



Report and Recommendation of the President to the Board of Directors

Project Number: 38908
January 2007

Proposed Equity Investment Credit Orientwise Group Limited

In accordance with ADB's public communications policy (PCP, 2005), this abbreviated version of the RRP excludes confidential information and ADB's assessment of project or transaction risk as well as other information referred to in paragraph 126 of the PCP.

Asian Development Bank

CURRENCY EQUIVALENTS

(as of 12 October 2006)

Currency Unit – yuan (CNY)

CNY1.00 = \$0.12
\$1.00 = CNY7.91

ABBREVIATIONS

ADB	–	Asian Development Bank
CAGR	–	compound annual growth rate
CGC	–	credit guarantee company
COG	–	Credit Orientwise Group Limited
CVCI	–	Citigroup Venture Capital International
EARG	–	Regional Cooperation, Governance, and Finance Division, East Asia Department
FATF	–	Financial Action Task Force
HYB	–	high-yield bond
IPO	–	initial public offering
IRR	–	internal rate of return
ITIC	–	international trust and investment corporation
NDRC	–	National Development and Reform Commission
OECD	–	Organization for Economic Cooperation and Development
OIH	–	Orientwise International Holding Limited
PBOC	–	People's Bank of China
PRC	–	People's Republic of China
PRCM	–	ADB Resident Mission in the People's Republic of China
PSOD	–	Private Sector Operations Department
SMEs	–	small and medium-sized enterprises
SOCB	–	state-owned commercial bank
SOE	–	state-owned enterprise
SWOT	–	strength, weaknesses, opportunities, and threats
TA	–	technical assistance
TIC	–	trust and investment corporation

NOTE

In this report, "\$" refers to US dollars.

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I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed follow-on equity investment of up to \$3.0 million equivalent in Credit Orientwise Group Limited (COG), an offshore principal holding company with subsidiaries operating as credit guarantee companies (CGCs) in the People's Republic of China (PRC) and specializing in guaranteeing loans for small and medium-sized enterprises (SMEs) and individuals.

2. In April 2005, the Asian Development Bank (ADB) invested \$10.0 million in COG.¹ The capital infusion was used to finance the expansion of the company's guarantee business through the increase in paid-in registered capital of COG's PRC subsidiaries.

II. BACKGROUND AND RATIONALE

A. Access to Credit for Small and Medium-Sized Enterprises

3. SMEs² play a significant role in the PRC economy and are key drivers of employment, economic growth, and development. They account for almost half of the gross domestic product (GDP), two-thirds of industrial value added, 60% of exports, and 40% of fiscal revenues.³ SMEs also provide 75% of urban and rural employment. Private SMEs have grown more quickly than the larger state-owned enterprises (SOEs). The industrial output of SMEs has been increasing at an average annual rate of 30%, compared to 20% for the industry as a whole.⁴ Consequently, the development of SMEs is an important engine of growth and a key contributor to poverty reduction by creating employment, increasing individual incomes, and generating tax revenues in the PRC.

4. SMEs rely heavily on access to external capital to finance their operations. However, more than 80% of the PRC's SMEs have difficulty accessing financial services and securing financing.⁵ Although bank loans in the PRC account for 70% of total external financing, as the corporate bond market is underdeveloped, only 30% of PRC SMEs have access to bank lending (mostly for working capital). Lack of access to bank lending is considered the main financing difficulty and a stumbling block for sustaining SME growth.

5. The limitation of banking services available to SMEs is mainly due to the following reasons:

- (i) State-owned commercial banks (SOCBs) are not geared to service SMEs, particularly private ones. PRC banks have a strong state-sector bias, and the perception prevails that SMEs are not creditworthy borrowers. This is especially true of the four big SOCBs that dominate bank finance in the PRC with 60% of total PRC bank lending, which have the reputation of being unwilling to lend to SMEs, as their traditional customers are large SOEs and shareholding companies.

¹ ADB. 2004. *Report and Recommendation of the President to the Board of Directors on a Proposed Equity Investment in Shenzhen Orientwise Guarantee and Investment Co., Ltd.* Manila.

² Medium-sized industrial enterprises are those with a maximum of 2,000 employees, CNY400 million in assets, and CNY300 million in sales. Small industrial enterprises are those with a maximum of 300 employees, CNY40 million in assets, and CNY30 million in sales.

³ ADB. 2003. *Private Sector Assessment in the PRC.* Manila.

⁴ ADB. 2004. *Technical Assistance to the People's Republic of China for SME Development and Finance.* Manila.

⁵ According to a survey by the State Information Center; ADB. 2004. *Technical Assistance to the People's Republic of China for the Development of Small Medium Enterprise Credit Guarantee Companies.* Manila.

- (ii) Other banking institutions have limited coverage and financial products and depend heavily on collateral. The high frequency and short-term nature of SME loans, unfamiliar markets, ownership structures that are often complicated, and lack of sufficient and reliable operational and financial data for loan appraisal have resulted in high business development and administration costs for banks.⁶ Because of the long process of recognition, registration, and evaluation for the SME borrower's collateral, banks have difficulty meeting SMEs' frequent and seasonal demand for debt.
- (iii) To reduce nonperforming loans, many commercial banks have adopted a policy of permanently assigning the responsibility of loan performance to the loan officers. This has resulted in acute risk aversion at the sub branch and loan officer level, curtailing loans to SMEs.
- (iv) The PRC does not have a diversified financial sector capable of serving SMEs, as financial institutions specialized to provide loans for SMEs are lacking.
- (v) Credit allocation is distorted by a continued policy of lending through government-owned banks and restrictions on competition from foreign financial institutions.
- (vi) Guarantees offered by the SMEs are often insufficient to support their borrowings. Real estate and equipment are the major forms of collateral taken by the banks. However, most SMEs, especially privately owned ones, cannot provide such collateral. In addition, the value of collateral available for loans is reduced following the discount at which banks value it. Based on a survey conducted by the People's Bank of China (PBOC), the discount rates are 50–70% for real estate and equipment.
- (vii) Most importantly, while PBOC allows bank lending rates for SMEs to deviate within a band from the lending base rate,⁷ the maximum rate remains insufficient to compensate banks for the higher risk that SME borrowers represent unless guaranteed by a third party of better credit standing.⁸

B. Role and Development of Credit Guarantee Companies

6. To ease constraints arising from the guarantee requirement for SME borrowing, business organizations, local governments, and individuals have been encouraged by the PRC Government to establish CGCs and so facilitate bank lending to SMEs. State-owned CGCs were first introduced in the early to mid-1990s, while private sector CGCs started receiving licenses by 1999. By end of 2006, the number of CGCs in the PRC is expected to exceed 3,000.

⁶ According to the State Information Center, over half of all SMEs lack proper financial management, and over 60% have a credit rating of BBB or worse. Over 80% of bank loans go to AAA or AA-rated enterprises. Over half of the SMEs have only a single product line, and 70% do not have a stable customer base. SMEs borrow five times more frequently than large enterprises. However, the average size of an SME loan is only about 5% of that of a large enterprise, and the administration cost is about five times higher.

⁷ Currently 1.7 times the base rate of 5.3%.

⁸ ADB. 2003. *Private Sector Assessment in the People's Republic of China*. Manila; International Finance Corporation. 2000. *The PRC Emerging Private Sector*. Washington, DC.; ADB. 2004. *Technical Assistance to the People's Republic of China for the Development of SME Credit Guarantee Companies*. Manila.

7. An estimated 60% of all bank loans in the PRC are supported by a guarantee of some kind. However, of these guarantees, approximately 90% are intra-group and parent company guarantees wherein an affiliated company guarantees the liabilities of other group companies, 5% are government guarantees, and only about 5% are provided by specialized CGCs, of which private sector CGCs account for only about 1% of guarantees outstanding.⁹

8. Of the approximately 8 million SMEs nationwide, CGCs currently serve only 48,000, or 0.6%. This mismatch of market demand and supply is a result of several factors: (i) most government-funded CGCs lack an optimal corporate structure or commercially oriented decision-making functions; (ii) the capital base of most CGCs is too small to meet the growing demand for credit to SMEs; (iii) with limited capacity to assess the risks associated with expanded guarantee products, many CGCs do not maximize the utilization of their capital bases, and those that are smaller or lack track records have limited credibility with banks and so need to pledge as collateral their own cash deposited with the lending bank for acceptance. As a result, most CGCs, especially those established for policy reasons, are small and inactive.

9. PRC CGCs do not have directly comparable counterparts in more developed markets, such as Europe. In more developed markets, working capital in SMEs, as in larger companies, is mainly obtained from the revenues generated by the enterprise (or by supplier credit, which often provides the SME with sufficient time to generate enough revenues to pay all its bills). If revenues do not optimally match the need for working capital, commercial banks provide credit lines to the SME. The flexible current account facility is the main banking product that is offered to SMEs. This loan may be guaranteed personally by the entrepreneur, particularly in the case of a recent customer relationship between the bank as lender and the SME, but guarantees from nongovernmental third parties are not commonly used. Banks in developed markets have deep and stable relationships with SMEs, a particular business focus on SMEs, and the ability to thoroughly evaluate and price SME credit risk. As these elements are still developing in the PRC banking sector, CGCs address a particular weakness and are very much justified as a sustainable business model until the PRC banking sector has made significant progress.

10. A few CGCs including COG have succeeded in filling this gap by creating thriving niches in specialized sectors where commercial banks lack experience or incentives for assessing SME credit risk. These CGCs have garnered credibility with banks and, as a result, enjoy less stringent requirements for cash deposits as security for loans. Such companies are widely seen as leading the development of the sector and assuming a greater role as financial intermediaries in the PRC (see Appendix 1 for a sector analysis of the credit guarantee market in the PRC).

C. Sector Policies and Regulations

11. The sector is not formally regulated but under the oversight of the National Development and Reform Commission (NDRC), which has issued *Guidelines on Developing the SME Credit Guaranty System*¹⁰ to facilitate the establishment of an SME credit guarantee system across the country. The guidelines also cover (i) prudential capital adequacy ratios (governing the maximum value of guarantees outstanding compared to registered capital); (ii) the maximum guarantee fee chargeable (as a maximum percent of the loan interest rate, which is itself regulated); and (iii) such other issues as risk management policies and limitation on geographic expansion. In

⁹ Discussion with PBOC and COG staff.

¹⁰ NDRC. 1999. *Guidelines on Developing the SME Credit Guaranty System*. Beijing.

addition, the Ministry of Finance has issued *Interim Administrative Measures on the Risk Management of SME Financing Guarantee Institutions, a Notice on Strengthening Financial Administration*,¹¹ and *Policy Support for SME Credit Guarantee Institutions by Local Finance Bureaus*¹² to clarify the government's risk management of, and policy support for, SME credit guarantee institutions. The Ministry of Finance is also working on draft accounting methods for guarantee institutions to enhance correct information disclosure.

12. Furthermore, administrative measures¹³ proposed in early 2004 contain more detailed guidelines. The proposed measures include the requirement for a minimum capitalization of CNY500 million for national CGCs, CNY200 million for province-wide CGCs, and CNY50 million for municipal CGCs. Moreover, to establish prudential operations, the measures propose that the guarantee-to-capital multiplier not exceed 10 times, and the maximum amount of a guarantee for any customer not exceed 10% of the CGC's net asset value. The proposed measures also stipulate that 50% of guarantee fees be set aside as reserves for outstanding liabilities and that annual provisioning be required for 1% of outstanding guarantee liability, up to an aggregate level of 10%.¹⁴

III. THE PROPOSED INVESTMENT

A. The Investee Company

13. COG, an off-shore holding company with several subsidiaries in the PRC, is a leading provider of guarantee products and services in the country. The company is primarily engaged in providing financial guarantees, entrusted lending, and related advisory services to SMEs and individual customers. It is one of the few CGCs with operations in multiple high-growth regions in the PRC including the Pearl and Yangtze deltas and Capital Economic Zone. Unlike many state-owned CGCs, COG provides guarantees only to private sector SMEs and individuals.

B. Previous ADB Investment and Engagement

14. In April 2005, the Asian Development Bank (ADB) invested \$10 million in COG.¹⁵ In October 2005, Citigroup Venture Capital International (CVCI) and, in March 2006, the Carlyle Group (Carlyle) each invested \$25 million as follow-on investments directly sourced and catalyzed by ADB. The capital infusion was used to finance the expansion of the company's guarantee business through the increase in paid-in registered capital of COG's PRC subsidiaries.

15. ADB has played an active role in the development of COG in the past 18 months through its board representation, especially with respect to (i) revamping its credit approval process, (ii) enhancing its information technology systems, and (iii) key hires of senior management personnel.

¹¹ Ministry of Finance. 2001. *Interim Administrative Measures on the Risk Management of SME Financing Guarantee Institutions, a Notice on Strengthening Financial Administration*. Beijing.

¹² Ministry of Finance. 2003. *Policy Support for SME Credit Guarantee Institutions by Local Finance Bureaus*. Beijing.

¹³ NDRC. 2004. *Provisional Measures on the Administration of Credit Guarantees for SMEs*. Beijing.

¹⁴ Further policy measures are in place with respect to reemployment guarantees and housing loan guarantees.

¹⁵ ADB. 2004. *Report and Recommendation of the President to the Board of Directors on a Proposed Equity Investment in Shenzhen Orientwise Guarantee and Investment Co., Ltd.* Manila.

C. Corporate Structure and IPO Plans

16. COG undertook a series of restructuring transactions in 2004 and 2005. The reorganization effectively created a holding company domiciled in the Cayman Islands,¹⁶ which is in line with standard Hong Kong market practice for listings by PRC companies.¹⁷

D. Business Description

17. Although COG has a market share of only about 2.4% in terms of registered capital, it is one of the largest private guarantee companies in the PRC. Its key businesses include corporate, individual, and performance guarantees; entrusted lending; and advisory services. The company does almost all of its corporate business with SMEs.

18. The underserved financing needs of SMEs and the PRC's underdeveloped credit culture have together acted as the key drivers behind COG's quick growth and the high profitability of its guarantee and entrusted loan businesses.

IV. PROPOSED ADB ASSISTANCE

A. Proposed Equity Investment

19. The proposed ADB investment will be in the equity capital of COG for a stake of up to 2.0%. The transaction will bring ADB's total equity stake in COG to 5.98%, from its current ownership stake of 4.81%. ADB will not acquire a stake in COG larger than 9.9% to avoid becoming a "substantial shareholder" or "connected party"¹⁸ under Hong Kong Stock Exchange listing rules.

¹⁶ The Cayman Islands' legal system is based on British law, and therefore the legal concepts are familiar and acceptable to international investors. The Cayman Islands comply with the standards set by the Organization for Economic Cooperation and Development (OECD) Financial Action Task Force (FATF). In addition, the Cayman Islands have responded to the "harmful tax practice" initiative of the OECD by giving an advance commitment to OECD, which kept the Cayman Islands off the OECD official list of tax havens published in June 2000. OECD has confirmed that the Cayman Islands system of no direct taxes is not in itself considered harmful.

¹⁷ Most PRC companies seeking a listing at the Hong Kong Stock Exchange incorporate their listed companies in the Cayman Islands. ADB's external counsel and COG's external counsel have confirmed that, in the present circumstances, a direct listing of COG as a PRC entity is not feasible, as listing would require, inter alia, transforming COG from a Sino-foreign joint venture into a "company limited by shares." This involves a highly bureaucratic process, which is why PRC companies tend to use an offshore jurisdiction accepted by the Hong Kong Stock Exchange. Among the possible choices (Hong Kong, Cayman Islands, or Bermuda), the Cayman Islands is generally regarded as desirable because (i) the legal requirements regarding capital reduction and the distribution of capital are less complicated than are those in Hong Kong, (ii) Hong Kong stamp duty is not chargeable for share transfers that take place prior to the IPO, and (iii) the Cayman Islands are FATF compliant and not on OECD's tax haven blacklist.

¹⁸ ADB plans to introduce best management practices and credit-risk procedures to COG, and PSOD and COG may also cooperate in further business development and will enter into a memorandum of understanding in this regard. However, if ADB owns more than 9.9% of COG at its initial public offering on the Hong Kong Stock Exchange, Hong Kong listing rules will (i) require shareholders' approval for each transaction between ADB and COG in the future and (ii) impose certain liabilities on ADB resulting from having a director on the board of Orientwise and ADB's mention in the prospectus. To avoid these liabilities, ADB decided to stay below the threshold of a connected party.

V. PROJECT BENEFITS, IMPACTS, ASSUMPTIONS, AND RISKS

A. Justification for the ADB Investment

1. Investment Objective

20. ADB's objective in the proposed investment is to reorganize COG's shareholdings. The proposed investment and the acquisition of certain minority shareholdings is essential to reorganizing COG's shareholdings, in order to bring the Company's planned IPO closer to realization. The follow-on investment is a clear signal of ADB's continuing support to COG especially at a time when market perception is critical. ADB's vote of confidence in the company will send a positive signal to the investment community regarding COG's credibility, which could attract strategic and business partners needed as the business model expands beyond the current guarantee products. A successful investment into, and exit from, COG will also demonstrate to other potential investors the attractiveness of investing in other strong CGCs, thus promoting private sector investment transactions in the CGC market.

2. Development Outcome

21. Given the current constraints in the PRC's financial market (i.e., a weak credit culture at state-owned banks, limited business scope, and rigid interest rates), CGCs that assess credit soundly, such as COG, are needed to fill the gap between viable and growing SMEs and their access to financing. Commercially viable SMEs that benefit from additional guarantees made possible by the increased capital base of COG will be supported in their expected growth and sustainable operations. As a result, employment at such SMEs can be sustained or increased, thus promoting job creation, economic growth, higher tax payments to the government, and poverty reduction

22. **SME Financing.** SMEs play a significant role in all of ADB's DMC economies and are key drivers of employment, economic growth, and development. They often have a significant impact on the gross domestic product (GDP) and in most cases grow faster than state-owned enterprises (SOEs). The development of SMEs is therefore an important engine of growth and a key contributor to poverty reduction by creating employment, increasing individual incomes, and generating tax revenues.

23. SMEs rely heavily on access to external capital to finance their operations. However, in most of ADB's DMCs, SMEs have difficulty accessing financial services and securing financing. Although bank loans are dominating any external financing (due to the underdeveloped corporate bond markets), only a small number of SMEs in the region have access to bank lending (mostly only for working capital). Lack of access to bank lending is considered in most DMCs as the main financing difficulty and a stumbling block for sustaining growth of SMEs.

24. The limitation of banking services available to SMEs is mainly due to the following reasons: (i) State-owned banks (like in the PRC) are not geared to service SMEs, particularly private ones; (ii) Other banking institutions have limited coverage and financial products. The high frequency and short-term nature of SME loans, unfamiliar markets, ownership structures that are often complicated, and lack of sufficient and reliable operational and financial data for loan appraisal have resulted in high business development and administration costs for banks. Because of the long process of recognition, registration, and evaluation for the SME borrower's collateral, banks have difficulties meeting the SMEs' frequent and seasonal demand for debt; (iii) To reduce nonperforming loans, many commercial banks have adopted a policy of permanently

assigning the responsibility of loan performance to the loan officers. This has resulted in acute risk aversion at the subbranch and loan officer level, thus curtailing the amount of loans to SMEs; (iv) In most of the DMCs a diversified financial sector capable of serving SMEs is lacking, i.e. focused financial institutions that are specialized to provide loans for SMEs are missing or only marginal market participants; (v) Credit allocation is in many markets distorted by continued policy lending through government-owned banks, and restrictions on competition from foreign financial institutions; (vi) Finally, in many instances regulated (domestic) bank lending rates do not allow domestic banks to price risks for appropriately and therefore shy away from this asset which is often perceived as highly risky. This is however in most cases contrary to reality, if appropriate protection is sought and thorough due diligence is undertaken. Appendices 14 and 15 discuss the development impact of SME finance and the SME financing gap in Asia, respectively.

25. **Financial Sector Development.** The credit-assessment skills found in COG will help to develop the PRC's credit culture, whether COG sustains its operations as an SME credit guarantor or its credit competency is eventually acquired and absorbed into a bank's credit department or extended into other, similar lines of business. A strong credit culture is crucial to strengthening the PRC's financial sector.

26. **Private Sector Development.** The support for the growth of a leading private provider of guarantee services will contribute to the shift away from government dominance of the sector toward a more market-oriented, private sector-led industry, which will promote sound risk-management practices and the efficient allocation of resources.

2. Value Added by Asian Development Bank

27. ADB's proposed investment will add value by (i) demonstrating the possibility of replicating such a model for financial intermediaries serving SMEs in the PRC and other developing member countries; (ii) catalyzing additional investments from outside sources (HYB and IPO investors) into COG as confidence rises as a result of ADB's investment and continuing commitment; and (iii) promoting best commercial practices and good corporate governance, ADB's direct involvement with COG and the firsthand experience thus gathered has led to enhanced policy support to the Government.

B. Environmental Aspects and Social Policies

28. COG has been classified as FI under ADB's environmental policy, and has (i) adopted an appropriate environmental management system comprising a policy and procedures; and (ii) is currently undergoing training in environmental impact assessment and auditing.

29. The investment is classified as category C with respect to indigenous people and involuntary resettlement safeguards. COG is not expected to cause any involuntary resettlement or affect indigenous people, as the guarantees are extended to SMEs mainly in urban areas.

C. Development Impact Measurement

30. ADB will measure the expected development impact of the investment. These performance measures follow the multilateral development banks' Evaluation Cooperation Group's Standards for Evaluation of Private Sector Investment Operations. Development impact is measured in three distinct categories: (i) business performance of the investment itself, (ii) economic sustainability, and (iii) private sector development. Appendix 3 shows the development impact framework.

D. Records, Auditing, and Reporting

31. COG will continue to (i) maintain accounting, management information, and financial control systems acceptable to ADB; (ii) maintain independent auditors from auditing firms licensed to operate in the PRC (the foreign shareholder of which will be an internationally reputable accounting firm) and acceptable to ADB, and will authorize auditors to submit financial statements to ADB at least annually and to be available to discuss these financial statements with ADB; (iii) maintain, in addition to PRC accounting standards, international accounting standards or any other accounting standards acceptable to ADB; and (iv) provide ADB representatives with access to all sites where the activities of COG are conducted as well as to its books, accounts, and records, as well as permit ADB, if and when it deems necessary, to engage auditors at its own expense to audit the accounts and accounting systems of COG.

E. Anticorruption Policy; Combating Money Laundering and the Financing of Terrorism

32. COG was advised of ADB's Anticorruption Policy and Policy relating to the Combating of Money Laundering and the Financing of Terrorism. Consistent with its commitment to good governance, accountability and transparency, ADB will require COG to institute, maintain and comply with internal procedures and controls following international best practice standards for the purpose of preventing corruption or money laundering activities or the financing of terrorism. It should be noted that COG already has in place a framework for training employees in the prevention of money laundering.

VI. LEGAL ASSURANCES

33. A framework agreement confirming ADB's status, privileges, and immunities with respect to ADB's equity investments and lending operations in the private sector is in effect between the PRC Government and ADB. ADB will seek the Government's "no objection" concurrence with the proposed additional investment in COG and will complete its investment only after the Government's acknowledgement has been obtained.

34. ADB will enter into a share purchase agreement and ancillary documents, following approval of the proposed investment by the Board. These agreements will be on terms and conditions satisfactory to ADB.

VII. RECOMMENDATION

35. I am satisfied that the proposed investment would comply with the Articles of Agreement of the Asian Development Bank and recommend that the Board approve the investment of up to \$3,000,000 equivalent for an equity stake in Credit Oriented Group Limited from the Asian Development Bank's ordinary capital resources.

Haruhiko Kuroda
President

16 January 2007

INDUSTRY OVERVIEW

A. The Credit Guarantee Market in the People's Republic of China

1. As one of the fastest growing major economies in the world, the People's Republic of China (PRC) presents significant potential for the credit guarantee industry. According to the National Bureau of Statistics, the PRC's gross domestic product (GDP) reached CNY18.2 trillion in 2005 and CNY9.1 trillion in the first half year of 2006. Total outstanding bank loans reached CNY22.8 trillion at the end of June 2006. However, in most cases, fast-growing SMEs have difficulty borrowing from banks because of their relatively weak credit history. Individuals also find it difficult to secure loans for business or personal consumption.

2. To address the needs of these potential borrowers, credit guarantee companies (CGCs) have emerged, and the number of CGCs has been significantly increasing in recent years. In addition, as economic activities in the PRC continue to expand in scale and volume, demand for performance guarantees as a hedge against counterparty risk is expected to grow.

B. Rapid Growth of the Small and Medium-Sized Enterprise Sector Creates Demand for the Corporate Guarantee Business

3. Since the PRC's economic reform and development began in 1978, the small and medium-sized enterprise (SME) sector has grown substantially. According to statistics of the National Development and Reform Commission (NDRC), from 2001 to 2004, the number of registered SMEs increased from 16,968 to 27,326, representing a compound annual growth rate (CAGR) of 17%, the revenues of these SMEs grew from CNY6,325 billion to CNY12,769 billion, representing a CAGR of 26%, and the net income increased from CNY264 billion to CNY643 billion, representing a CAGR of 35%. SMEs play a significant role in the PRC's economy and are key drivers of employment and economic growth. As of end 2005, SMEs were contributing 75.0% of employment opportunities, 74.7% of industrial output, 62.3% of exports, 58.9% of sales, 55.6% of GDP, and 46.2% of fiscal revenues in the PRC.

4. Table A1.1 sets forth the general criteria of SMEs in the PRC.

Table A1.1: General Criteria of SMEs in the People's Republic of China
(CNY Millions)

Industry	Number of Employees	Total Assets	Sales
Industry	<2,000	<4,000	<300
Construction	<3,000	<4,000	<300
Wholesale and retail	<500	—	<150
Transportation and delivery	<3,000	—	<300
Hospitality/food and beverage	<800	—	<150

— = not available, SMEs = small and medium-sized enterprises.

Source: Interim Provisions on the Standards of Small and Medium-Sized Enterprises, issued by the State Economic and Trade Commission, the Ministry of Finance and the National Bureau of Statistics of China on 19 February 2003.

5. SMEs rely heavily on access to external capital to finance their operations. Despite their significance to the PRC's economy, more than 80% of SMEs have difficulty securing financing, and only 10% of all SME loan demand is met by banks. According to NDRC, the rejection rate

of SMEs' loan applications by banks is over 56%, of which 23.8% are for lack of guarantees, and another 32.3% are for lack of fixed assets that can serve as collateral. One third of the funds for SMEs came from unofficial lending networks with financing costs ranging as high as 25% to 30%.

6. SME's limited access to bank financing can be attributed to their (i) small size and private ownership, (ii) lack of track records or audited financials, (iii) variable credit profiles, (iv) failure to provide fixed assets as collateral, and (v) lack of guarantors. Traditional financial institutions such as banks are reluctant to lend to SMEs as the former lack in-house risk-assessment capabilities and have insufficient industry knowledge, high risk aversion due to low tolerance for nonperforming loans, and internal requirements to obtain fixed assets as collateral.

7. Commercial CGCs emerged to bridge the gap between state-owned commercial banks' lending requirements and SME borrowers' qualifications by providing credit guarantees. Compared with banks, CGCs have flexibility to accept various types of collateral in addition to fixed assets, such as unlisted securities, and to offer more flexible repayment options.

C. Demand for Individual Guarantees

8. The real estate market and the fast-growing consumer sector—including household appliances and consumer electronics, automobiles, and home decorations—have been driving the individual guarantee business. According to the National Bureau of Statistics, at the end of 2005, the outstanding balance of residential mortgages in the PRC was \$228 billion, having shown a CAGR from 2001 to 2005 of 35.3%. Consumer retail sales grew from \$520 billion in 2001 to \$832 billion in 2005, representing a CAGR of 11.8%.

9. The structure of transactions in the secondary residential property market in the PRC creates business opportunities for CGCs. Demand arises because the PRC's mortgage lending rules require that a seller must discharge an existing mortgage before the seller's bank can release the home ownership certificate, without which a buyer's bank will not fund the buyer's mortgage loan. As a result, simultaneous closings at which a seller's repayment of his mortgage is funded by proceeds of a buyer's mortgage loan are not possible. By providing a guarantee to the buyer or the seller's bank so that the seller will have sufficient funds to discharge the existing mortgage, the CGCs facilitate these secondary residential property transactions.

D. Demand for Performance Guarantees

10. The PRC's building, infrastructure construction, and domestic trade sectors have been driving the growth of the performance guarantee business. The total value of the PRC's construction market increased from \$186 billion in 2001 to \$335 billion in 2004, representing a CAGR of 21.8%. Fixed asset investments increased from \$449 billion in 2001 to \$1,098 billion in 2005, representing a CAGR of 24.2%. Domestic trade commodities sales increased from \$875 billion in 2001 to \$1,378 billion in 2005, representing a CAGR of 16.4%.

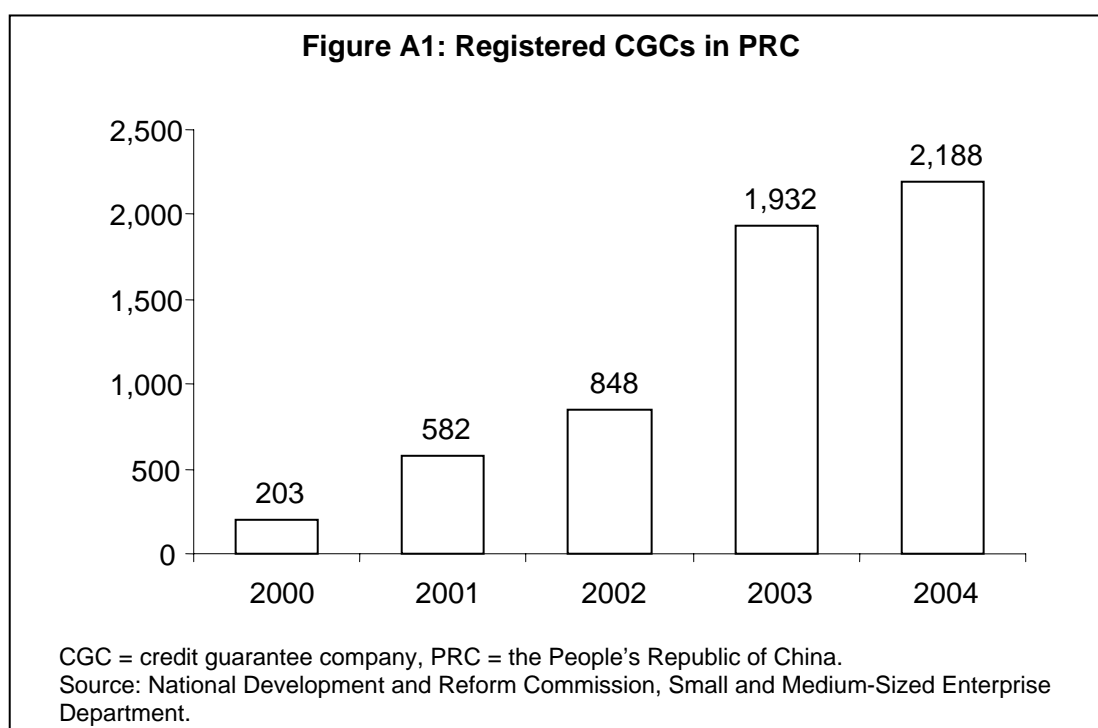
11. During the past 2 years, the Ministry of Commerce has actively promoted the guarantee system for construction projects to promote the development of the PRC's construction industry. In October 2005, the six cities of Changzhou, Chengdu, Hangzhou, Qingdao, Shenzhen, and Xiamen were chosen by the ministry as pilot cities for the implementation of construction guarantees. The construction-related guarantees, including contract tendering and bidding guarantees, payment guarantees, construction performance guarantees, and construction

quality guarantees, meet the objectives of the government and the needs of the construction industry.

12. Unlike transactions in international trade, for which PRC banks can issue letters of credit to ensure payment by the counterparty, no such service is available to parties engaged in the domestic trade. The emergence of trade-related payment guarantees fills such needs for domestic companies, facilitating the growth of domestic trade.

E. CGCs in the PRC

13. At the end of 2004, there were 2,188 CGCs registered with the NDRC. Figure A1 shows the rapid growth in the number of registered CGCs in the PRC in the past 5 years.



14. According to NDRC, despite the large number of CGCs, the average registered capital per CGC was merely CNY30 million (\$3.7 million). Table A1.1 shows a brief profile of the CGCs in the PRC at end 2004.

Table A1.1: Profile of the CGCs in PRC at end 2004

Item	
Number of CGCs	2,188
Total registered capital (CNY millions)	65,720
Average registered capital (CNY millions)	30
Number of cumulative guaranteed corporate customers (units)	188,395
Number of cumulative loans guaranteed (units)	365,842
Total cumulative guaranteed liability (CNY millions)	323,700
Total cumulative revenues (CNY millions)	4,620

CGC = credit guarantee company, CNY = yuan, PRC = the People's Republic of China.

Source: National Development and Reform Commission, Small and Medium-Sized Enterprise Department.

F. Types of CGCs

15. CGCs in the PRC can be classified into three main categories, namely government financed, industry and trade organization financed, and commercial. Table A1.2 sets forth the number, funding source, business objective, features, and some representatives of these three categories of CGCs.

Table A1.2: Types of CGCs

Category	Number ^a	Funding Source	Business Objective	Feature
Government-financed CGCs	196	Local or state government	Not for profit	Focus on government policy in developing target industries
Industry and Trade Organization-financed CGCs	113	Member enterprises of industry association	Not for profit	Not enterprise legal persons Focus only on member enterprises
Commercial CGCs	1,879	Enterprise or individual Retained earnings	For profit	Offering diversified products to a wide range of customers Quick response to customer needs Focus on risk assessment and market-driven pricing mechanisms

CGC = credit guarantee company.

^a At end 2004.

Source: National Development and Reform Commission, Small and Medium-Sized Enterprise Department.

16. **Government-financed CGCs.** As of 2004, there were 196 government-financed CGCs, accounting for 9% of the total. Government-financed CGCs are generally independent legal entities and not profit-oriented. These CGCs often focus their business on a certain industry to promote certain government policy directives. As a result, they are limited in their ability to support a wide range of SMEs in other industries.

17. **Industry and Trade Organization-financed CGCs.** As of 2004, there were 113 industry and trade organization-financed CGCs, accounting for 5% of the total. These CGCs are established by local and regional associations of SMEs operating in a particular industry to provide guarantees for members and so help them obtain financing. They are small and financed by member companies or local industrial or business associations. Since these CGCs are usually self-financed and take on their own risks, they pool the risk through re-guarantees.

18. **Commercial CGCs.** As of 2004, there were 1,879 commercial CGCs in the PRC, accounting for 86% of the total. These are generally established as corporate entities by enterprises and individuals. They are generally independent legal entities operated for profit. They respond promptly to market needs, customize their product offerings to a wide range of

industries, and price the risk commercially. They also depend on sophisticated risk assessment skills, as risk control is an essential element to their business operations.

19. At end 2004, the total registered capital of CGCs was CNY65.72 billion, of which the government's contribution was CNY19.28 billion (29.3%) and the private contribution was CNY46.44 billion (71.7%). The funding background of the CGCs is set forth in Table A1.3.

Table A1.3: Funding Background of the CGCs

CGCs	Number
Wholly financed by government	460
Partly financed by government	477
Privately financed	1,251
Total	2,188

CGC = credit guarantee company.

Source: National Development and Reform Commission, Small and Medium-Sized Enterprise Department.

G. Competition

20. The CGCs in the PRC compete with each other in many ways. One of the most important is registered capital. The relevant PRC regulations limit the aggregate exposure of guarantees provided by a CGC for a single customer to a certain percentage of its paid-in capital. Banks' internal guidelines provide for limitations on the amount of exposure to any single CGC, which is usually based on a certain percentage of the CGC's registered capital. Draft regulations by local and national governmental authorities impose various capital thresholds for CGCs. The size of a CGC's capital base will continue to determine the size of its operations.

21. On 12 June 2006, the China Banking Regulatory Commission announced new guidelines encouraging commercial banks to accept guarantees only from those CGCs with paid-in registered capital of CNY100 million or more. As registered capital requirements for CGCs become stricter with the implementation of regulations that apply both directly to CGCs and to banks' ability to accept guarantees from CGCs, consolidation in the credit guarantee industry is expected to occur, with smaller and weaker CGCs either being acquired by larger, better capitalized CGCs or exiting the business.

22. As of August 2006, the four largest CGCs in the PRC are Credit Oriented Group Limited with registered capital of CNY1.58 billion, China Investment Credit Guarantee Company Limited (CNY1 billion), Chang'an Credit Guarantee Company Limited (CNY1 billion), and China Economic and Technology Investment Guarantee Company Limited (CNY646 million).

DEVELOPMENT IMPACT FRAMEWORK

1. **Private Sector Development.** Contribution to the growth of viable financial sector and financial markets development.

Impact	Reported Measure
<p>Growth and stability in the credit guarantee industry</p> <p>Development of SME finance market</p>	<ul style="list-style-type: none"> • Consolidation in the credit guarantee industry to a sustainable number in the next five years • Increase in the average registered capital per CGC by 10% • Diversification and expansion of CGCs' business models to include non-guarantee products, guaranteeing capital market securities, and widening customer base towards riskier clients in the next five years • Increase in SME lending from private banks and local city commercial banks by 10% in the PRC banking system by 2011

CGC = credit guarantee company, PRC = People's Republic of China, SME = small and medium-sized enterprises.

2. **Economic Sustainability.** Allocation of resources and provision of financial services of COG to viable private enterprises

Impact	Reported Measure
<p>Contribution to widening SME access to finance</p>	<ul style="list-style-type: none"> • Growth in number of SME borrower clients of COG by 15% in next 5 years • Growth in guarantee and entrusted lending volume of COG by 15% in next 5 years • Credit training for staff • Stable credit quality monitored via stable NPL ratios and default ratios of not more than 4.0% • No breach of prudential norms as prescribed by the regulator and as covenanted in shareholder and HYB documentation

COG = Credit Oriented Group Limited, HYB = high-yield bond, NPL = nonperforming loan, SME = small and medium-sized enterprises.

3. **Business Performance.** Anticipated profitability and commercial viability of Credit Orientwise Group Limited (COG).

Impact	Reported Measure
Overall performance of the financial institution	<ul style="list-style-type: none"> • Return on equity of 20% by 2011 • Cost/income ratio of 18% by 2011 • Equity adequacy ratio of 6.0 times by 2011 • Average annual growth in revenues of 25% in next 5 years • Average annual growth in net income of 25% in next 5 years • Average yield of total portfolio of 6.0% in next 5 years • Growth in market share to 5% by 2011 • Successful high-yield bond issuance in 2006 • Successful IPO in 2-3 years • Development of COG into a non-bank, diversified financial services company • Guarantee multiplier (pledged cash as a % of guarantee volumes)

COG = Credit Orientwise Group Limited, IPO = initial public offering.