai, Yunnan, Nei Mongol.

¹⁹ They had been filled in by 105 enterprises' bosses, 567 enterprises' staff members and 1 117 sole industrial & commercial proprietorships (*getihu* enterprises).

loans are associated with larger informal financing. This finding suggests that informal financial institutions make an effort to reduce monitoring costs by exploiting the monitoring carried out by banks. At the same time, it may also suggest that many firms use informal finance to supplement their borrowing from banks.

Table 3 – SMEs’ informal finance size index in 17 provinces

SMEs’ informal finance size	coefficient	Choice %	Total	East	Centre	West
A.>=formal finance size	100	0.1828	18.28	17.39	20.30	21.61
B.<half of formal finance size	50	0.2610	13.05	11.88	15.10	18.01
C.<10% of formal finance size	10	0.4528	4.53	4.72	4.41	3.56
D. without informal finance	0	0.1034	0	0	0	0
Informal finance size index		1	35.86	33.99	39.81	43.18

Notes: 1) Choice %: percentage of enterprises in sample which have chosen such response;

*2) Total=coefficient*Choice %*

Source: China’s underground finance survey (LI Jian Jun, 2006), China’s underground finance size and its influence on macro-economy study (LI Jian Jun, 2005)

Table 4 – Informal finance supporting index for SMEs in 17 provinces

Informal finance’s role in supporting SMEs’ business and production	coefficient	Choice %	Total	East	Centre	West
A. a lot	100	0.3272	32.72	37.41	24.29	11.72
B. certain/some	66.7	0.3842	25.62	23.11	30.18	36.84
C. little	33.3	0.2042	6.8	6.29	8.4	8.5
D. none	0	0.0844	0	0	0	0
Informal finance supporting index		1	65.14	66.81	62.87	57.06

Notes: 1) Choice %: percentage of enterprises in sample which have chosen such response;

*2) Total=coefficient*Choice %*

Source: China’s underground finance survey (LI Jian Jun, 2006), China’s underground finance size and its influence on macro-economy study (LI Jian Jun, 2005)

6. Conclusion

The private sector has spread increasingly across the economy and emerged as its major driving force. The private enterprises have outpaced the public sector and produce more than a half of GDP. They account for close to 70% of international commerce and create three-fourths urban employment.

The growth of the private sector has been facilitated by an increasingly tolerant policy environment and widespread structural reforms. The State Council issued guidelines on February

2005 that encourage ministries and local governments to further improve the regulatory environment for private companies by facilitating their entry into many sectors that were previously heavily restricted, such as utilities, health and education, and national defense.

However, SMEs, which represent 98% of private sector, have always not adequate access to credits to develop in line with the needs of the economy. Limited information, lack of collateral, high risk, and great transaction costs make SME financing difficult. Ensuring adequate SME financing requires a range of measures, not only to improve the capabilities of lenders but also to provide supporting facilities to help them bear the risk and acquire the necessary information. Equally important, SMEs themselves need to improve their performance so that they become more creditworthy than they are now.

The major problem facing SMEs is that banks are reluctant to lend to them because of the lack of collateral. A credit guarantee program can be an effective means to improve access to credit for the private sector and to fill market gaps. To facilitate lending to a specific sector, credit guarantee schemes seek to reduce risks and transaction costs by supplementing bank credit analysis and pricing processes. They overcome limitations on the ability of businesses to provide acceptable collateral and to circumvent interest rate controls. Pooling a large number of loans in a large credit guarantee program offers risk-sharing advantages.

Interest-rate liberalization is a key to improve pricing risk capabilities in China's financial system. Furthermore, a publicly available credit information system and a nationwide collateral registry are strongly needed, and credit rating agencies' role on SMEs' evaluation should be strengthened. A SME credit service system is being completed and improved.

SME board has grown rapidly after its creation in 2004 and admitted 119 SME members undergoing substantial expansion or modernization of their capacities. It will have a more healthy development after equity division reform and help more SMEs to enlarge their financing channels.

Finally, informal finance plays a significant role in SME financing. But a key challenge is to build up an efficient and modern financial system with the co-existence of formal and informal financial institutions.

Resolving SMEs' financing problems and fostering their development are indispensable to stimulate China's economic growth and to develop a harmonious society.

ANNEX

Chinese Banking System

Central Bank

The People's Bank of China (PBC)

Four State-Owned Commercial Banks (SOCB)

Industrial and Commercial Bank of China (ICBC)

Agricultural Bank of China (ABC)

Bank of China (BOC)

China Construction Bank (CCB)

Three Policy Banks

China Development Bank

Agricultural Development Bank of China

The Export-Import Bank of China

Thirteen nation-wide Joint-Stock Commercial Banks (JSCBs)

Bank of Communications

China Citic Bank

China Merchants Bank

China Minsheng Banking Corp.Ltd

Hua Xia Bank

Shanghai PUDONG Development Bank

Shenzhen Development Bank

China Everbright Bank

Guangdong Development Bank

Industrial Bank

Bohai Bank

Evergrowing Bank

Zhejiang Commercial Bank

Postal Savings Banks

City Commercial Banks

Rural Commercial Banks, Rural Cooperative Banks, Rural Credit Cooperatives

Urban Credit Cooperatives

Foreign financial institutions

Trust and investment companies, finance companies and leasing companies

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