Final Report

Asian Development Bank TA 3534 - PRC

Development of SME Financing Support System

May 30, 2002

EXECUTIVE SUMMARY

Membership in WTO and participation in global markets are expected to bring enormous benefits to China. In the short term, however, these economic developments will probably cause dislocations in certain sectors of the economy, resulting in increased levels of unemployment is some areas. To mitigate this likely possibility, the government of China is encouraging rapid development of small and medium-sized enterprises (SMEs), which are the principal generators of new jobs and economic activity in China, as in most other countries.

A major barrier to rapid development of the SME sector is a shortage of both debt and equity financing, coupled with laws and regulations that restrain rather than encourage development of new enterprises. With the support of the Asian Development Bank, The State Economic and Trade Commission (SETC) of China has asked Pragma Corporation and Dayue Consulting Company to assemble a panel of international and domestic experts to advise on steps it might take to increase the availability of financing to SMEs, and establish a more supportive legal and regulatory environment. This report summarizes the review and recommendations of that panel.

China's future will be based on companies serving both traditional industries and those based on advanced technology. Both are of vital importance: To compete in the markets of the future, it is important that China develop a leadership position in research, manufacturing, and service activities based on new technological advances. At the same time, China has exceptional competitive advantages in traditional sectors that can provide a more immediate job-creating impact on its economy.

For example, a recent visitor to Chengdu in Sichuan Province was impressed by a manufacturer of women's shoes that had grown to an employment of 800 people, based on reinvestment of earnings alone. Most are low-skill workers, trained by the company. New financing of less than 10 million RMB is expected to double the size of the company, and increase its employment to nearly 2,000, in a short period of time. In the same week, a complex of German high-tech chemical and plastic plants being built in Shanghai announced that for an investment of around 25 billion RMB, it will create 2,000 jobs over the next several years. A great number of these will be high-skill workers that

are already in short supply. Both of these enterprises are important to China, but the shoe company SME will surely have the most immediate impact on employment of low skilled workers.

China is providing important support to technology-based businesses, including venture capital financing, credit guarantees, technical assistance, business incubators, tax relief, and special economic zones with liberal legal and regulatory systems. In this Report we make recommendations that are designed to make these even more effective. In addition, we recommend additional programs of government support under the leadership of SETC, for credit guarantees, re-guaranties, and equity financing, and propose legal and regulatory changes that will assist in the financing of companies in traditional industries as well as those based on advanced technology. These proposals will help China to take advantage of its current competitive strengths, and should make a significant near-term contribution to its economic development in an environment of global competition.

The Challenge of Attracting SME Financing From Non-Governmental Sources

In China, the Central Government and the state and provincial governments have recognized the importance of small and medium sized enterprises to the economy, and their particular importance in economic sectors based on technological developments. The principal initiatives for financing these new enterprises have come from government. By establishing and funding venture capital companies, local and provincial governments have created an equity financing network, while by setting up credit guaranty facilities they have made bank loans available for small private companies that were previously unable to borrow for their expansion. Government drives the process, with the objective of later attracting private financing to these or successor financing facilities.

This is a fundamentally different pattern from the models of other nations having mature venture capital industries and that have been studied by the international consultants. Before attempting to consider the application of international best practices, therefore, it is critically important to understand the difference in the role of government and private financial institutions in financing SMEs in China, compared to the West.

In the West, governments have had the same appreciation of the importance of SMEs, and similarly have sought to increase the availability of financing for them. In these countries, however, the role of government is to encourage private sources of financing to make investments or loans they otherwise would not make. In the case of equity financing, government programs aim to increase the potential investment return or reduce the risk of loss to private investors that will invest in sectors of the economy the government wants to encourage. Similarly, government credit guaranty programs are intended to increase the profitability of loans to companies in these sectors, or reduce the risk of loss to the lending institution.

The concept of a "sustainable" investment or a "sustainable" enterprise is crucial in considering best practices, especially from non-governmental sources. It is not sufficient for a financing source to pump money into a developing enterprise. It is essential that the form and amount of the financing be designed to enable development of a company that earns enough profits and cash flow to sustain itself without repeated injections of money from outside the company. Early financings may not be sufficient to make a company sustainable, but they must at least be supporting a plan that will lead to it in the future.

The financing plan for a company must also include an eventual "exit" for the financing, either by repayment of debt or by sale of an equity ownership to others, either through a public sale in the capital markets, sale of the business to another company, or a sale back to the company or its principal owners. Without an adequate "exit" mechanism, the investor or lender is unable to recycle its funds, and must rely on continuing injections of capital. This is totally unacceptable to non-governmental sources of financing.

In the most successful venture capital models, the private equity investors or the lenders have a real risk of loss and a real opportunity for profit from participation in the government-supported program. In addition, the private investors or lenders control the decision on what investments or loans are made. Governments in both models are motivated by a goal of economic development. In the most models, this is accomplished by the regulations governing the support program, which limit the use of funds to the sectors designated by government. The weakness of these programs is that government has little or no control over the rate of investments or loans. They rely on the fact that managers of the supported financing entities are motivated to be active and to seek financing opportunities aggressively, since they share in the profits from these financings. In addition, these programs must be carefully designed and regulated in order to avoid abuse by the private partners.

By providing all of the funding, governments can better control the investment or loan program. The risk they run, however, is that the companies they finance may not be "sustainable", since there is not a co-investor or co-lender that is focused primarily on profitability of the enterprise, or on the eventual sale of investments or collection of loans that would provide cash for later investments. Without this influence, a venture fund manager whose primary responsibility is economic development may find it hard to resist investments that provide immediate jobs or revenues, but are not sustainable in the longer run.

In both the Chinese program and the other national programs described under “International Best Practices”, successful implementation is dependent on strong, well-trained management. Most successful programs rely on individuals to organize financing organizations and to apply for government support, while the Chinese pattern has been more often for government to form the organizations and to seek the best possible managers for them. In either case, it is critically important that managers have access to

training, and to be motivated by the opportunity of sharing in the profits to be made by the debt or equity financing activity.

The challenge for the present project, then, is not only to determine those practices that have been particularly elsewhere, but to decide what ones will provide both safe and effective support in the Chinese model, and particularly what variations will be required to attract non-governmental sources of financing. Our aim is to build upon the financing structures that have been established, and to suggest support programs that will:

- Increase the total amount of equity and debt financing available to SMEs
- Encourage sustainability of investments, by providing motivations to invest in companies that will produce a positive rate of return on investment, and that provide an opportunity for sale or recovery of the investment or loan.
- Provide training for the managers of equity investment funds and credit guaranty companies, so they can take advantage of best practices.
- Attract non-governmental sources of financing, by suggesting programs that will increase potential returns or reduce the risk of loss

The Project

While our focus is on possibilities for the future, we must begin with a recognition of the astonishing pace of development of private enterprises in China, and the financing mechanisms required to fuel their growth and development. Private ownership and the rule of law were incorporated into the Chinese Constitution only three years ago - in March 1999. Today there are already around 200 active venture capital investment firms providing equity financing for technology-based SMEs, and around 300 credit guaranty companies that provide credit enhancements to facilitate bank lending to these small and medium sized businesses.

With the exception of foreign venture capital funds, virtually all of these financing institutions have been formed and financed by local and provincial governments, with the active encouragement of the Central Government. These new institutions have put in place a delivery mechanism for financing of small and medium sized enterprises, especially those based on technology. Rather than waiting for a full development of underlying laws and regulations, they have been introduced and set in motion based on the existing framework, using currently available personnel. It is a tribute to the ability and dedication of these managers that these new equity funds and credit guaranty facilities are running as well as they are.

The Central Government recognizes that to make these institutions effective and sustainable for the long term, it must now provide a more supportive base of laws and regulations, and consider financial support that will encourage expansion of their

activities and focus on their future. As part of this process, our Project will make recommendations in the following areas, based on a review of the current situation in China and international best practices:

1. Equity financing of SMEs in traditional or low technology sectors.
2. Legal and regulatory framework
3. Venture capital equity financing of technology-based enterprises
4. Credit guaranty support for bank loans to SMEs

As a basis for discussion, the consultants on October 30-31, 2001 conducted a seminar on all aspects of the project, and attended by representatives of SETC and other government agencies. The visual presentations presented at the seminar are bound separately as an Appendix.

In addition, we have assisted in the planning and implementation of an Overseas Study Tour that has given officials of SETC and other government departments direct access to counterparts in the United States and Australia, both of which have effective programs in place, both for support of equity investment funds and credit guaranty programs. Participants in the Study Tour have had an opportunity to learn from experiences with successful programs and earlier experiments in these countries.

A report on the project and the overseas study tour was presented at a public forum held in Beijing May 14-15, 2002. Visual presentations and texts of all the reports made by Pragma's international and Chinese experts are bound separately as an Appendix.

Equity Financing for SMEs in Traditional Sectors

Virtually every major government in the world has some kind of a support program to encourage direct investment in young SMEs. These are needed because, with the exception of popular high-tech companies, investors are generally unwilling to invest in SMEs. They believe the potential return on their investment is not high enough to justify the risk of loss and the length of time required before they can sell their investment at a profit. The government support programs are designed either to increase the potential profit to the investors, or to reduce their risk of loss.

With the exception of one development-oriented fund in Sichuan Province, there are no organized investment funds operating in China that have a significant interest in investing in SMEs operating in traditional industries. Considering the perceived risk/reward potential of such investments, we do not believe there will be any in the future, unless they are supported by the government. We believe such support is warranted to accelerate the inception and development of job-creating SMEs.

As a basis for recommending a specific support program, we have reviewed the support programs of many countries, in order to determine international best practice.

All of the most successful programs are based on government support for funds that have the following characteristics:

1. They also have non-governmental co-investors.
2. They are managed by independent fund managers who are motivated by receiving a portion of the ultimate profit from the investments of the fund.
3. Government increases the potential rate of return to the other investors by limiting the profit it will take on the Government investment or loan to the fund.
4. Government satisfies its economic development objectives by limiting the right of the fund to investment only in businesses that are smaller or younger than prescribed limits.

Drafters of the SME Promotion Law are providing for development funds, which can be used by SETC to invest in both credit guaranty companies that enable bank loans to SMEs, and to finance a new support program for investment funds that will provide equity financing for these companies. We strongly support this proposal, and believe it can have a major impact on the availability of financing for SMEs. We therefore recommend a pilot program, to be administered by SETC, in which at least five new funds would be formed.

These funds would be managed by independent managers: neither SETC nor the development funds would participate in investment decisions. However, by agreement with SETC the funds would be allowed to invest only in companies meeting the criteria set up by SETC. These would be:

1. Direct investments (or loans with equity rights)
2. Companies less than three years old, and smaller than a specified maximum size. For simplicity, we recommend the size restriction be a maximum of 250 employees for manufacturing companies, or 100 employees for non-manufacturing companies. SETC would have the right to allow investments in SMEs based on other criteria if requested by the fund manager.
3. Companies in any industry, with the exception of real estate and socially undesirable fields such as alcohol, tobacco, armaments, and the like.

Hopefully, the proposed investment funds law will soon be enacted, and will allow draw-downs against commitments by investors and the development funds, so the individual investment funds will not have significant levels of excess cash at any time. No trading or investment in open market securities should be allowed, as this inevitably diverts management from its primary mission of direct investing in SMEs. **Investment funds in other countries never allow investment of excess cash in anything except bank deposits or short-term debt of governments or very large companies.**

We considered programs that are successful in other countries as possible models for a pilot program of government support for direct equity investment funds that would

invest in both traditional and technology-based companies. The pilot would be managed by SETC. All of the models we considered are designed to attract non-governmental sources of investment, with three of the four limiting the profit to be taken by government, and allocating a higher share of profits to the non-governmental investors. Characteristics of individual support programs of other countries are described in the body of the Report. The following four models seemed most relevant for consideration by China:

1. Co-investment with local and provincial governments in new direct equity investment funds managed by independent managers. This would be the quickest way to launch these funds, but it would not encourage the participation of non-governmental sources. And since all investors have economic development as a principal objective, all-government funds risk having insufficient emphasis on profitability of investments and the ultimate sale. Consequently, the funds might not be self-sustaining.

2. The Israel Yozma fund model, which introduced venture capital to Israel in the early 1990s, with spectacular results. Government provided 40% of the investment capital for each of a series of funds, with private investors providing the remaining 60%. For a period of five years, the private investors had the right to purchase the government's share at its cost, plus a small interest rate. For a successful fund, therefore, the private investors received virtually all the profits, but risked only 60% of the investment. If the funds lost money, all investors, including the government, shared proportionately in the loss. The program is simple to administer, but subjects government to considerable risk, and requires the other investors to add to their investment later, possibly before it is clear that the fund will be profitable.

3. The Australian Innovation Investment Fund Program model, based on government investing two-thirds of the total investment capital of the fund, with non-governmental investors responsible for the remainder. If the fund is successful, all investors receive distributions in proportion to their investment, until government has received back its investment plus interest, calculated at a government bond interest rate. Thereafter, government receives only 10% of distributions, with the other investors receiving 90%, even though they had invested only one-third of the fund total. Government has the same risk of loss as the investors, but a significantly lower profit potential.

4. The U.S. Small Business Investment Company (SBIC) model, the oldest and largest in the world, having operated since 1959. In its original form, the government loans two-thirds of the total investment capital of licensed funds, at a low government-based interest rate. By using discount notes, the program can be modified to eliminate the need for the fund to make cash payments of interest as its investments mature. All profits in excess of the interest on the government loans are paid to the investors who put up the remaining one-third of the fund. This is a powerful incentive for investment by non-governmental

sources. At the same time, if there is a loss, government has priority on payments from the fund, and shares in the loss only if the private investors have lost everything. This greatly reduces the risk for government.

In our opinion, the program described in paragraph 4 above provides the best balance of incentive to non-governmental investors and risk of loss to the government. Consequently, we recommend that SETC be authorized to use a portion of the development funds to support at least five new investment funds. SETC would make discount loans to these funds, in a ratio of 1:1 for investment capital provided by government sources, and 2:1 for non-governmental sources. Experience of most countries with similar support programs suggests that a 2:1 ratio is required in order to increase the potential rate of return to a level that makes participation attractive to non-governmental sources.

Experience of other countries has confirmed that the most important determinant of success of any investment fund is the quality of its management. Moreover, it is important that management be allowed to operate independent of pressures from investors or government, and that it be motivated by a share of the eventual profits from the investment program. The fund managers should be selected by competitive tender, and be held responsible for arranging the investment capital of the fund. The manager will be motivated to seek as much non-governmental money as possible, since SETC would loan twice the amount of this capital, compared with only 1:1 loans against capital coming from governmental sources.

A full set of Guidelines for the operation of the pilot funds is included as Appendix A. Papers by domestic consultants discussing equity financing of both traditional and high-tech SMEs are included as Appendix B. We expect that such a program will attract non-governmental financing, particularly if it is promoted actively by national leaders.

In order to increase the number and quality of managers for these funds and for existing venture capital funds, we believe the development and implementation of training programs is of critical importance. Consequently, we recommend that ADB and other development agencies support this effort by tendering for proposals from training organizations and universities. The training program should be based on the case method of instruction, to give the students the most practical knowledge, and should be coupled with internships or other opportunities for the students to participate directly with successful investment funds.

We strongly recommend against the practice of allowing venture capital or direct equity funds to also make investments in listed securities sold in the open market. Such practice is not allowed in government-supported programs in other countries, and rarely if ever allowed in purely private investment funds. While open market investing can be profitable, it has little impact on economic development, and ties up capital in investments that the fund manager is reluctant to sell when needed for direct equity investments. While Chinese markets have been robust in the past, market prices

inevitably fluctuate up and down. A particularly risky variation that has been used by some Chinese venture funds is that of guaranteeing to investors cash returns immediately, based on the expectation that open market investments will provide the liquidity and profitability required. This practice, which is totally contrary to international experience, substantially increases the risk of loss for all the investors in the fund.

Legal and Regulatory Framework

As the government recognizes, the absence of supportive laws and regulations severely limits the availability of financing for SMEs, especially from non-governmental and foreign sources. From the past experiences of our legal team and the interviews we have had with domestic and foreign fund managers and investors, it is clear that the most serious barriers to investment in SMEs come from problems related to:

- Laws respecting the organization and operation of investment funds and credit guaranty organizations

- Corporate laws, including those dealing with the formation of corporations and issuance of different classes of stock

- Exit and Security legislation, especially with regard to transferability of shares held by founders and investors prior to public listing

Issues related to credit guaranty organizations will be discussed under Task C below. With respect to debt financing, we found the following principal financing barriers for SMEs:

- Commercial Banking Law provides that a commercial bank can only charge a loan interest rate within a range set by the central bank. This differential is not enough to compensate the bank for the additional risk and cost of servicing smaller loans. We recommend that a commercial bank be given flexibility to set its loan interest rate, especially with regard to the costs and risks involved in lending to a SME

- Current law prohibits lending between enterprises; we suggest that these be permitted, and regulate inter-company loans so as to make available new financing channels for SMEs

As to equity financing, our work to date suggest the principal legal and regulatory impediments include the following:

Investment Funds

- Company Law does not allow a company (other than those investment companies and holding companies allowed by the State Council) to invest over 50% of its net assets in the securities of other companies. This prevents the legal formation of many

investment funds. Therefore, we recommend that this cap be abolished for investment funds.

- The national law does not currently permit the formation of limited partnerships, which is the form used most often by venture capital funds in countries with mature venture capital industries. We suggest addition of a chapter on limited partnership to the partnership law, taking into consideration local regulations and practices (such as Beijing Limited Partnership Regulations). In addition, current laws relating to Limited Liability Companies in China do not in fact provide the protection from personal liability that is common in Western law. Since this form of organization has become the most popular for investment funds, we recommend that Chinese law conform to the pattern of other countries.

- There is no relaxation of laws or regulations for the benefit of substantial and sophisticated investors, who are able to protect their own interests

- Investment funds and individual investments must receive government approval before they commence operations and in the event of significant investment, including particularly investments by foreign entities

- Rules that set a maximum value for intangible assets (currently at no more than 35% of the registered capital of a company) make it difficult to price technology companies, which have a high goodwill factor; we suggest that valuation of intangibles be determined by market forces. However, laws should provide greater protection of trade secrets.

- Investors who commit to invest in venture funds are required to put up the full amount of their commitment at inception of the fund. With so much excess cash, fund managers typically invest in open market securities, which is distinctly contrary to international best practice. In more mature markets, best practice allows fund investors to make commitments to invest that are drawn upon only as needed for investments or to pay expenses of the fund.

Corporations

- Minimum paid-up capitalization rules require a larger capitalization than is necessary for SMEs; we suggest the minimum level be lowered or eliminated.

- Current law limits capital contribution in the form of technology to no more than 35% of the registered capital of a company. Since so much of the value of technology-based companies is in their intellectual property, this prevents realistic valuations for investment. Similarly, we recommend that the law also permit capital contribution in other forms such as stocks and creditor's rights, to encourage investment.

- Corporations are limited to issuing only one class of stock; preferred shares may not be issued. This restricts the flexibility of investors in structuring venture financing; we suggest to allow the issuance of preferred shares to attract risk-averse investors

- Options and warrants are not allowed. This limits the potential use of quasi-equity securities (such as bonds convertible into shares or bonds that carry warrants to purchase shares), and the issuance of management stock options to align the interests of management with that of the investors. We recommend, without governmental approval, pre-authorization of shares for later issue, increase of share capital, repurchase or redemption of shares and holding of treasure shares.

- Companies limited by shares and foreign-invested enterprises are subject to governmental approval for capital increase, share transfer and other corporate acts; we suggest changing the current governmental review procedure to a simple registration system.

- MOFTEC regulations require that a foreign-invested enterprise must have three consecutive profitable years before conversion into a company limited by shares; we suggest this minimum profitable period be shortened, in order to enable more SMEs to convert to a form preferred by investors.

- Company Law requires a company to specify its scope of business in its articles of association; we suggest to require only "lawful business or purposes" (such as required under US Delaware General Corporation Law) so that a SME will have flexibility to conduct its affairs

- Company Law has not provided enough protection of minority shareholders (often the case with investors in a SME); we suggest adding clauses on cumulative voting, a right to form a voting trust, right to approve related party transactions, right to bring derivative suit and permissible exit strategies (see below)

Exits

A venture capital or SME equity investment fund must have an ability to sell its holdings in portfolio companies ("exit") as they mature. The law imposes severe impediments to the most common ways of accomplishing this:

- Investors who are shareholders prior to an initial public offering (IPO) are required to hold their shares for an extended "lockup" period following the IPO, generally three years. This compares with international practice of generally less than six months. The extended lockup period has often been cited as such a serious problem that it forces investors to organize outside China.

  Company Law has not provided, and could be revised to provide, the following rights necessary to exit strategies (i.e., as generally recognized in the US) for investors: piggy-back rights, demand registration rights, tag-along rights, drag-along rights and

tender offer rights upon change of control. As suggested above, the ability to use options, warrants, or debt to equity conversions would allow greater flexibility in designing investment structures to encourage later management repurchases

- The purchase of shares by the issuing corporation and their cancellation is subject to the consent of the other shareholders and the creditors of the corporation.
- Lack of a "second board" has denied this outlet for the sale of shares in small or new companies; in the absence of a second board in Shenzhen, we suggest liberalization of listing requirements of the Hong Kong Growth Enterprises Market so that more mainland SMEs can qualify for such second board.

As discussed in the body and exhibits of this report, new laws being drafted will deal with some current limitations. Specific impediments of existing law and our recommendations for legislative changes are detailed in the report.

Venture Capital Investing

To support development of technology-based enterprises, provincial and local governments (with active encouragement from the Central Government) have established almost 200 venture capital funds. Some of them appear to be well managed and focused on investing in companies that can produce an investment return to the fund, and the opportunity for their investments later to be sold. Many of the funds, however, do not have targets for rates of return, and understand their mission to be investing in companies solely for the purpose of economic development and job creation.

While these developmental objectives are critically important, the investment funds will ultimately die if their investments do not ultimately produce a positive return, or cannot be liquidated. International best practice would require both private investors who are focused on investment returns, and an independent fund manager motivated by sharing in the profits of the fund.

In the absence of private investors, the China funds still can have independent management that is motivated by a participation in profits. This will be essential if the funds are to appeal to non-governmental investors. Most international development agencies, including IFC, require that funds in which they invest provide such incentives to management. The industry standard is a "carried interest" to management of 20% of profits from the fund in excess of a "hurdle" rate of return, generally 6% to 8% per year.

Most managers of venture funds in China have not had specialized training in this field, nor experience working with similar investments. While some short courses in venture fund management are available, more intensive and focused training is essential for the future success of the industry. We recommend that development institutions such as ADB tender for proposals to develop course material for such training, ideally based on the case method of instruction, as well as the offering of such courses. This would be the same course discussed above with reference to investments in traditional industries.

Although detailed data is not available, anecdotal evidence suggests that a substantial amount of investment capital in the existing domestic venture capital funds is invested in mature companies in the later stage of their development, or in securities purchased in the open market from other investors, rather than from direct investment in companies. The greatest need for investment, however, is in seed and early stage companies. Consequently, we recommend that the pilot program of government support for SMEs described above should be available for investments in either traditional or technology-based companies, but only for direct investment in companies meeting prescribed size standards.

A government supported program would not only increase the amount of capital available, but would provide an opportunity for the Central Government to establish important standards for funds receiving such support. We recommend that the following be minimum requirements for funds that receive support:

1. Fund managers must demonstrate they have had relevant experience and/or training for this role.

2. Fund managers must be motivated by a compensation system that allows significant sharing of profits of the fund when investments are liquidated and cash is returned to investors.

3. Funds must be limited to investing directly into companies that meet specific size limitations, and no investments may be made in open market securities. As a beginning pilot program, the size limitations should be quite small, and coupled with a requirement that the companies should not be more than three years old.

4. Funds must agree to avoid investments in real estate and socially undesirable sectors.

Successful programs are characterized by transparency and honesty at every level:

- Program regulations are clear and complete.
- Selection of funds to be supported is based on published criteria.
- Selection process is transparent and objective.
- Administration of the selection process and monitoring of funds by government is managed by honest and well trained officials.
- Reporting of investments by fund managers and independent examination by government confirms that regulations are being followed.
- Fund managers work closely with companies in which they have invested, to add value and to insure that program regulations are being observed.
- Appropriate action is taken when regulations are not observed.

Successful programs have strong and public support from the highest levels of government. In addition to the economic encouragement provided by government support, it is important for the highest levels of government to stimulate investment in SMEs and to encourage fund managers to use the support program to accelerate the formation of new investment funds. Major private investors must be approached with an emphasis on both the potential investment return and the importance to the economic development of the nation. This can best be accomplished by persons of recognized stature, both public and private.

Credit Guarantees

General

For many SMEs the ability to borrow money to support their business is even more critical than the need for underlying equity investment. Consequently the segment of this project referred to as Task C covers several aspects of establishing and operating programs that will increase the availability of debt to SMES in China. We have endeavored to present what we believe to be the best practices used in such programs. We have included in this report examples of legislation, program rules and regulations and operating procedures for the processing, servicing and liquidation operations in a loan guaranty program, as well as program review formats, and loan scoring elements. We have also included recommendations for future action and have included draft legislation for a loan re-guaranty association and by-laws/Regulations for such an entity.

We believe that a very important part of a strong SME community is the ongoing education of the SMEs and a vibrant exchange of information. We have included in the report model legislation for the establishment of an educational program dedicated to SMEs along with model Rules and Regulations.

Although not part of this contract, we have also included at the request of SETC a write-up on a possible structuring of a Credit Bureau in the PRC. Pragma Corporation is currently working on the establishment of a national credit bureau in Kazakhstan. We believe that serious consideration should be given to structuring such a system within the PRC.

A Glossary of Terms has also been included to assist in the understanding of the various technical references in the report.

Credit Guaranty in China

A review of the background of the credit guaranty program in the PRC and the following are the findings that will give a good understanding of the history as well as the current operations within the PRC.

SME Promotion Law

In March 1999, the National People's Congress drafted important amendments to the Constitution. One of the most important changes proposed is that the non-state economy, (the private economy), is no longer considered a "supplement to the socialist market economy", but rather an "important component of the socialist market economy". Accordingly, on April 8, 1999 the Finance and Economy Committee of the National Peoples Congress named a team for the drafting of an SME Promotion Law and another team to draft regulations that would support the creation and growth of SMEs in China.

To understand why the Congress took such action one needs only to look at the very important impact that SMEs have had on the country's economy. Of the total output of the country, SMEs account for 60% of all sales, 57% of all profits generated, pay approximately 40% of all taxes and account for over 60% of the total exports.

SMEs also provide 75% of all jobs in the urban areas of the country and most of the 200 million-person labor force transforming from the countryside of China to the urban areas between the years 1978 and 1996 were hired by SMEs. More than 4.6 million laid-off employees were hired by SMEs in 1998 alone.

The State Economic and Trade Committee took responsibility for drafting the SME Promotion Law and on July 4, 2000 a discussion draft was submitted to the Finance and Economy Committee. The initial draft has been revised, and has been read twice before the Finance and Economic Committee of the National Peoples' Congress. A final reading and approval is expected within a few weeks.

This Law is intended to be a very important signal for the acceleration of SME development within China in order to assist in relieving the unemployment problem that now exists, accelerating the use of technology and innovation and sustaining social stability. The Law as drafted will also assist in solving many problems that plague the SMEs. These include proper financing programs and management and technical assistance and access to equity funds.

A successful demonstration of the draft Law is critical to urge the government to establish an improved support policy for SMEs and to embrace the enthusiasm within the country for a fair market economy. We have included in Appendix C the contents of the draft PRC Law and the SETC Guide Principles. In Appendix D we have included opinion papers submitted by the local consultants addressing local conditions and their recommendations.

The Law as drafted gives the different levels within government much latitude in structuring programs that support the SME community. This latitude insures the support or "buy-in" of the Provincial and City governments. However, it provides an opening for a multitude of programs having varying degrees of risk being implemented within the country without the Central Government having the ability to keep such risks within an acceptable range.

The degree and quality of programs that will be implemented will depend, in large part, on the expertise in developing such programs in any given area of the country, the support for such programs at any location and the financial ability of various regions.

Currently the national emphasis on SME development has been met with a patchwork of programs with no common thread to tie the programs together on a national basis. Where some areas are reported to have very good programs with reasonable risks being taken, others have troubled programs and even other regions of the country having nothing in the way of operating programs. To achieve the vision set out in the law that is being passed by Congress, there must be programs available in all sectors of the country. Those programs must be financially sound and well managed.

Normally, in most countries, a law passed by the Central Government will have certain limits for such structures where, within those limits, lower level governments could design certain aspects of the programs, but normally will not leave open the option whether a region or local government will implement the program. (See the model legislation in Appendix E.)

The Central Government should consider such limits on any additional legislation, especially if the re-guaranty program is created at the National level. The re-guaranty program could be constructed in a way in which the limits that were not included in the original legislation could be instituted for those that take advantage of the national program. The Law does provide a wide menu of services that would be implemented in support of SMEs, similar to those that are in operation in the United States, the U.K., and Japan. On balance, the Law is a good law and one that will deliver much needed services to the SME community, provided that the various programs throughout the country can be pulled together in a cohesive manner.

In June 1999 SETC issued the guide found in Appendix C. The guide was based on SME credit guaranty experience in some regions within China. Under the Guide, credit guaranty institutions at the Provincial and City levels were developed. The guaranty institutions based in cities were set up to provide SME credit guaranty services to lenders while re-guaranty institutions at the provincial level would provide re-guaranty services for guaranty institutions within the individual provinces.

By December 31, 2000, pilot programs for SME credit guaranty systems at the provincial and municipal levels had been developed in the 30 provinces, autonomous regions, and cities. The number of direct guaranty institutions of various types had reached 300. Provincial institutions for re-guaranty had been set up in some provinces and regions.

The following are our findings and opinions as of this date. We have structured the comments starting at the level of program implementation (city level) and progressing up the program chain to the National level.

City Level

Although there is much interest in guaranteeing SME activity in many areas, not all areas of the country are being covered at the local level. This of course makes it difficult to have a complete program nationally. Efforts should be undertaken to fill the gaps left by uninterested local entities or those localities that do not have the resources to construct a guaranty program so that SMEs have the same opportunity to contribute to the national economy no matter where they are located.

In the opinion of several that were interviewed, there is a need for training of the local entities in credit analysis. There is also a need to improve management controls on local programs thereby achieving better control over the risks being taken.

According to the present policies, guaranty institutions can only request a re-guaranty if their capitalization goes below a set level. However, there are very few direct guaranty institutions where, at the present time, the demand within the acceptable risk band of the guaranty institution taxes their capital structure to the point required by the program. Therefore, it appears that SMEs are being denied assistance even when they would qualify under the risk band established by the re-guaranty authority. In this case they do not qualify within the risks criteria normally used by the guaranty institution without applying the re-guaranty. Moreover, the re-guaranty often cannot be applied due to the under-capitalization of the guaranty institution.

This problem goes to the heart of the purpose of a re-guaranty program. If the purpose of the re-guaranty program is to widen the risk ban to include SMEs that would not normally meet the requirements of a guaranty program at the city level, then a change in the above restriction should be made. However, if the purpose of the re-guaranty program is only to protect the financial exposure taken by the financing institution, without expanding the risk band, then the restriction as to capital structure and level of capitalization is meeting its purpose.

Because the re-guaranty program bridges various local jurisdictions, it has the ability to spread its risk over several economic zones. In doing so, consideration should be given to allowing guaranty institutions to apply for the re-guaranty regardless of their capitalization or capital structure.

Provincial

According to many institutions and professionals, the development of a re-guaranty program is critical in promoting SME credit guaranty services and there is great demand for re-guaranty services in China's economy. However, re-guaranty service is not developing very rapidly.

Although a great number of re-guaranty institutions were set up in many provinces, many of them are still in the early stages of development and have as yet

unproven operations. It can be said that there is an imbalance in the development of re-guaranty services in the various regions of China that needs to be corrected if the level of service to SMEs is to be achieved as envisioned.

The main reasons for the imbalanced or slow development of the re-guaranty enterprise in China are as the follows:

(i) Lack of support, insufficient financial capacities, or differing views of leaders within the various Provinces has contributed to the varying degrees of success of implementation of the re-guaranty program. At present, in order to create a re-guaranty institution, the support of local leaders and departments is required. Furthermore, due to differing views on the value of such a program within the various departments, many Provinces have been slow in developing such a program while other Provinces have been eager to implement one.

(ii) Given the share of risk taken, the benefits being derived by re-guaranty institutions have not been sufficient to maintain profitability or at a break-even for some entities. Therefore, this level of risk has hindered the development of the re-guaranty program.

(iii) Because of its inefficient administration, some re-guaranty institutions have not been able to assist the guaranty institutions to share risk and lower the cost of management. Some re-guaranty institutions have even dealt with the direct guaranty of enterprise themselves or added the responsibility of the direct guarantor to the contract of re-guaranty, thereby increasing the cost to the SMEs. This increase in costs has reduced the market for such re-guarantees.

(iv) As noted above, with regard to the need for training at the City level, most of our interviews have pointed to the lack of training and management controls at the Provincial level as well.

Some consideration should be given to whether Provincial or Central re-guaranty institutions could be allowed to operate as guaranty providers where services are not being delivered by local entities. This would permit greater coverage for the SMEs and at the same time would present an opportunity for the re-guarantors to generate greater income.

Risk of Loss

As with any guaranty or insurance program, the credit guaranty and reguaranty institutions discussed in the report reduce their risk of loss by guaranteeing a large number of individual loans. Risk is also reduced to the extent the direct lending institution shares in the risk. We are concerned by the apparent widespread practice of the credit guaranty companies in guaranteeing 100% of the value of loans. This not only increases their percentage risk, but removes the responsibility of the lender, effectively making the lender solely a servicing agent, with the credit guaranty company acting as

the true lender. Well managed guaranty companies minimize this risk by demanding substantial collateral coverage, but this is not always available at fast-growing SMEs. A preferable approach, in our judgement, would be to insist on the lender retaining some minimum percentage of the risk of loss.

Similarly, it is important that guaranteed loans carry terms that are appropriate. For example, if a short term loan does not have a requirement that it be fully repaid for an agreed "clean-up" period each year, and if it is repeatedly renewed upon maturity, it may effectively be used as part of the capital base of the company, with no hope of repayment.

We have included in this report a series of papers prepared by the local consultants that reflect the historical and present SME conditions in the PRC along with recommendations based on local perspective. These papers can be found in Appendix D of this report.

RECOMMENDATIONS

Throughout this report we have included many observations, opinions and recommendations. The following is a summary of the recommendations that will be found in the body of the report.

Task A - Equity Financing for SMEs

1. Equity Financing for SMEs in Traditional Industries

As it enters WTO, China has an immediate objective of creating jobs to replace those expected to be lost to global competition. While technology-based industries create the jobs of tomorrow, traditional industries create the jobs of today. Therefore, we recommend that the government offer the same support and incentives to all SMEs, not just those in high-tech industries.

2. Support for Equity Investment Funds investing in SMEs.

Investors are generally unwilling to invest in equity funds that invest in traditional industries, since they do not believe the potential profits are consistent with the risk of loss. Almost all countries where venture capital is highly developed have programs that increase the investors' potential profit or reduce the potential for loss from investment in these funds. To demonstrate the possible impact of such a program, we recommend that SETC begin a pilot program in which it will loan or guarantee loans to an initial five SME equity funds. Loans will be discount loans, at a ratio of one times any local government-sourced investment, and two times any non-government sourced investment. This proposal is described in full in the Executive Summary and the body of this Report.

3. Recognition of Importance of Investment Fund Management

International best practice recognizes that the most important basis for success of a direct equity investment fund is the quality and experience of its management. Consequently, in encouraging or supporting these funds, we recommend that the Government of China look first at the proposed management, and indeed require the prospective managers to convince investors that they should participate in the fund. When the fund is in operation, the manager should make all investment decisions, providing they are within the limits of size, age, or other general criteria set by government at the beginning of the fund.

4. Motivating Management to have the same objectives as the investors

In order to be certain the fund managers will have the same goals as the investors, it is important they be required to invest within government's established guidelines, and also that they are rewarded for making investments in companies

that grow and prosper, and finding or creating ways to sell the investments after they mature. This is best accomplished by a compensation structure that allocates a portion of the profits of the firm to its management.

5. Training fund managers

Since the activity is so recent, China does not have a large number of prospective fund managers with experience in direct equity investing. From its economic history, China has not had institutional investors or investment banking professionals who could use their experience in managing such a fund. It is imperative, therefore, that opportunities be created for training. A successful program should simulate real investment decisions and real problems that are faced by SME managers and managers of investment funds. We recommend that ADB, either alone or in concert with other development organizations, tender for proposals to develop and present such training. This is an ideal field in which to use the case method of study, which places students in the position of actual managers, and requires them to decide what to do.

Legal and Regulatory Framework

The present legal and regulatory structure of China imposes serious barriers to both debt and equity financing of SMEs by domestic and foreign sources. Supportive laws to protect investors and lenders must be enacted or strengthened, and new laws to allow greater flexibility must be in place if China wants to attract non-governmental sources of financing. In particular, emphasis should be placed on: (1) laws dealing with corporate formation and operation; (2) laws relating to the organization and operation of investment funds; and (3) laws affecting the right of investors to sell their shareholdings. Laws related to credit guaranties and loans are discussed in a later section, except for a few overriding recommendations listed below.

We recommend the following changes to laws and regulations:

1. General laws relating to lending:

a. The present limit on interest rates that can be charged to SMEs should be increased or eliminated, and banks given flexibility to charge rates that reflect the risk and costs of lending to SMEs

b. Inter-company loans should be allowed, to provide additional financing sources for SMEs.

2. Investment Funds

a. Investment funds should not be subject to the present limit of investing no more than 50% of net assets in other businesses.

b. The partnership law should be amended to include limited liability partnerships, the form most preferred by investment funds. Similarly, limited liability company laws should be modified to conform to global practices, eliminating the unlimited liability of management.

c. There should be a relaxation of protective laws and regulations that restrict investments by persons or institutions that are substantial and experienced.

d. Regulations requiring government approvals of investments should be limited or eliminated for investments in SME.

e. Rules that limit the value that can be placed on intangible assets inhibit investments in technology companies. We recommend they be eliminated, and valuations left to market forces. On the other hand, laws protecting trade secrets should be strengthened.

f. Legislation should be promulgated to allow investors and lenders to make commitments to investment funds that can be drawn down as needed, rather than requiring full investment at the outset, before investments are identified.

3. Corporations

a. The current minimum capitalization requirements of corporations restrict the formation of SMEs. These requirements should be eliminated, or significantly reduced.

b. To recognize the value of intangible assets, particularly in technology-based companies, we recommend elimination of restrictions on capital contributions in the form of non-cash assets.

c. To provide greater flexibility in structuring investments, we recommend that current restrictions be eliminated, so as to allow issuance of special classes of shares, with different rights, and permission to use options, warrants, and debt conversion rights that are commonly used in other countries.

d. Similarly, we recommend relaxation of rules to allow pre-authorization of shares for later issue, increase of share capital, and repurchase or redemption of shares without approval of government or creditors.

e. To encourage foreign investment, we recommend replacement of the current government approval requirements with a simple notification and registration system.

f. There should be a shortening of MOFTEC regulations requiring three years of profitable operations by a foreign-invested company before conversion into a

company limited by shares. Since SMEs frequently do not generate profits in their early years.

g. To allow new enterprises to take advantage of developing market opportunities, we recommend elimination of the current requirement that a company specify its scope of business, other than to limit it to any lawful purpose.

h. Laws respecting the rights of minority shareholders should be strengthened.

4. **Exit Mechanisms**

a. a. There should be a substantial reduction in the current three-year lockup requirement for investor-owned shares of a company selling stock in an initial public offering. This is a major deterrent to investment.

b. Use of conversion rights, and multiple classes of shares should be permitted, in order to allow flexible structuring of investments that will make it easier for an entrepreneur to refinance and repurchase the investor's shares.

c. The Company Law should be amended to allow exit strategies commonly used by direct equity investors, including piggyback rights, tag-along and drag-along rights, and rights upon change of control.

d. Repurchase and cancellation of shares by a corporation should be allowed, without approval of the other shareholders and creditors.

e. While awaiting the opening of a second board in Shenzhen, we recommend liberalization of listing requirements in the Hong Kong Growth Enterprises Market.

Task B - Venture Capital Equity Investment in High Tech Companies

1. Recommendations Applicable to all SME equity investing

Recommendations regarding equity investments in SMEs listed under Task A, above, all apply to venture capital investments as well.

2. Items of special importance to Venture Capital investing

a. To encourage venture investing in smaller and newer companies, we recommend that the equity investment funds to be supported by the suggested pilot program be allowed to invest in any SME meeting the stated size and age requirements, whether they participate in traditional or technology-based markets.

b. The training program recommend under Task A is critically important to the support of venture capital funds as well.

Task C - Credit Guaranties, Re-guaranties, and Credit Reporting

1. Consistency of Purpose and Policy

It is recommended that uniform Legislation, Rules and Regulations, and Operating Procedures be implemented in all guarantee programs in which Central, Provincial or City re-guarantees are utilized. It is important that uniform practices be used in all loan programs to ensure that implementation is consistent throughout the PRC. To assist in this implementation, we have included model Legislation, (Appendix E)) Rules and Regulations, (Appendix G), model Processing procedures, (Appendix H), Servicing procedures, (Appendix I) and Liquidation procedures, (Appendix J). The PRC has the opportunity, with the establishment of a Central Re-Guaranty program, of unifying the delivery of services to SMEs throughout the PRC.

Legislation being developed should accept the concept of one hundred per cent guarantees during a defined "early-stage" loan guaranty developmental period. However, such legislation should also identify a date by which the maximum loan guaranty to be accepted in the Central Re-Guaranty Program will be lowered (perhaps 90% with a further lowering after another identified period of time or based on a study to be performed at such time).

2. Size – SME

As part of a project to develop a national standard industrial classification system, a study should be undertaken to research the characteristics of those industries where large businesses dominate or control industrywide activities. Those businesses that exercise monopolistic or excessive control over an industry to the potential detriment of smaller enterprises should be excluded from the resultant size standard developed for that industry for purposes of qualifying as a SME.

3. Size – Type

We recommend that a total review of the size policies of the programs be made to determine whether the sectors currently receiving assistance are the employment generating sectors or are those actually reducing employment. In a loan program that is established to support public policy (in this case, the reduction of unemployment) it is necessary to assure that the assistance is going to the sector that is indeed increasing employment.

There should be a review of the type of businesses that are benefiting from the current guaranty programs. If the existing focus on hi-tech firms continues, the universe of SMEs that can take advantage of the guaranty program will be limited. Also, if the intent of the guaranty program is to lower unemployment through the creation and growth of SMEs, then a more broad approach to the availability of the guaranty programs would be of benefit. We recommend that stronger outreach efforts be initiated to focus on the credit needs of more traditional labor intensive

industries, including those in the service, retail, manufacturing sectors, as well as home based businesses.

Legislation authorizing a Central Re-Guaranty Program should exclude from it those industries and/or businesses that do not traditionally operate in a manner consistent with the purposes of the Program. These include businesses that do not enhance the country's employment opportunities, such as Real Estate investment (other than when the real estate will house an otherwise eligible operating SME), speculative enterprises where earnings are generated through fluctuations in markets rather than through the ongoing practice of traditional business activities, enterprises engaged in such illegal activities as may be related to prostitution, gambling, or drug dealing. Prohibitions should be worded to provide sufficient flexibility to the implementing Agency to address changes in operating as they develop in the marketplace.

4. Size – Loan

A maximum loan size should be legislated, but with a stipulation permitting the Agency to develop Special Programs that may exceed the legislated maximum, provided no more than a specified proportion of its funding will be used for the Special Programs in the aggregate. See Special Programs in this Section.

5. Loan Maturities

Many loans to SMEs have been made with short-term maturities, even though the proceeds may have been for long-term purposes. Such practice impedes the ability of the lender to perform realistic, long-term planning and causes unnecessarily high burdens on a borrower's cash flow, thereby creating higher risk of loan repayment. Permitting and encouraging longer maturities will increase the number of SMEs that will be able to take advantage of the loan program and at the same time lower the risk being taken due to the lower fixed obligations on a given loan.

A needs assessment should be undertaken in the PRC to ascertain the loan maturities that would most benefit the Country's SMEs.

Re-Guaranty legislation should be sufficiently broad to permit the longest possible maturities and Agency loan programs should similarly be designed with longer maturity benefits for SMEs in mind. Considering the present banking environment and range of SME financing needs, no minimum maturity should be called for.

6. Interest Rates

There should be a review of the interest rate policies currently established within the PRC for loans supporting SMEs. Although recent changes have been made, existing SMEs should be surveyed on their thoughts as to why loans are not

being made available to them. It appears that current interest rates are hindering the extension of credit to SMEs and may need to be adjusted further in order to increase the flow of capital to this sector.

7. Regulations

Develop a set of Regulations that further develops legislative language and adds clarity and specificity to enacted legislation. This document will provide the foundation for development of consistent policies and procedures that will be used for the day-to-day conducting of loan guaranty operations. Model Regulations have been included in Appendix M.

Provide flexibility in design of final policies and procedures to permit the development of Special Programs with terms and conditions or loan structures to accommodate special needs in the marketplace.

8. Prudent Credit Standards

Both the lenders and the guarantor should rely on traditional prudent lending practices, including such requirements as: sound character of SME borrower, prudent credit standards, and personal guarantees of the SME owners, with the primary lender continuing to take part of the risk of loss if the loan or interest is not repaid.

Commercial lending in the PRC in recent years has been dominated by lending to SOEs with little funding being made available to the SME segment of the market. SOEs had, until the last several years, been considered a relatively risk-free market for the Country's state-owned banks, since the SOEs were ultimately backed by the State. As changes are being brought about in converting the planned economy to a free-market economy, SOEs, as a group, have suffered severe losses that have resulted in significant losses of employment for many citizens. Notwithstanding these setbacks, the prevailing mentality among commercial lenders appears to continue to favor lending to SOEs. The traditional characteristics of sound credit analysis have reportedly at times been subordinated to the expectation that loans to SOEs would ultimately be covered by the State, relegating the need for sound credit analysis to a secondary position.

Final design of the Central Re-Guaranty Loan Program must incorporate policies that base loan and loan guaranty decisions on traditional, internationally accepted credit analysis techniques. These should be augmented with the initiation of a Loan Scoring System to help validate the traditional judgmental processes of evaluating credit risk. (See sample Loan Scoring model in Section 4).

9. Central Re-Guaranty Loan Program

We believe that it is essential that a Central Re-Guaranty program be instituted. The current array of guaranty and re-guaranty programs throughout the

nation was established to obtain the support for SMEs at all levels and geographic areas. We believe that it is time to tie the programs together to achieve uniform approaches to the extension of credit thereby bringing consistency and manageable risk within the program.

This should be done by layering the Central Re-Guaranty program over the existing programs thereby keeping the involvement of the Provincial, City and private guaranty companies but at the same time instituting a nationwide guaranty system. The establishment of such a program will also introduce the ability to sell the guaranteed portions of the various loans into the open market thereby bringing new capital into play. The consistency that a Central Re-Guaranty program will bring will increase the acceptability by the investors in a secondary market.

We have included recommendations with regard to for the establishment of an association dedicated to the re-guaranty of SME loans, Model Legislation, (Exhibit K), Central Re-Guaranty Association Model By-Laws, (Exhibit L), and Central Re-Guaranty Rules and Regulations, (Exhibit M).

10. Marketing and Outreach

The PRC should implement a promotional program within the country that will support the establishment of SMEs throughout the nation. As the country expands its goal of privatization, it is important to deliver a message to the general public of the attributes of business ownership, the contribution that SMEs make in the growing economy of the nation and the importance placed on this sector by the National, Provincial and City governments. National awards should be developed for citing the accomplishments of individual SMEs in each geographic sector of the nation. Public announcements and media campaigns should be developed that will promote the formation of enterprises.

The Central Re-Guaranty Program must develop a comprehensive marketing strategy that will: clearly articulate the purpose of the Program, the intended benefits to the local, provincial, and national economy, the SMEs and the lenders, and the systems to be used in implementing the Program. The strategy must be multi-faceted with marketing efforts directed toward SMEs, lenders, accountants, lawyers, SME and financial consultants and should be executed at the Program Headquarters and field levels as well as by other governmental and social cooperating institutions.

11. Training – SMEs

Training of the SME sector is critical. It is recommended that a Central Training Association be established that would design and implement training programs for SMEs. These training programs would include accounting, business management, preparation of business plans, financial statement analysis, personnel management, marketing and other subjects as well as one-on-one counseling of business owners. The lack of such training is adversely affecting the ability of SMEs

to acquire financing and raises the risk being taken by the SMEs and lenders by entering business without the benefit of such training.

We have included model Legislation and Rules and Regulations for such a program in Section VIII of this report.

The present SME Service Center concept should be expanded by adding training programs and additional center locations. Systems should be established to facilitate the use of the Centers as centers to gain input from SMEs about their credit needs and the operations of the Re-Guaranty systems for possible improvements.

12. Communications

Promote and potentially sponsor the initial development of groups of SMEs and of lenders in order to better acquire information that would be worthwhile in developing policies and procedures that will benefit the Program. Without the initial and ongoing contributions of those directly influenced by the Program, its sustainability will continuously be in doubt.

13. Risk Management and Central Data Base

We recommend that a strong lender oversight and review system be instituted at once. The strict monitoring of lender operations, including historical experience, is critical to a successful program. We have included a set of lender oversight and review procedures in Section VI of this report.

It is recommended that a central data gathering system be designed and implemented to deal with SME information, including information on the guaranty and re-guaranty programs. This system should include a risk management system as well as demographic and risk experience data. The gathering of credible information is extremely important as the program grows. Such data accumulation and analysis provides the only way to control future program operations, properly assess the risks being taken, and accomplish the public policies addressed by the program.

In the Central Re-Guaranty Program, the Agency should establish a comprehensive, computerized database of information to track the performance of the loans in its guaranteed loan portfolio. It should also establish a physical loan case file review system to examine files for compliance with established policies, procedures, and prudent lending practices. The system recommended would be two-tiered: The first evaluation of a local guaranty company's loan portfolio should be conducted for the purpose of determining which loans will be accepted for the Central Re-Guaranty. These physical reviews will be carried out periodically to assure ongoing compliance by the local guaranty company. Subsequently, continuous monitoring of that company's portfolio performance should be carried out by the Central Re-Guaranty Company's Risk Management group, once a local guaranty company's loans have

been accepted for re-guaranty,. See Section 6 for policies addressing Program Oversight and Review.

14. Lender Issues

Changes in legislation should be explored that will allow non-financial institutions to enter the lending arena for the sole purpose of lending to SMEs. It is evident from our involvement that the best approach to increasing lending support to SMEs is to introduce outside competition in the way of non-financial institution (non-bank) interests. Lending to SMEs is totally different from lending to larger firms and is not always consistent with the traditional thinking of many financial institutions. At the same time, the Agency should open and develop communication with other appropriate governmental units involved with the financial industry in effort to promote the concept of opening the industry to outside competition, specifically to organization with more experience and commitment to SME lending.

The development of training for lenders, as well as lower-tier guarantors, in the guaranty programs is critical. The expertise in SME lending is varied throughout the country and such inconsistency contributes to questionable risks being taken and a varied acceptance of SME lending. The opportunity for unified training will be established once a universal set of Regulations and Operating Procedures have been adopted. A permanent program of training must be carried out in order to ensure that new lending officers are trained in the program. This same training must be made available to all Provincial, City and private guaranty and re-guaranty entities.

Training programs must provide a full range of materials needed by the lender and lower-tier guarantors to successfully conduct business under the Central Loan Re-Guaranty Program. These materials would include: Program purpose and policies, long-term credit risk analysis, loan portfolio performance expectations, portfolio monitoring, and review standards and procedures. Lenders must understand the Program requirements and what is expected of them in order for the Program to become successful.

After lenders have been properly trained, consideration should be given to requiring the lenders to perform all servicing and liquidation functions rather than exiting the partnership upon loan default. Experience has shown in other countries that allowing the lenders to exit the partnership upon payment default increases the probability that less focus will be placed on proper evaluation at the time of loan processing since the lender realizes that they will not have to live with the credit if it should get into trouble. It should be the aim of a program of this nature to hold the partnership with the borrower together throughout the life of the loan, including through the liquidation process.

15. Credit Reporting System

The design and implementation of a credit reporting system should be undertaken at once. The lack of such a system within the PRC is inhibiting the extension of credit to SMEs. We have included a proposal for such a system in Section VII of this report. Pragma is in the process on instituting such a system in Kazakhstan and would be available to discuss such a project in the PRC.

16. Secondary Market

We recommend that steps be taken to establish a secondary market for the guaranteed portions of the loans being granted to SMEs. Although it is early in the establishment of the program, the need to generate capital will become very important as the program grows and the time is right to start the process of planning. The introduction of a secondary market will increase profit margins for lenders and thereby assist in both bringing more lenders into the program and increasing the current lenders' interest in these types of loans.

17. Micro Loan Program

Thought should be given to the establishment of a Micro Loan Program to deal with the needs of smaller, start-up enterprises. This program should be designed using non-traditional lenders, community groups, unions, and other such organizations. It should be focused on the re-employment of individuals through the establishment of very small, (sometimes one-individual), enterprises. Most of these businesses could be home-based businesses located in rural areas of the country. While there are clear distinctions separating micro- from small- and medium-sized enterprise, micro-businesses often become future SMEs. Some of the same Best Practices can be applied with some variations to the micro-enterprise field.

China does have the broad tools and support to build an excellent SME lending program. However, it needs to put in place a unified approach, encompassing an array of Rules and Regulations, Policies and Practices tahat will assist it in strengthening the programs. In doing so it will make real the vision put forward by the Peoples Congress.