PANGÆA FINANCE
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RESEARCH COMPILATION:

SME & Private (non-SOE) Sector Credit Markets in China

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Law, finance, and economic growth in China ☆

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Abstract

China is an important counterexample to the findings in the law, institutions, finance, and growth literature: neither its legal nor financial system is well developed by existing standards, yet it has one of the fastest growing economies. We compare growth in the State Sector (state-owned firms), the Listed Sector (publicly listed firms), and the Private Sector (all other firms with various types of private and local government ownership). With poorer applicable legal and financial mechanisms, the Private Sector grows much faster than the State and Listed Sectors, and provides most of the economy's growth. This suggests that there exist effective alternative financing channels and governance mechanisms, such as those based on reputation and relationships, to support this growth.

" The Private Sector has been growing much faster than the others and has been contributing to most of the economy's growth. Our conclusion for the imbalance among the three sectors is that there exist effective, alternative financing channels … to support the growth of the Private Sector," (page 59) "We believe the most important reason for the [Private] growth is the work of alternative financing and governance mechanisms. " (page 96)

"… most of the bank credit is issued to companies in the State and Listed Sectors. Moreover, China's banking system is not efficient… " (page 70) "Private Sector Self-fundraising includes all forms of internal finance, capital raised from family and friends, and funds raised in the form or private equity and loans. Clearly, this category is by far the most important source of financing. " (page 82)

" In fact, not a single [Private] firm rates banks as very important or extremely important during their growth period. Financing from private credit agencies (PCAs), instead of banks, is the most important channel during a firm's growth period. These nonstate lenders usually charge very high interest rates and/or require a large amount of collateral on loans, and can force liquidation should the entrepreneurs default;" (page 95)

" …. there has been a boom in the entry and growth of non-state financial intermediaries, and this trend is expected to continue….." (page 77)

Allen, Franklin and Qian, Jun and Qian, Meijun, Law, Finance, and Economic Growth in China. *Journal of Financial Economics*, Vol. 77, No. 1, pp. 57-116, July 2005.

"The Private Sector dominates the State and Listed sectors in terms of both the size of the output, and the growth trend: the Private Sector grew at an annual rate of 14.3% between 1996 and 2002, while the combined State and Listed sectors grew at 5.4% during the same period . In addition, the growth rates for investment in fixed assets of these sectors are comparable , which implies that the Private Sector is more productive than the State and Listed sectors. " (pages 77, 78)

"The size of total self-fundraising of all firms grew at an average annual rate of 14% over the period of 1994 to 2002. Moreover, self-fundraising is the most important source of financing for many types of firms. For example, individually owned firms (Private Sector), not surprisingly, rely mostly on self fundraising (about 90% of total financing)." (page 80)

"Second, internal financing, in the form of retained earnings, is also important : Survey firms retained an average of 55% to 65% of their net income for reinvestment during the initial two to three years of existence. Third, funding from financial intermediaries is one of the most important sources for the surveyed firms."(page 94)

"China's banking system is much more important in terms of size relative to its stock markets, with its ratio of total bank credit to GDP (1.11) higher than even the German-origin countries (with a weighted average of 0.99). However, when we consider bank credit issued (or loans made) to the Private Sector only, China's ratio drops sharply to 0.24, suggesting that most of the bank credit is issued to companies in the State and Listed Sectors." (page 70)

"Given all other countries' measures are based on private bank credit only, if we only include China's private bank credit, we find that China's overall financial market size (''Finance activity'' and ''Finance size'') is smaller than the LLSV-sample average level, and is only higher than the French-origin countries' average. In terms of the efficiency of the financial system, China's measure is below all subsamples of LLSV countries. Based on the above evidence, we can conclude that China's financial system is dominated by a large but inefficient banking sector." (page 72)

"Panel B compares listed firms converted from the State Sector to those nonstate firms. First, 80% of the sample of listed firms used to be state-owned (921 out of 1163 firms). Second, the two groups of firms are similar in terms of most of the financial ratios except for leverage: Firms that used to be state-owned have much higher leverage than the other group, partially due to the large amount of bank loans accumulated in these firms prior to their IPO." (page 86)

"The evidence in Table 8C is consistent with previous evidence at the aggregate level: In terms of total equity, the listed Chinese companies do not rely on external markets as much as their counterparts in LLSV countries, but they do rely more heavily on debt, and in particular bank debt, than firms in LLSV-sample countries.." (page 88)

Tsai, Financing Small and Medium Enterprises in China: Recent Trends and Prospects beyond Shadow Banking. HKUST Institute for Emerging Market Studies: HKUST IEMS Working Papers, No. 2015-24, May 2015.

HKUST IEMS
INSTITUTE FOR EMERGING MARKET STUDIES

Financing Small and Medium Enterprises in China: Recent Trends and Prospects beyond Shadow Banking

Kellee S. Tsai

HKUST IEMS Working Paper No. 2015-24
May 2015

Abstract

Small and medium enterprises (SMEs) represent the backbone of China's economy, yet they lack access to bank credit. SMEs thus rely on a wide range of alternative sources, including informal finance, online peer-to-peer (P2P) platforms, registered non-banking financial institutions (NBFIs), and underground financiers. This paper distinguishes among different types of 'shadow banking' to clarify popular misconceptions about the nature of risks associated with informal financial intermediation in China. The evolution of SME finance in other contexts suggests that regulated and well-managed NBFCs provide an enduring foundation for commercialised financial intermediation even in advanced industrialised economies.

"The paper makes three main arguments. First, the SME financing gap will persist as a systemic issue in China given that demand for SME finance is growing faster than its supply. Second, the services provided by NBFIs should not be conflated reflexively with shadow banking. Third, the evolution of SME finance in other contexts suggests that regulated and well-managed NBFIs provide an enduring foundation for commercialised financial intermediation even in advanced industrialised economies.," (page 2)

"The historical experience of advanced industrialised economies shows that while large corporations benefited from the establishment of formal banks and securities markets, a variety of NBFIs emerged to serve the particular financing needs of SMEs. Yet the rise of non-banking financial intermediation was not merely a transitory stage in the process of economic modernisation. To date, both SMEs and NBFIs play a vital role in high-income countries, and their economic contributions are especially evident in Asia, including China. " (page 3)

" Given these structural constraints on private sector borrowing from state banks, China's SMEs have depended on non-banking sources of credit since the earliest years of reform. In surveys of private businesses conducted during the mid-1990s and mid-2000s, over two-thirds of the respondents indicated that they had relied on some form of informal finance [Tsai, 2002]. More recent research indicates that reliance on non-banking financing mechanisms has not abated. A World Bank survey of 2,700 private firms in 2011 to 2013 found that only 25 per cent had bank credit and 90 per cent drew on internal financing [World Bank, 2012]. Within that period, a 2012 survey of SMEs in fifteen provinces conducted by China's Central University of Finance and Economics (CUFE) found that 57.5 per cent had participated in informal credit markets [Li and Hu, 2013]. The bi-annual national surveys private enterprises administered by the All-China Federation of Industry and Commerce [Various years since 1992] consistently find that 'accessing bank credit' is among the top self-reported challenges facing the private sector.. " (page 10)

"The reliance of China's SMEs on NBFIs and less institutionalised forms of informal finance is understandable given the challenges they face in accessing bank credit. China's SMEs are not unique in this respect. According to the International Finance Corporation (IFC), SMEs in emerging markets account for 60 per cent of the global SME funding gap (total funding required minus total funding received), yet SMEs receive only 20 per cent of the total credit extended in the world [Sheng, Ng and Edelmann, 2013]. Within the latter, NBFIs represent the primary source of institutionalised credit for SMEs.;" (pages 26 - 27)

Liu, Xiangfeng, Impacts of the Global Financial Crisis on Small and Medium Enterprises in the People's Republic of China (December 16, 2009). ADBI Working Paper No. 180.

ADBInstitute

ADBI Working Paper Series

Abstract

This paper conducts an in-depth analysis of the impacts of the global financial crisis on the People's Republic of China's (PRC's) small and medium enterprises (SMEs). It also provides relevant policy suggestions at the end. First, this paper reviews the impacts of the 1997 Asian financial crisis on the PRC's SMEs, evaluating the policy measures for coping with the crisis at that time and summarizing the relevant experiences. Second, it analyzes the impacts of the current global financial crisis on the PRC's SMEs, focusing the discussion on the causes of and resulting problems from SMEs' shrinking export markets via reduced export orders, rising operating costs, decreased efficiency, increased shutdowns, sharply rising unemployment, weakened investment confidence, broken lines of funding, and reduced resources. Third, the paper makes a preliminary analysis of the countermeasures taken by the government of the PRC, focusing on its support policies for SMEs and the problems exhibited in the implementation of those policies. Finally, the author makes policy suggestions for boosting the development of SMEs and puts forward relevant measures in the context of an SME credit guarantee, the expansion of financing institutions and channels, tax reductions, the improvement of service systems, and strengthening SMEs' self-construction mechanisms.

"Since the onset of global financial crisis, the situation has become more severe. The crisis has dramatically increased the financing costs from SMEs." (page 14)

"In 2008, the financial fees for industrial SMEs sales in Zhejiang Province with over CNY5 million in annual increased 26.9%, while interest increased 32.0% year on year… The monthly interest rate of non-governmental loans is generally over 1%, plus an asset appraisals fee, financial fee, and guarantee fee. The annual interest rate of non-governmental loans will generally fall between 20–30%. In general, financing costs have increased by 40–50%." (page 14)

"Most development funding for the PRC's SMEs comes from the capital of business owners and their internal retained profits, which are maintained at levels over 50–60%. Direct financing, such as corporate bonds and equity financing, accounts for less than 1% and bank loans account for around 20%.... Over 70% of short-term funds for all private enterprises will have to rely upon credit and loans from non-governmental sources. " (page 14)

"Although both the central bank and CBRC expressed their intent to strengthen the credit support for SMEs, banks remain reluctant to issue loans to SMEs if the government does not provide the final guarantee and bear the losses of banks . In addition, it is difficult to launch small loan companies, which both takes a long time and requires business development.." (page 18)

Liu, Xiangfeng, Impacts of the Global Financial Crisis on Small and Medium Enterprises in the People's Republic of China (December 16, 2009). ADBI Working Paper No. 180.

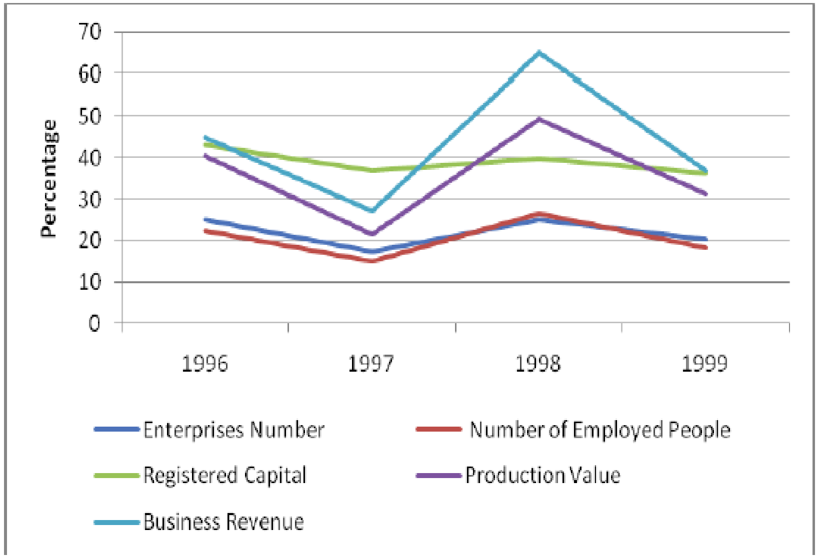
"**IMPACTS OF THE 1997 ASIAN FINANCIAL CRISIS ON SMES IN THE PEOPLE'S REPUBLIC OF CHINA**"

"Although there was a downturn in SMEs in 1998, their various indicators maintained relatively high growth rates." (page 8)

"Clearly, private enterprises were encouraged by the rapid growth of production values, especially micro-small enterprises since their production values were generally the same as those of SMEs and their sales several times more than those of SMEs. Consequently, micro-small enterprises were fast in responding to the market and able to make quick adjustments." (page 6)

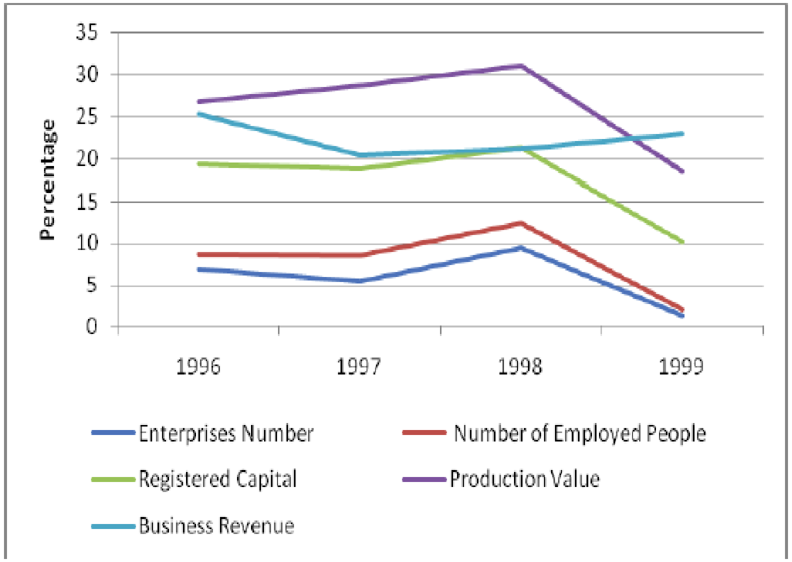
"…. the growth rate of the PRC's economy was 9.6% in 1996, 8.8% in 1997, 7.8% in 1998, and 7.3% in 1999.." (page 2)

Figure 4: Growth Rate of Related Economic Index of Small and Medium Private Enterprises 1996–1999 by Percentage Point



Source: PRC Industry and Commerce Association (2003).

Figure 5: Growth Rate of Related Economic Index of Micro-Small Private Enterprises in the People's Republic of China (%) 1996–1999



Source: PRC Industry and Commerce Association (2003).

"The efforts to support SME growth and development from the financial sector were not great in the PRC. In 1997, loans garnered by all private enterprises accounted for only 2.3% of the total bank loans. Even in Jiangsu Province, where all private enterprises were developed relatively well, the ratio of the balance of their bank loans to the various types of loans was only 4.8% in 1999, and in 2000 the ratio only slightly increased to 5.2%." (page 6)

Liu, Xiangfeng, Impacts of the Global Financial Crisis on Small and Medium Enterprises in the People's Republic of China (December 16, 2009). ADBI Working Paper No. 180.

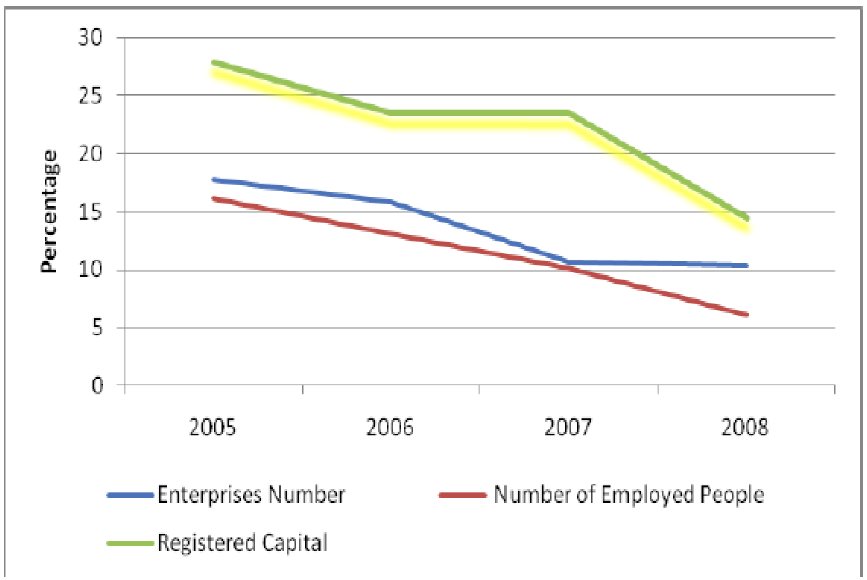
"**IMPACTS OF THE CURRENT FINANCIAL CRISIS ON SMES IN THE PEOPLE'S REPUBLIC OF CHINA**"

"The PRC's private enterprises have maintained a relatively high growth rate." (page 9)

"The current financial crisis has had two big impacts on SMEs in the PRC. The crisis has resulted in a sharply decreasing external need for export-oriented SMEs and more severe financial difficulties for all SMEs overall…. most SMEs are unable to obtain new loans from banks" (pages 12 – 13)

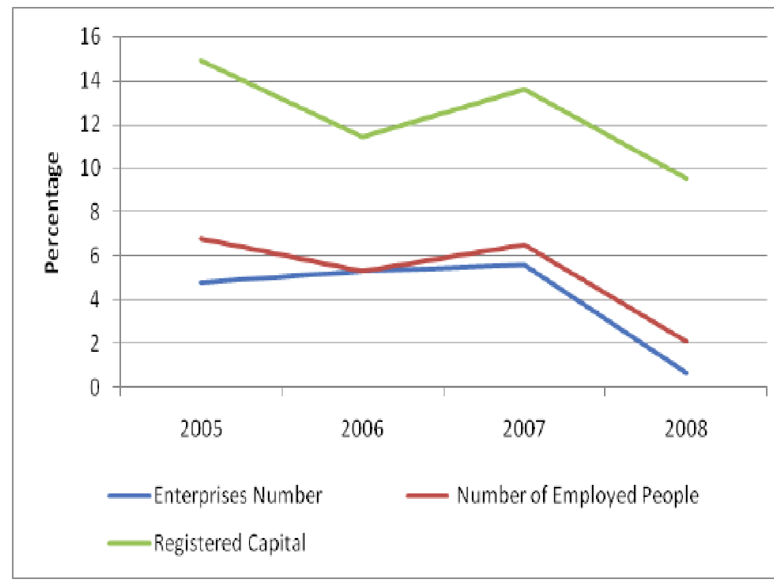
"….GDP growth rate in 2007 was 11.9% and quickly dropped to 9.0% in 2008. GDP grew at 6.1% in the first quarter of 2009, the worst performance in the PRC economy since 2002." (page 10)

Figure 7: Growth Rate of Related Economic Index of Small and Medium Private Enterprises 2005–2008



Source: PRC Industry and Commerce Association (2009).

Figure 8: Growth Rate of Related Economic Index of Micro-Small Private Enterprises in the PRC (%) 2005–2008



Source: PRC Industry and Commerce Association (2009).

"….the east coastal region being hit most severely. Most of the enterprises that were forced to shutdown were export-oriented SMEs." (page 12)

"To continue coping with the financial crisis and to assist the recovery of SMEs, the PRC government has taken a series of measures …." (page 15)

Shimamura, Takeshi. “Chinese credit investment opportunities and risks.” Nomura Research Institute (lakyara vol. 167). May 2013

NRI FinancialSolutions

lakyara vol.167

Chinese credit investment opportunities and risks

Takeshi Shimamura

30. May. 2013

Chinese credit investment opportunities and risks

by Takeshi Shimamura May. 2013

Some funds are starting to pursue relatively high returns by lending money to credit-starved Chinese SMEs. Although the potential returns are attractive, such lending poses practical challenges.

“While the supply of credit is thus growing, it is not evenly distributed throughout the Chinese economy. Rather, it flows disproportionately to large corporations. Exhibit 1 provides a simplified overview of the status of credit supply by type of company.” (page 1)

“Bank lending, like bond issuance, is skewed toward large companies.“ (page 2)

Exhibit 1: Overview of credit supply in China

Type of borrower	Credit supply			Interest rate level
	Bonds	Loans		
		Bank	Nonbank	
Large companies	○	○	—	Low to moderate
SMEs	×	△	△	High

N o t e: O = sufficient supply; Δ = insufficient supply; × = virtually no supply
Source: NRI, based on PBoC, China Bond Information Network, and interview survey data

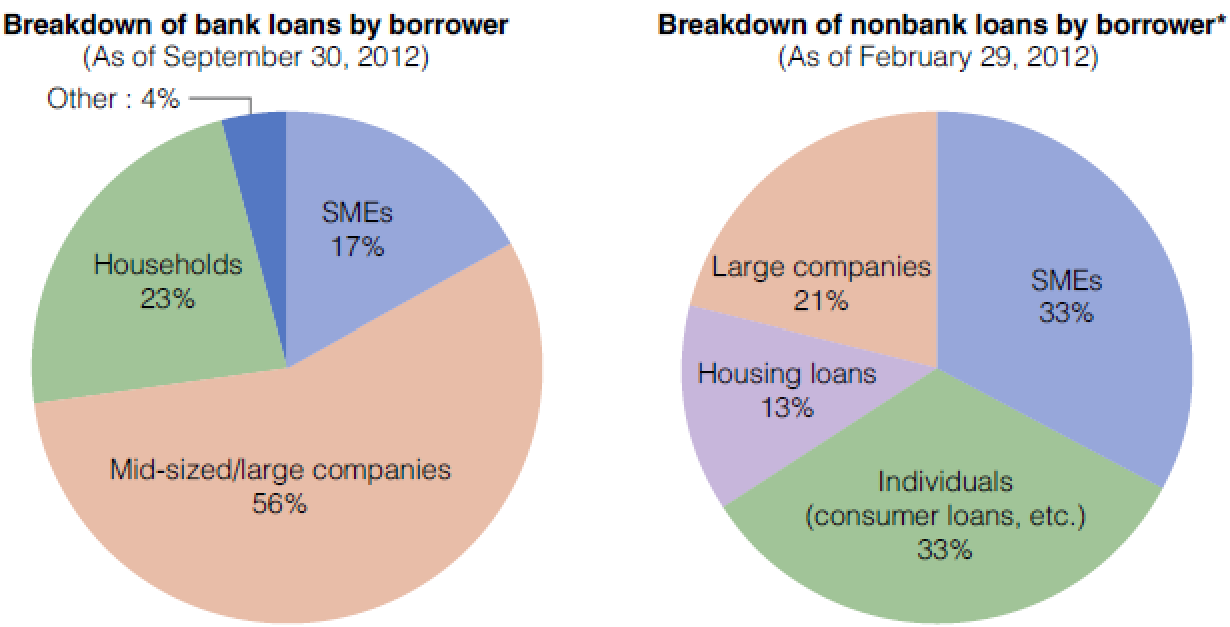
Shimamura, Takeshi. "Chinese credit investment opportunities and risks." Nomura Research Institute (lakyara vol. 167). May 2013

"While the Chinese economy appears at first blush to be amply supplied with credit, small companies are credit-constrained ….

"In fact, in Wenzhou, a city with an active nonbank lending market, the average interest rate on aggregate outstanding loans is 20.86%, far above banks' one-year base lending rate of 6%…. Wenzhou borrowers, many of which are SMEs, are forced to pay high interest rates because the supply of credit is insufficient to meet SME demand for funds." (page 2)

"Secured lending to Chinese SMEs offers attractive potential returns, but investors must conduct thorough due diligence on investment opportunities in light of practical challenges….For Japanese and other foreign investors, finding a partner with the requisite operational capabilities and experience in the Chinese credit market may be a realistic first step." (page 3)

Exhibit 2: Breakdown of outstanding loans in China by borrower



*Note: For the breakdown of nonbank loans by borrower, we used data for Wenzhou, a city with an active nonbank lending market.

Source: NRI, based on PBoC and interview survey data

Degryse, Hans and Lu, Liping and Ongena, Steven, "Informal or Formal Financing? Or Both? First Evidence on the Co-Funding of Chinese Firms " (June 2013). Centre for Economic Policy Research (CEPR); *CentER Discussion Paper Series* No. 2013-034

Centre for Economic Policy Research

Abstract

The recent financial crisis has reopened the debate on the impact of informal and formal finance on firm growth in developing countries. Using unique survey data, we find that informal finance is associated with higher sales growth for small firms and lower sales growth for large firms. We identify a complementary effect between informal and formal finance for the sales growth of small firms, but not for large firms. Informal finance offers informational and monitoring advantages, while formal finance offers relatively inexpensive funds. The simultaneous use of formal and informal finance, or co-funding, is the optimal choice for small firms. (100 words)

DP9519 Informal or Formal Financing? Or Both? First Evidence on the Co-Funding of Chinese Firms

Author(s):	Hans Degryse, Liping Lu, Steven Ongena
Publication Date:	June 2013
Keyword(s):	Co-Funding, Formal Finance, Growth, Informal Finance
JEL(s):	G21, G32, P2
Programme Areas:	Financial Economics
Link to this Page:	http://www.cepr.org/pubs/dps/DP9519

"39% [of Private firms in Survey] use neither informal nor formal finance (apparently financing everything out of pocket)."

"11% of the firms rely solely on informal finance, while half of the firms access formal finance (36% employ only formal finance and 14% engage in co-funding (use both informal and formal finance))…." (page 18)

" China's state-owned banks are inefficient in extending credit to the private sector due to substantial policy burdens, soft-budget problems, and substandard organizational structures. Moreover, all types of banks prefer lending to state-owned enterprises and large private firms…. Poorly performing firms are more likely to obtain loans from state-owned banks in China, pointing out an inefficient allocation and use of loans from state-owned banks. Moreover, the preferential treatment given by banks to state-owned and large private firms limits the access to bank finance by smaller private firms" (page 21 - 22)

"The distortion in the formal banking sector contributes to the vigor of the informal credit market…Chinese private firms rely less on bank loans to finance investments, and more on retained earnings and informal finance,." (page 12)

" Both the demand and supply of funds contribute to the development of the informal credit market, which funded about a quarter of total firm borrowing over the last decade.14 Appendix 2 shows that the proportion of self-financing and other sources (which includes informal finance) in fixed asset investment increased steadily over the past two decades, approaching the 80% level in recent years. As informal finance goes mainly to SMEs, informal finance plays a significant role in sustaining China's high economic growth.." (page 12)

Degryse, Hans and Lu, Liping and Ongena, Steven, "Informal or Formal Financing? Or Both? First Evidence on the Co-Funding of Chinese Firms " (June 2013). Centre for Economic Policy Research (CEPR); *CentER Discussion Paper Series* No. 2013-034

"The negative impact of finance obstacles is stronger for small firms. Thus, financial development exerts a disproportionate positive effect on small firms ." (page 7)

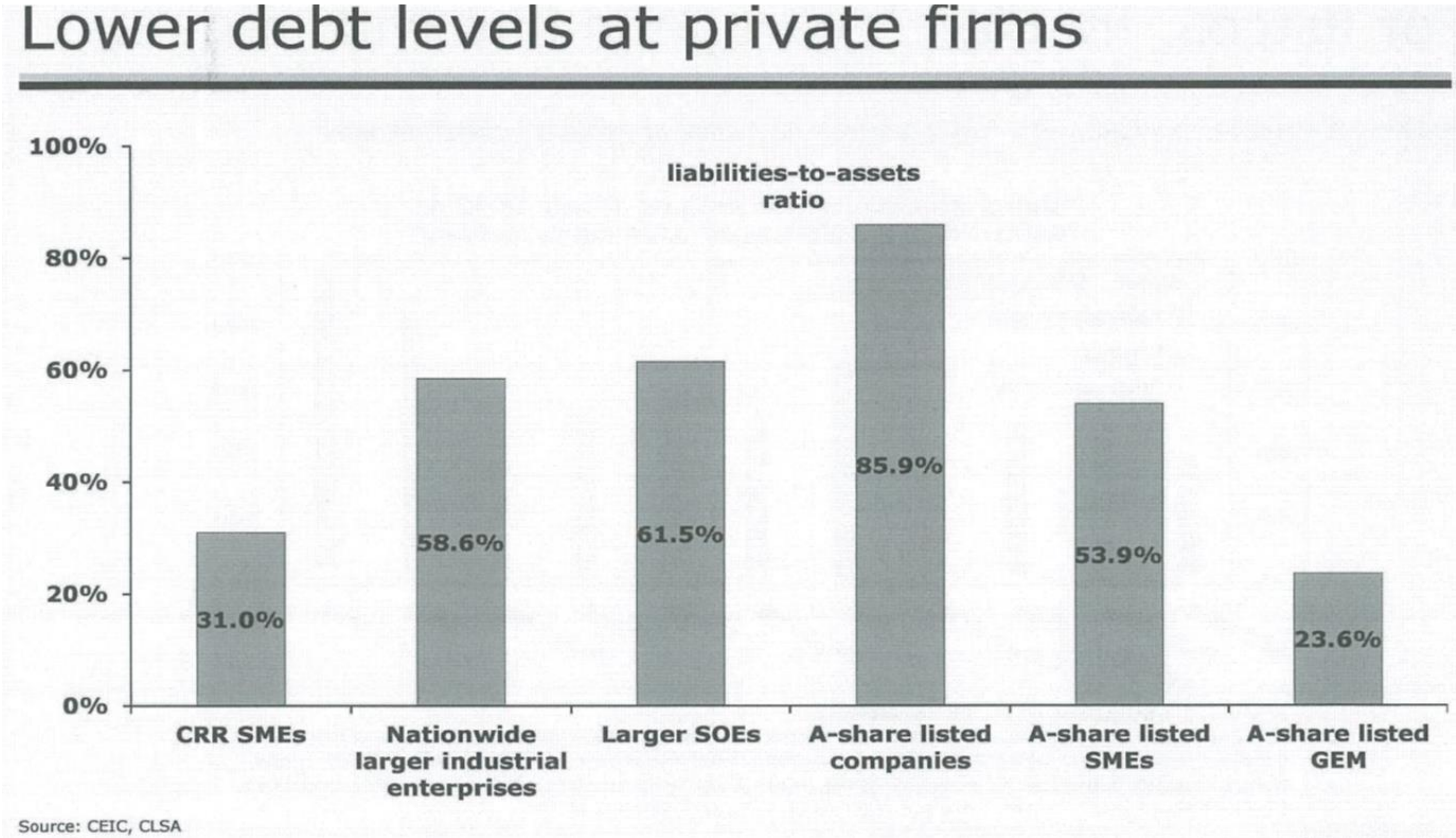
"We identified a complementary effect between informal and formal finance for small firms….." (page 35)

"The co-existence of informal and formal finance for the same firm may be an optimal choice for small firms, which may explain the persistent existence of informal credit markets in emerging economies such as China, where information asymmetries may remain fairly severe….While information asymmetries make lending to small firms difficult for banks, the problem can often be surmounted through the inclusion of informal finance in the mix." (page 35 - 36)

"Co-funding is found to be an optimal choice for both informal and formal lenders (Jain, 1999), as well as a Nash Equilibrium under the strategic interaction between them (Andersen and Malchow-Møller, 2006). In particular, informal financiers employing their proprietary information can screen borrowers before the lending decision and monitor the borrowers after the loan has been granted. Formal finance, in contrast, induces lending at a lower interest rate on the condition that a monitor is on board. " (page 9)

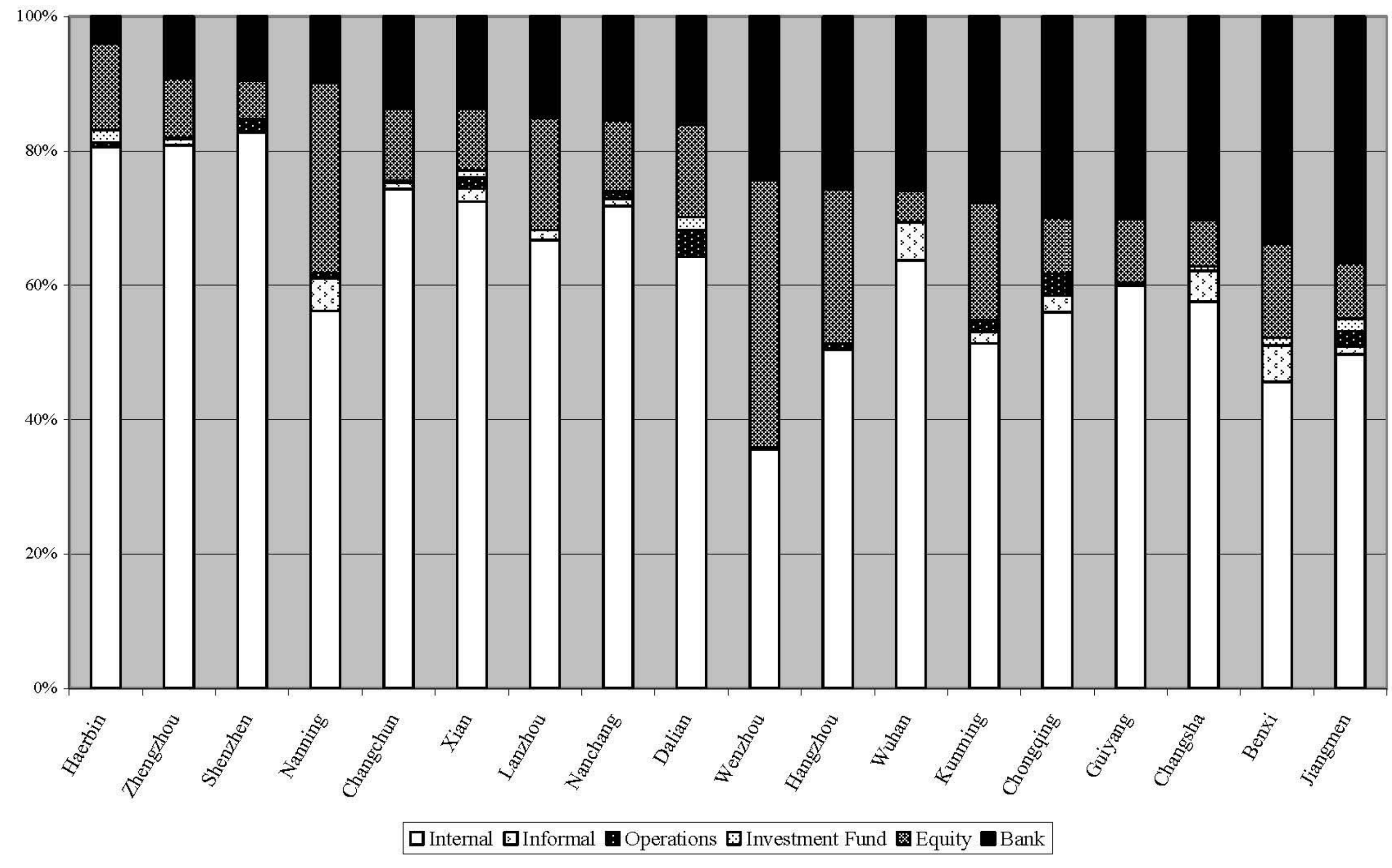
"In sum, the co-funding equilibrium as an optimal choice for both type of lenders will be sustained under various circumstances.." (page 10)

Rothman, Andy. "How to Think about China: slower growth with difficult problems, or crisis?" CLSA Investor Forum, September, 2013



Ayyagari, Meghana and Demirgüç-Kunt, Asli and Maksimovic, Vojislav, Formal versus Informal Finance: Evidence from China (January 1, 2008). World Bank Policy Research Working Paper Series, Vol. , pp. -, 2008.

Figure 2: Aggregate Financing Patterns across Chinese Cities



Chong, Terence Tai-Leung, Liping Lu, and Steven Ongena. "Does banking competition alleviate or worsen credit constraints faced by small-and medium-sized enterprises? Evidence from China." *Journal of Banking & Finance* 37.9 (2013): 3412-3424.

Journal of Banking & Finance
Volume 37, Issue 9, September 2013, Pages 3412–3424

Does banking competition alleviate or worsen credit constraints faced by small- and medium-sized enterprises? Evidence from China

Terence Tai-Leung Chong[a], Liping Lu[b], , Steven Ongena[b, c]

Abstract

Banking competition may enhance or hinder the financing of small and medium-sized enterprises. Using a survey on the financing of such enterprises in China, combined with detailed bank branch information, we investigate how concentration in local banking market affects the availability of credit. We find that lower market concentration alleviates financing constraints. The widespread presence of joint-stock banks has a larger effect on alleviating these constraints, than the presence of city commercial banks, while the presence of state-owned banks has a smaller effect.

“Table 5 presents summary statistics for the credit constraints measures, and the explanatory and control variables. The sample firms have a mean ROE of 0.30, which indicates a high profitability for SMEs….”

“The mean value of DGAP and GAP are 81.70 and 64.22 percent respectively. **Put differently, 81.70 percent of the [SME] firms face credit constraints while 64.22 percent of the credit required by the firm is not met by credit supply, which is consistent with the usual claims by SMEs about their financing challenges.**” (page 21)

“The Chinese government has long recognized the problem and tried to help SMEs in obtaining bank financing in the past decade. It even added SME financing to the national development agenda which resulted in the “SMEs Promotion Law” in 2003. However, SMEs financing difficulties persist according to a government report in 2005 based on a survey of 3,000 SMEs. Among the SMEs owners that responded, 79.50 percent of them rated financing environment as “not changed” or “deteriorating” compared with the years prior to 2005. Furthermore, this proportion was as high as 90.90 percent in the western China, which is relatively less developed. Hence SME financing difficulties may have never been fully solved by the implemented government policies.“ (page 3)

“…. the Chinese banking market is rather highly concentrated compared to other economies.” (page 21)

Zhao, Hongjiang; Wu, Wenxu; Chen, Xuehua (2006) : What factors affect small and medium-sized enterprise's ability to borrow from bank: Evidence from Chengdu City, capital of South-Western China's Sichuan province, Working Papers of the Business Institute Berlin at the Berlin School of Economics (FHW-Berlin), No. 23

Zhao, Hongjiang; Wu, Wenxu; Chen, Xuehua

Working Paper
What factors affect small and medium-sized enterprise's ability to borrow from bank: Evidence from Chengdu City, capital of South-Western China's Sichuan province

Working Papers of the Business Institute Berlin at the Berlin School of Economics (FHW-Berlin), No. 23

Provided in Cooperation with:
IMB Institute of Management Berlin, Berlin School of Economics and Law

Abstract

There are many factors that affect SMEs' ability to borrow from bank. Based on facts and data about SMEs' financing in Chengdu city, capital of Southwestern China's Sichuan province, this paper is intended to investigate the factors affecting SMEs to borrow from bank by methods of empirical study. We find that whether SMEs can provide collateral or guarantee is a decisive factor, factors such as firm size, willingness to accept bank's clauses, close relationship with bank play an important role. But in contrast to intuition, correlation analysis and regression result shows that SMEs' financial variables such as income, net profit, asset-debt ratio and credit score is not obvious to affect their ability to get bank loan. Consistent with theory prediction and qualitative analysis, firm size is the most important factor to affect SMEs' ability to borrow from bank. The regression results reflect information asymmetry between SMEs and banks, and that banks had taken a simple way to protect themselves.

"The Financial gap of SMEs. From Table 2, we can see that 129 of total sample 342 SMEs, 37.7% of total sample once got loan from bank, 213 of the sample, 62.2% of which have not yet gotten bank loan.." (page 12)

Table 2
Percentage of SMEs who once got or did not get loan from bank

	observation	Percentage (%)
SMEs who have gotten loan from bank	129	37.7
SMEs who have not yet gotten loan from bank	213	62.2
Total	342	99.9

Cinda International; Cinda International Research Ltd. “SME Financial Services in China: Institutional Framework and Emerging Opportunities.” 2013

信達國際 CINDA INTERNATIONAL

SME Financial Services in China:

Institutional Framework and Emerging Opportunities

Rapid growth in the non-bank financing sector creates opportunities

We estimated that the CAGR for new loan from non-bank channels grew at 32.8% during 2008-2012, far exceeding new RMB bank loan growth of 13.7%. This is due to the government's promuglation of new regulations on non-bank financing institutions. As a result, the sector grew rapidly, for example, small loan companies experienced 98% and 51% growth in loan during 2011 and 2012, and finance leasing companies recorded 40% growth in receivabes during 2011. We believe that the industry is in its infancy and will grow substantially, but the industry is still quite fragmented with yet non-existence of national players.

Significant opportunity as well as risks

Considering their ability to meet SME demand and likely policy changes, we forecast that the small loan industry will grow the fastest among those subsectors, followed by financial leasing, pawn loan, and loan guaranty. We expect industry growth rates to range from 17-30% CAGR from 2012-16, significantly higher than the expected growth of 10.5% for commercial bank loan.

“Barriers of bank financing for SMEs include: 1. Evaluation of business nature, loan usage, registered capital and credit history; 2. Lengthy and complicated credit approval; 3. Prudent and rigid policies – regulators make it difficult for banks to offer flexible products, such as unsecured lending and short-term bridge loans. For SME loans, commercial banks accepts only real estate collaterals, and they almost do not provide loans based on business cashflow or inventories; 4. Government policy preferences dictate loan allocation – companies in industries not currently favoured by the government (e.g. property development and energy-intensive manufacturing) find it very difficult to obtain credit; 5. No automatic loan renewal mechanism; 6. Reluctance to provide short-term financing. “ (page 10 - 11)

Cinda International; Cinda International Research Ltd. "SME Financial Services in China: Institutional Framework and Emerging Opportunities." 2013

Exhibit 7.:SMEs' financing needs not satisfied by commercial banks

Financing needs	Situation	Banks' limitation in satisfying such needs
Working capital	Production expenses for a confirmed order	Loan approval process is complicated and lengthy
Bridging loan	Extension of a certain loan	Banks require repayment in full before approving a new loan
Deposits for tender	To show capable for taking up a project	Banks require business plan and operation rights before grantinga loan
Tax expenses	Tax can't be made due to cash flow problems	Tax payment seldom an allowable loan purpose by China banks

Source:CIRL

Exhibit 9.: Commercial banks vs. non-bank financing institutions

	Non-bank financing institutions	Banks
Regulator	MOFCOM, local Bureau of Financial Work	CBRC
Loan type	Pawn loan, small loan, entrusted loan, financial leasing	Retail loan, corporate loan
Objectives	Prevent loan losses Smooth foreclosure Efficient approval process	Prevent delinquency Capital management (against risk) NIM management (against funding cost)
Risk management	Collateral protection	Client's borrowing/banking record Understanding of funding use Evaluation of business Collateral protection
Policy factors affecting loan business	Nil	Government policies (industries prefered by the state) Monetary policy (loan quota imposed by CBRC)
Preferred clients	SMEs with solid assets	SOEs
Usual time required for loan approval	2-7 days except financial leasing	1 month or more
Duration of loan	Below 6 months except financial leasing	1 year or longer

Source: CIRL

Cinda International; Cinda International Research Ltd. "SME Financial Services in China: Institutional Framework and Emerging Opportunities." 2013

" **Government policies – the road ahead:"**

"After establishing regulations on each segment of the non-bank financing industry, we believe the government will continuously fine-tune those regulations and roll out focused policies. Apart from supporting SMEs, the government also intends to bring underground finance back under surveillance by formalizing alternative finance institutions such as small loan companies and pawn loan companies, in our view. The evolution of government policies should reflect this intention. Also, we will likely see more initiatives to help the financing of those institutions "

"Higher leverage for certain non-bank financing institutions. So far, there are only a few provinces which allow small loan companies to obtain borrowing fund more than 50% of registered capital. Currently the ratio for small loan companies is even lower than for pawn loan companies. Also the government may take more active role in encouraging commercial banks to provide additional fund to non-bank financing institutions (whether equity or direct lending), such that their corporate governance and risk management can be further improved."

"Relaxing restrictions on shareholding. For small loan companies, the regulation announced in 2008 stated that single individual or corporate shareholders of small loan companies should not hold stake more than 10%. This has led to a lot of proxy holdings intended to circumvent the shareholding regulation. Since 2010, some local governments have raised this percentage, such as Shangdong, Chongqing and Shanghai (to 25-30%)."

"Relaxing restrictions on interest rate: Current maximum interest rate allowed is 4 times the PBOC rate (i.e. currently 6% x 4 = 24%). Due to the strong demand, the active interest rate is usually higher than that, after taking into account "administrative fee" charged which is effectively part of the interest. We believe a reasonable relaxation of this would bring more transparent and flexible pricing to segregate good and bad borrowers. Note that the maximum interest rate allowed for money-lenders in Hong Kong (equivalent to small loan companies in China) is 60%, and for pawnbrokers is ~42% per annum, which are far higher than that in mainland China.."

(page 15)

Smith Street Solutions research: "*China's Financial Industry*." 2009

SMITHSTREET SOLUTIONS

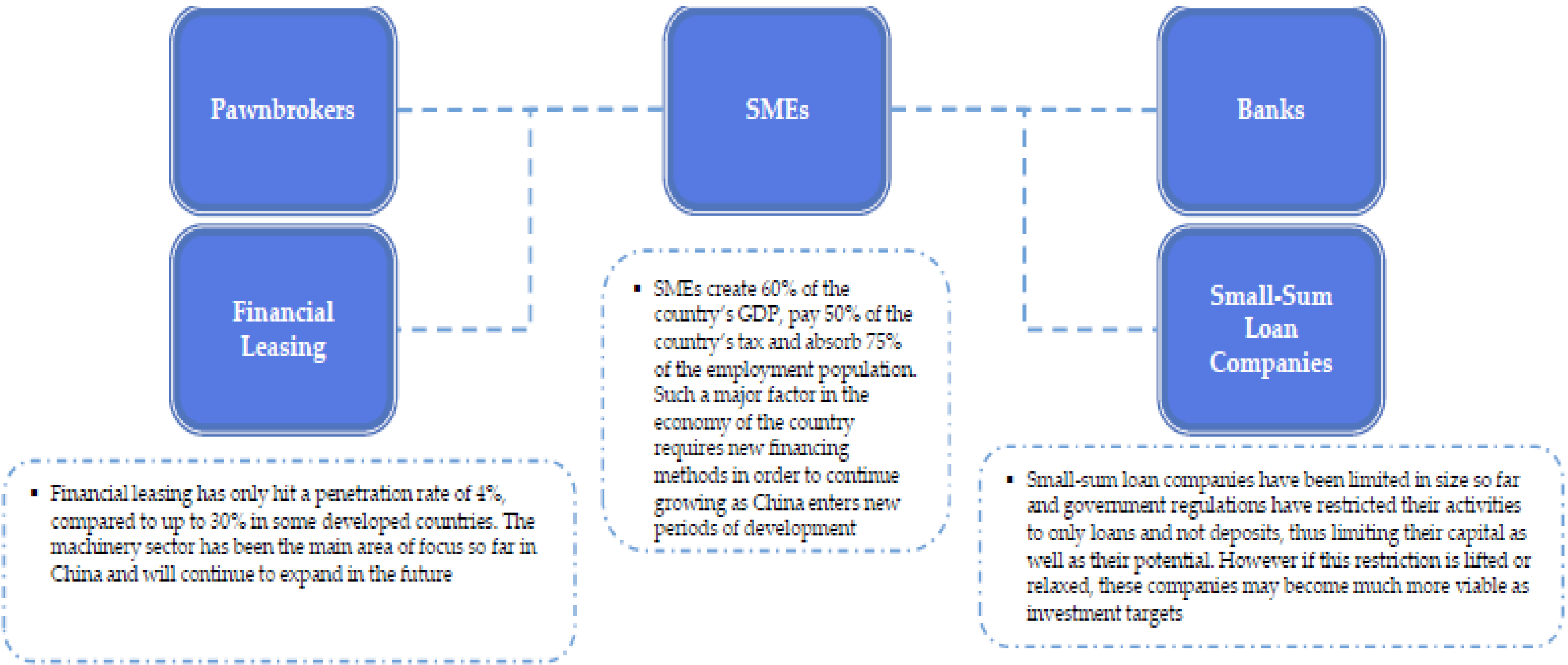
China's Financial Industry

Executive Summary

As the Chinese Financial System grows in terms of complexity and services offered, coupled with the increase in urbanization and SMEs, improvement in infrastructure and the rise of the affluent Chinese consumer leads to a multitude of investment potential in several areas.

1) Increase of Small Medium Enterprises

The growth of SMEs has been encouraged by the government and with this, new services and financial institutions have sprung up to fuel their need for loans, as well as a surge in lending from non traditional sources. Industries supporting the SME growth trend will be of great interest to investors.



Small-Sum Loan Providers

In China, SMEs make up more than 90% of the total enterprises in the country. For a long time, due to the difficulty of direct financing, SMEs main debt financing method has been to rely on indirect financing. Small-sum loan companies are a new government-backed financing method which mainly provides funds to support SMEs and agriculture including farming activities. Although small-sum loan financing in China has developed and made great progress over a period of more than 10 years, it is still on its initial stages with incomplete regulation and barriers to entry

Large Potential Market

- In China, SMEs take up more than 90% of total enterprises in the country, created 60% of the country's GDP, pay 50% of the country's tax, and absorb 75% of the employment population. The potential for expansion is huge
- Currently only 5% of bank loans go to SMEs because of their uncertain industry future and financial performance which make SMEs resort to the informal lending market. The PBoC estimates that private financing in China is about USD140 million, and up to 50% of the external financing of SMEs

Financial Leasing Market Overview

Compared to European and American markets, China's financial leasing market is still immature.

China's financial leasing industry, especially the construction machinery financial leasing market, has huge growth potential. Investment opportunities come from significant importance of infrastructure construction to the Chinese economy and China's determination to develop its domestic SMEs.

Low Penetration Rate Implies Development Potential

- Financial leasing penetration rates in European and American markets are about 15% and reach up to 30% in some countries. But in China, this rate is only 4%
- Low penetration rate indicates huge growth potential in Chinese financial leasing industry

China's Commitment to Expand GDP and Develop SMEs are the Main Investment Themes

- Fixed assets investment (FAI) is an important tool for China to push economic growth; equipment investment accounts for about 40% of FAI
- Financial leasing has a unique advantage in promoting the development of SMEs

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