

## **TASK C: CREDIT GUARANTY PROGRAMS**

### **General**

Task C covers several aspects of establishing and operating programs that will benefit the SME community in the Peoples Republic of 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 depends on 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 Kazakstan. We believe that serious consideration should be given in 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 you only need to look at the impact that SMEs have had on the country's economy.

In China, small and medium enterprises play a very important role in the 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-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. A recap of that Law is included in this report.

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 of having 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 a 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 **Exhibit E**.)

The National government should consider such limits on any additional legislation especially if the re-guaranty program is created at the National level. By constructing the re-guaranty program in a certain way, 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, England and Japan. On balance, the Law is a good law and one that will deliver much needed services to the SME community, if the various programs throughout the country can be pulled together in a cohesive manner.

In June 1999 SETC issued the guide found in **Exhibit 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 the SME credit guaranty services to lenders while the re-guaranty institutions at the provincial level would provide re-guaranty services for the 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 guarantying 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 of training for 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 capital structure goes below a set level. However, there are very few direct guaranty institutions where at the present time the demand, within the acceptable risk ban of the guaranty institution taxes their capital structure to the point required by the program. Therefore, it appears that SMEs are being denied assistance although they would qualify under the risk ban established by the re-guaranty authority. They do not qualify within the risks normally taken by the guaranty institution without applying the re-guaranty, but the re-guaranty cannot be applied due to the capital structure 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 some 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 ban than the restriction as to capital structure is meeting its purpose.

Because the re-guaranty program bridges various local jurisdictions, it has the ability of spreading 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 capital structure.

### **Provincial**

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

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 with 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 need 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) The lack of support, financial capacities or differing views of the leaders within the various Provinces has contributed to the varying degrees of implementation of

the re-guaranty program. At present, in order to create a re-guaranty institution the support of the local leaders and departments are required and due to the 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.

- (iii) The share of risk taken versus the benefits being derived by the re-guaranty institution has not been enough to keep some of the entities profitable or at a break-even point and therefore 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 share risk-taking and lower the cost of management. Some re-guaranty institutions even dealt with direct guaranty enterprise themselves or added the responsibility of the direct guarantor in the contract of re-guaranty, thereby increasing the cost to the SMEs. The increase in costs has reduced the market for such re-guarantees.
- (iv) As noted above as 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 the local entities. This would allow for greater coverage for the SMEs and at the same time would present an opportunity for the re-guarantors to generate greater income.

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.

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 but is being presented here for the ease of the reader.

## **Recommendations**

### **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 consistency is implemented throughout the PRC. To assist in this implementation, we have included model Legislation, (**Exhibit E**), Rules and Regulations, (**Exhibit G**), and model Processing procedures, (**Exhibit H**), Servicing procedures, (**Exhibit I**) and Liquidation procedures, (**Exhibit 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; but, 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 industry wide activities. Those businesses that possess 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 that are currently receiving assistance are the employment generation sectors or whether the programs are supporting industries that are 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. Due to the focus on hi-tech firms, the universe of SMEs that can take advantage of the guaranty program is 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 specify those industries and/or businesses that do not traditionally operate in a manner consistent with the purposes of the Program. Consideration should be given to those 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 practices impede the ability to perform realistic long-term planning and cause 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 legislated.

#### **7. 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 why loans are not being made available to them. It appears that the 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.

## 8. 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.

## 9. Prudent Credit Standards

Strong reliance by both the lenders and the guarantor on traditional prudent lending practices, including such requirements as: sound character of SME borrower, prudent credit standards, and personal guarantees of the SME owners.

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).**

## 10. 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.

We recommend that this 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 guaranty 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 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**).

## **11. 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.

## **12. 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.

### **13. 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.

### **14. 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 dealing with SME information, including information on the guaranty and re-guaranty programs. This 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. It is the only way to control future program operations, proper assessment of the risks being taken and the accomplishments of the public policies that the program is addressing.

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 and 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 a 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. Once a local guaranty company's loans have been accepted for re-guaranty, continuous monitoring of that company's portfolio performance will be carried out by the Central Re-Guaranty Company's Risk Management group. See **Section 6** for policies addressing Program Oversight and Review.

## **15. 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 than to larger firms and is not attuned to 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 is contributing to questionable risks being taken and a varied acceptance to 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 assure 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 material needed by the lender and lower tier guarantors to successfully conduct business under the Central Loan Re-Guaranty Program. This 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 what the Program requirements are 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 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 together throughout the life of the loan, including the liquidation process.

## **16. Credit Reporting System**

The designed 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.

## **17. Secondary Market**

We recommend that steps be taken to establish a secondary market for the guaranty 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 the profit margins for the lenders and thereby assist in bringing more lenders into the program and increasing the current lenders interests in these types of loans.

## **18. Micro Loan Program**

There should be thought given to the establishment of a Micro Loan Program to deal with the very small needs of start-up enterprises. This program should be designed using non-traditional lenders, community groups, unions and other such organizations and should be focused on the re-employment of individuals through the establishment of very small, (sometimes one individual), enterprise. Most of these businesses could be home-based businesses located in very rural areas of the country. While there are clear distinctions separating micro from small and medium-sized enterprise, micro businesses are often the future SMEs and 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 program but needs to put in place a unified approach, encompassing an array of Rules and Regulations, Policies and practices that will assist in strengthening the programs and in doing so making that vision put forward by the Peoples Congress come true.

## **Best Practices**

This section of the Report reviews some of the “Best Practices” used in the formation and operations of guaranty loan programs. Best Practices are those that have been proven successful in other programs given certain governmental or private sector conditions. Practices used in one set of circumstances may not be the practices that should be used under a different set of circumstances.

Usually, Best Practices are seen as being good because of a wide variety of circumstances that have made the program in which the practices are used a successful program. Great care should be taken in making sure that practices that are included in any program are in tune with local economic, political and social environments in which the practices will be used.

As an example, lifting a total program that have the best of practices and placing it in a different social or economic environment will not guaranty a successful program. By the

same token, inserting good practices and controls that have been designed with the local economic and social environment being taken into consideration is a must in order to have a successful program.

As we discuss the various Best Practices used in many guaranty programs we will try and relate the practice to the social and economic conditions within the PRC and recommend a host of areas that will need to be considered prior to implementing any of the practices. Before we get into the individual best practices of guaranty programs, we should cover a much more broader issue and that is what type of enterprise environment assists SMEs to develop and prosper. It is not enough to develop a good loan guaranty program but rather a total environment that will ensure that the population knows of the benefits of entrepreneurship within the community, an educational environment that promotes educational programs geared to operating a small enterprise and a public sector that supports every facet of SME development.

Most SME loan programs are successful due to other programs that are developed to bring support to SMEs. These include enterprise education courses that are developed within the university system or the private sector with SMEs in mind. It also includes enterprise support networks where SMEs can assist each other on common problems. It may include special rules that allow SMEs to participate in government procurements and it includes a long-term informational program that tells the story of entrepreneurship even in the early years of educational development.

We will address a few of these SME support programs later on in this section.

The following are what we would classify as best practices in a guaranty loan program.

## **LEGISLATION**

It is important that a guaranty program be anchored by a law that is well designed and allows the Agency responsible for its implementation the necessary flexibility to manage the program, but which also protects the government's interest and the interests of the SME community. Some of the items that should be included in such legislation are as follows:

- **Purpose, Authorities and Responsibilities**

The Agency's purpose, authorities and responsibilities must be clearly spelled out in legislation. Currently, China's SME guaranty programs are being implemented at the city and provincial levels of government with varying degrees of success. Guaranty fund risks vary and the saturation of programs differ from area to area. There appears to be a lack of coordination of different programs and a lack of universal credit guidelines and training in the guaranty process. A re-guaranty program at the national level, accompanied by a set of loan criteria, training and overview for all those that participate

would bring sound management to the extension of credit to SMEs. We will cover the establishment of a re-guaranty program later in this Report.

### **Recommendation:**

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 consistency is implemented throughout the PRC. To assist in this implementation, we have included model Legislation, (Exhibit E), Rules and Regulations, (Exhibit G), and model Processing procedures, (Exhibit H), Servicing procedures, (Exhibit I) and Liquidation procedures, (Exhibit 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.

### **Maximum Size of an SME**

The maximum size of an SME that will be eligible for financial assistance under a credit guaranty program must relate directly to the purposes that the credit guaranty program has been developed. It is very important to assure that those receiving the assistance are members of the segment of the enterprise sector that the government is trying to stimulate. Funding sources available to support credit guaranty and related programs generally face severe pressures on their limited resources, so it is critical to the success of a program to assure that these limited funds are used for the specific purposes intended by the legislation.

In the PRC, size standards used to define SME appear to be broad, permitting guaranty funds to be used for relatively large businesses. While the use of broad size standards is not uncommon in international practices, lower limits on the maximum amount of loans allowed in the guaranty programs effectively limit the size of the business that seek out the guarantor's credit enhancement. In other words, if a guaranty program has a maximum loan amount of RMB 5 million, not many big businesses will apply for assistance from the program.

Currently in the PRC, it appears, (through local interviews), that most of the funding through the guarantees are going to the high end of the SME size standard that, in most cases, are State Owned Enterprises, (SOEs).

Consideration should be given to whether or not existing size standards in current guaranty programs focus the guaranty on the segment of the economy that legislators intend to receive the assistance. Legislation should be broadly to permit the Agency to modify its size standards from time to time; however, it should be clear that the intended beneficiaries of the Program are smaller enterprises.

If the purpose of the government program is to reduce unemployment by encouraging individuals to enter the enterprise sector or for very small enterprises to

expand thereby adding to its workforce, then size policies must be slanted to that end of the SME market place. Indeed, Sun Yongfu, Director-General of the China International Centre for Economic and Technical Exchanges, was quoted in the **China Daily** newspaper on November 3, 2001 as saying: “SMEs have become a major contributor to the nation’s economy and 75 per cent of new jobs in recent years have been provided by them.” In keeping with the principal purpose of the Program, Size policies must be tailored to the needs of the true SMEs.

**Recommendations:**

A thorough analysis of the allocations of guarantees should be undertaken to ascertain the distribution of guarantees by SME size categories to assure that the allocation of the government’s guaranty is being targeted to the type of enterprise envisioned by the authorizing legislation.

A study should be undertaken to research industries in the PRC to determine the characteristics of those industries and the degree of control exerted over these industries by larger businesses. Those businesses that possess 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 and represent the maximum size standard for that industry for purposes of qualifying as a SME.

- **Loan Size**

Given the virtual universal shortness of capital available to fund credit guaranty programs for SMEs, it is critically important to take steps to assure that the funds contributed are used to support as many qualified SMEs as possible. The maximum loan size to a single enterprise, (including affiliates), should be set by law and not left up to the discretion of the managing Agency in order to minimize pressures on the Agency from powerful market forces.

There is no one policy addressing maximum loan sizes among the guaranty companies presently operating in China. The absence of a single policy often leaves SMEs and lenders alike in a position of uncertainty when considering the potential availability of a loan guaranty. Then maximum in one city may not be the same as in an adjoining city and the maximum in one industry may not be the same as for another industry in the same city

**Recommendation:**

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.

- **Ineligible Enterprises**

Loan guaranty legislation is generally targeted in its purposes to the degree that funding is expected to benefit selected segments of the broad SME market. This targeting is accomplished through the identification of those segments where funding will be precluded, such as those segments that may not be seen as likely to: enhance employment opportunities, locate in desired areas identified for economic development, or certainly those that may be illegal.

At present, loan guaranty companies at the local level are free to select those segments of their markets that they wish to support and those segments that they do not. There is no uniform group of businesses or identifiable characteristics of businesses that may preclude them from seeking financing under local loan guaranty programs.

**Recommendation:**

Legislation authorizing a Central Re-Guaranty Program should specify those industries and/or businesses that do not traditionally operate in a manner consistent with the purposes of the Program. Consideration should be given to those 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. Legislation should be worded to provide sufficient flexibility to the implementing Agency to address changes in the marketplace as they develop.

- **Loan Maturities**

Loan guaranty programs are generally established to help banks and other commercial lenders mitigate the risk traditionally associated with SME lending. A component part of the perception of higher risk among SMEs is the frequent need for longer-term maturities among SME borrowers. While big businesses historically have ready access to equity capital and bond markets, SMEs are severely limited in their ability to access these markets. Consequently, legislation establishing loan guaranty programs provide the basis for policies that will incorporate longer maturities into loan program structures. Prudent credit practices acknowledge the basic precept that the useful life of the asset financed should serve as the guide in determining loan maturities.

Currently in the PRC, lenders advise that much of the lending to SMEs is on a 30, 60 or 90 day basis with very little being done in the mid to long-term category. Lenders usually like short-term commitments in order to have a hedge against

future liquidity problems and in order to keep short-term control on the borrowing SME. However such short-term maturities hinder the borrower's ability to develop long-term management strategies, since it is continuously concerned about the likelihood that the loan maturity will be renewed or not.

Placing short-term maturities on long-term needs financings such as for machinery and equipment is a disservice to both the borrowing SME and the bank. It places an unreasonably high burden on the borrower's cash flow, restricts its ability to generate and accumulate higher levels of cash and equity, and unnecessarily clouds its ability to plan for the future. From the bank perspective, unreasonably short maturities result in a weaker borrower for the reasons stated above and diminish the amounts the borrower might otherwise have available to deposit, funds that could help the bank retain liquidity.

It is clear that loan maturities should be tied to the useful life of the asset being financed for cash flow purposes since at the end of the term the SME will likely need to finance its replacement. This structure also helps to protect the bank by helping to assure the value of the asset serving as its primary collateral does not lessen in value faster than the outstanding balance of the loan. However, it is also of great benefit to a growing SME to be able to borrow working capital funds on longer basis than on 30,60, or 90 terms since a longer payback period will, again, provide significant benefit to its cash flows.

**Recommendation:**

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 legislated.

○ **Interest Rates**

Interest rates in successful loan guaranty programs tend to reflect the risks associated with the individual loan approved by a commercial lender. The artificial limitation placed on interest rates in some programs have proven to be unsustainable in the long run and frequently have created an expectation on the part of the SME borrower that the government must subsidize this cost in order for the SME to be successful. A lender must have the ability to perform an independent assessment of the risk present in a loan application and to price its loan at a rate commensurate with the risk assessed.

Of much greater benefit to a SME borrower is the ability to stretch its loan payments over a period of time that is more in line with the useful life of the assets being financed (as discussed above under Maturities). The impact to a borrower of a moderately higher rate of interest on the amount of a monthly payment over a three or five year term loan is relatively insignificant when compared to the benefits to a lender of being able to charge a reasonable rate of interest. Without this ability many lenders will stay away from the market.

### **Recommendation**

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, surveys should be conducted with existing SMEs on their thoughts why loans are not being made available to them. It appears that the 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.

- **Guaranty Percentages**

Over time many successful loan guaranty programs are able to encourage increased participation by cooperating lenders, although it is rare that this level of participation can be developed in the early stages of a program before all parties concerned have developed a full understanding of the risks involved. In some mature programs, guarantees of as little as fifty per cent have been achieved in certain circumstances. Programs in the earlier stages of development, particularly where banking systems are also in the state of flux, may require full guarantees in order to attract the participation of the lending community.

This is a very important policy decision that needs to be taken into consideration. Usually, there are two points of views within government that pertain to the setting of the maximum guaranty percentage. First, usually the fiscal entity of government approaches the setting of the guaranty from a risk standpoint and wants the government's guaranty to be as low as possible. The program administrator wants the guaranty as high as possible so that the lending community will use the program and thereby bring more support to the small enterprise community.

The setting of the guaranty level has more to do with the current status of lending to SMEs in a given locality than it does purely from a risk point of view. In an area where the lending community is comfortable with lending to SMEs, where good credit information on credit applicants is available, where there is a history of credit to SMEs then usually the maximum guaranty can be lower. However, in an area where lenders do not have a history of supporting SME lending or where there is very little in the way of historical lending to SMEs, the successful SME guaranty program must anticipate a higher maximum guaranty percentage.

The risk in lending to an SME does not lie in the percentage of the guaranty but rather the credit analysis of an SME application. The arbitrary transfer of credit risk from the guarantor to the lender only limits the type of credit that will be extended to SMEs or prohibits it completely.

The thought that if the government has a low guaranty, thereby increasing the risk of the lender is good for the SME program cannot be supported. A lender has a risk band within which it is willing to lend without a guaranty. That risk band will widen depending on the level of the risk being taken on the unguaranteed portion of a loan when compared with the income opportunity present on the guaranteed portion of the loan. The higher the guaranty on a loan, the more income will be generated for the lender at no risk; thereby allowing the lender to expand the risk band. The lower the guaranty, the narrower the risk band becomes.

In the PRC, most local guaranty companies possess the authority to negotiate the percentage guaranty with the lender on a case-by-case-basis. Understandably, however, given the early stage development of the guaranty programs and the reluctance of lenders to accept any risk in their SME lending, lenders are generally unwilling to negotiate anything less than a 100% guaranty.

This situation must be tolerated for the immediate future as lenders become more acquainted with the evaluative processes needed to analyze SME credit risk. At such time as they are comfortable with their abilities to assess SME risk and can identify potential profit sources in the SME market, maximum guaranty percentages will be able to be debated and negotiated.

In the meantime the development of the Central Re-Guaranty Program can address the issue of “risk-sharing” with the guaranty companies by providing a partial guaranty to the loans accepted into the Central Re-Guaranty Program. While this will not have a direct influence on the level of risk being taken by the lender, it will have the indirect influence of strengthening the guaranty of the local guaranty organization.

**Recommendation:**

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

A draft Legislation for a Loan Guaranty Program that represents the best practices used in support of a program of this nature is included in **Appendix E**. (Note: This legislation

should not be confused with the legislation in (iii) which is legislation for a re-guaranty program.)

## **REGULATIONS**

Successful programs have well defined Regulations that expand the provisions of the legislation supporting the Program. In general, Regulations are used to inform the lenders and general public how the Program will be operated and the authorities and responsibilities of those that are participating in the Program. Usually, the following items will be included in a set of Regulations:

- Detail explanation of the authorities given to major positions within the governing Agency.
- Further explanation of the points covered in the legislation such as:
  - a. Eligibility Requirements for obtaining a loan.
  - b. Loan Proceeds
  - c. Ethical Requirements of borrowers and lenders
  - d. Credit criteria that will be used in judging the credit worthiness of an SME.
  - e. Any other laws affecting the extension of credit under the program.
  - f. How loan applications are to be filed and by whom.
  - g. Interest rates that allowed under the program
  - h. Fees that will be charged for the guaranty and lender fees allowed under the program.
  - i. Eligibility requirements for lenders participating under the program.
  - j. Right of access to borrower and lender's files for purposes of review.
  - k. Lender servicing requirements under the program.
  - l. Guaranty purchase procedures and requirements
  - m. Lender's responsibility as to the liquidation of loans under the program.
  - n. Lender's responsibility for closing of loans and disbursement of funds.

**Recommendation:**

Develop a set of Regulations that further explains legislative language and add 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 G.

▪ **Special Programs**

The basic Loan Re-Guaranty Loan program should be developed to meet the generally perceived credit needs of the wide majority of the Country's SMEs. However, special needs may exist for particular industries where a compelling reason exists to provide added benefit or incentive to lend to such industries. The design of such Special Programs could be accomplished in such a manner as to increase the support for the special group without hurting the assistance being provided to the general group.

For example: in order to provide increased incentives to lenders to make more loans of smaller amounts, the following structures might be offered:

- Higher guaranty percentage
- Lower guaranty fee
- Faster response time to guaranty request
- Shortened guaranty application package
- Higher interest rate

It is not recommended that prudent credit standards ever be waived or reduced in order to provide incentives for Special programs.

**Recommendation:**

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

**LOAN POLICIES AND PROCEDURES**

Another element found in good guaranty programs is a set of well-defined loan policies and procedures. Loan policies and procedures are used in the day-to-day operations of the loan program. They give specific instructions to those overseeing the program and to those cooperating in the program on how they are expected to use the program and what constitutes acceptable participation under the program.

Whereas Program legislation gives the broad and long-term guidance and the Regulations provide the Agency's interpretation of the laws, the Policies and Procedures Manual is a

living document that is modified as changes take place in the needs of the program or problems arise that need to be corrected. Policies and Procedures are issued by the managing Agency without the need for legislative or regulatory involvement.

A draft set of policies and procedures for loan processing, loan servicing, and loan liquidating functions of a Loan Guaranty Program is included in **Appendix H, I, and J**.

Key among all policies and procedures found in successful loan guaranty programs is the strict adherence to sound credit analysis techniques.

### PRUDENT CREDIT STANDARDS

Strong reliance must be placed on traditional prudent lending practices, by both the lenders and the guarantor, including such requirements as sound character of SME borrower, prudent credit standards, and personal guarantees of the SME owners.

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. SOE has 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.

### **Recommendation:**

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).

### MARKETING and OUTREACH

Both the guarantor and the cooperating lenders must conduct pro-active outreach and public awareness programs. These programs are generally multi-tiered with efforts made to educate both the SME community and the lending community about the benefits of the guarantor's programs. In addition, other related organizations like accountants, management consulting firms, attorneys, and other government sponsored organizations attempting to assist SMEs are targeted.

At present local guaranty companies generate their own publicity and market their own programs to the geographic areas they serve. Very little exists in the way of coordination of efforts over a wide geographic area. Cooperation of lending partners is accomplished more through efforts with local branches of the larger banks than through senior level commitment to the programs at their Headquarters locations.

**Recommendation:**

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 Country, 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.

**SME TRAINING**

Technical assistance programs offered to SMEs are critical to the success of many SMEs that had not had the benefit of academic or practical experiences to draw upon in the management of their businesses. These programs can be delivered by the guarantor itself or by other organizations, sometimes private and other times government sponsored. Oftentimes, even the private sources of technical assistance receive some type of remunerative assistance from the government guarantor. Capital without knowledge generally leads to failure. Capital with technical assistance leads to success.

Outside of the academic environs, efforts have been made in the PRC to develop educational and guidance resources for the Country's SMEs, most notably SME Service Centers funded primarily by SETC. These are excellent resources for SMEs interested in developing or strengthening those skills necessary to successfully manage small businesses.

**Recommendation:**

Further develop the SME Service Centers by adding subject matter and locations of the Centers. Set up systems to use the Centers as well positioned sources to gain input from the SMEs about their credit needs and the operations of the Re-Guaranty systems for possible improvements.

It is recommended that a Central Training Association, (CTA) 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.

## **COMMUNICATION**

The most successful SME programs have a willingness to listen to the needs of the SME and lender communities in developing strategies that will work in the marketplace. Program structures calling for quicker than usual payments (e.g. weekly rather than monthly), principal deferments for the first several months of a loan to a start-up SME, longer maturities than typically available in the lending community and similar non-traditional practices often separate successful from failed guaranty programs. This will include the lender practice of visiting the SME loan applicant at his place of business both at the time of application as well as during the term of the loan.

Attitudes in China appear to be remarkably enthusiastic and optimistic about the future of the market economy in general and about the SME potential specifically. Ideas and new concepts receive open and full discussion and a real “team” attitude appears to exist. This is crucial to the development of successful new systems, because programs developed for a constituency that has not been consulted during the design of those systems is destined to failure. While discussion is open and frank, the current process seems to suffer from a lack of structure and coordination and the input to the policy makers appears to be sporadic and potentially not representative of the whole of the SME universe.

With past emphasis in commercial lending focused on the SOEs and other big businesses, banking systems are generally unprepared to provide the depth of loan follow-up and servicing often needed in SME lending. While the previously-mentioned SME Service Centers are very worthwhile organizations to assist in the management needs of the SMEs, the banking community on the whole appears to be inexperienced and uncommitted in developing the expertise and expending the resources needed to set up strong SME outreach and follow-up staffs.

While loan follow-up or servicing responsibilities are generally focused on the lender, the Agency must be prepared to absorb this responsibility in light of the lack of risk sharing at this stage of development of the loan guaranty programs. If the lenders are not adequately servicing their guaranteed loans, the guaranty companies must.

## **RECOMMENDATIONS:**

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 whole. Without the initial and ongoing contributions of those directly influenced by the Program, and the general SME community its sustainability will continuously be questioned.

Develop minimum requirements for lender servicing practices for the Central Re-Guaranty Loan Program loans. These should include requirements for routine field visits to the borrower's place of business, as well as specified timeframes within which to follow up on past due payments policies and procedures that will benefit the Program. The Agency must always be alert to the possibility that it is receiving the views of a chosen few supporting or participating in the programs and not the SME community as a whole.

### **RISK MANAGEMENT SYSTEMS**

Strong risk management practices with emphasis on early detection of problematic lender loan portfolios and problematic lending patterns and trends must be developed. These practices coupled with comprehensive review systems that are geared toward the correction of weak lender operations through training, as opposed to threatening expulsion from the Program or other punitive actions, will be the basis for a lasting and strong program.

In the Central Re-Guaranty Program being developed, this best practice will relate to the local guaranty companies rather than directly to lenders, although the local guaranty company will be responsible for managing its cooperative lenders. It is important that the same quality program and procedures be implemented at all levels to avoid bad practices at a given level having an effect on the soundness of the Central Re-Guaranty Program.

Local loan guaranty organizations have had the latitude of developing management systems as they have independently seen fit. Undoubtedly, some are sound and comprehensive while others are likely suspect.

#### **Recommendation:**

In the Central Re-Guaranty Program, the Agency must establish a comprehensive computerized database of information to track the performance of the loans in its guaranteed loan portfolio. This must also include a physical loan case file review system to examine files for compliance with established policies, procedures, and prudent lending practices. The system must be two-tiered: the first, evaluation of a local guaranty company's loan portfolio will be conducted for the purpose of determining which loans will be accepted for the Central Re-Guaranty. Such physical reviews must be carried out periodically to assure ongoing compliance by the local guaranty company. Once a local guaranty company's loans have been accepted for re-guaranty continuous monitoring of that company's portfolio performance must be carried out by the Central Re-Guaranty Company's Risk Management group. See Section 6 for policies addressing Program Oversight and Review.

### **LENDER SKILLS AND TRAINING**

Any successful program must have specialized, well-trained lenders, committed to the SME market and to the guaranty program. If the local banking community has been unresponsive to the guarantor's well-designed programs, alternatives should be identified such as non-governmental organizations (NGOs), specially licensed small business lending companies (SBLCs), banks specializing in SME financing, and similar institutions.

Credit guaranty organizations provide an excellent enhancement to lenders to help mitigate the credit risk associated with lending to SMEs. However, by virtue of the fact that they are guarantors and not lenders, they are 100 per cent dependent on attracting funding sources whose loans they will then guaranty. For this reason, it is imperative to include lenders in all facets of the loan program design process and the processes designed to deliver the guaranty to those lenders.

China faces a sizeable challenge in attracting the traditional banking community to its Loan Re-Guaranty Program. Many banks appear to be entrenched in their traditional lending preferences in favor of SOEs, while the financial industry itself remains closed to outside competition. If the banks do not step forward, few alternative lending sources exist at the present time to take their place.

Lending practices must be developed among participating lenders that reward prudent risk-taking in return for supporting the growth and development of the SME sector of the economy and the ultimate earnings increases of the lender.

SME lending, like any other type of lending, will occasionally result in losses. The key to any successful loan program is not to avoid loss at all costs, but to correctly analyze the risk present and to decide if that risk is in keeping with the standards established by management. Some SMEs will fail and some guaranteed loans will not pay off. But to hold a credit analyst accountable for circumstances that may be beyond his control is tantamount to telling him to take no risk or make no loans. The lender or guarantor must develop loan performance standards, employee performance standards, employee training opportunities, and reward procedures for performance above the established standards.

In China at present the principle of life-long accountability appears to serve as a detriment in instituting the concept of rewarding risk taking. The critical issue, however, is to clearly identify what the credit analyst is actually accountable for and what is beyond his control or responsibility. If he is provided ample training and is held accountable for following prudent credit analysis techniques, he will be more likely to take a measure of risk when offered just rewards for performing a thorough credit analysis.

Once the loan program has been designed and methods developed to place the Central Re-Guaranty on loans, comprehensive training programs must be developed to give the lenders the best possible understanding of the expectations placed on them by participating in the Program. Only lenders with a solid understanding of the Program

benefits and the required processes can be expected to make the commitment necessary to become active, well-performing lending participants.

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.

### **RECOMMENDATION:**

Develop comprehensive training programs for Lender, Guaranty, and Re-Guaranty personnel covering program loan policies and procedures, credit analysis techniques including loan scoring, and risk management and review system procedures.

Training programs must be developed for lenders that provide a full range of material needed by the lender to successfully conduct business under the Central Loan Re-Guaranty Program. This 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 what the Program requirements are and what is expected of them in order for the Program to become successful.

### **MISSION STATEMENT**

A Mission Statement for a Loan Guaranty Program explains to lenders, the public and the personnel of the entity the purpose and goals of the program. It should be short and precise but cover the main aspects of the operation, as specified in the authorizing legislation.

### **RECOMMENDATION:**

In order to promote a clear understanding among all of the participating entities in the Program, a Mission Statement should be developed by the senior management of the Agency. A sample is included in Appendix F.

## **LOAN REGULATIONS, POLICIES AND PROCEDURES**

### **INTRODUCTION**

The policies and procedures governing the implementation of a Guaranty or Re-Guaranty Loan Program are comprised of three parts: Loan Processing, Loan Servicing, and Loan Liquidation. These policies and procedures are directed to Agency personnel, but should be thoroughly read and understood by all organizations participating in any guaranty program at any level and any loan program that is supported by a Re-Guaranty Program in order to best understand Agency requirements and rationale when making decisions.

The policies and procedures contained within these Parts are intended to govern the transactions occurring between the Central Re-Guaranty function and the Provincial Re-Guarantor. The Provincial Re-Guarantor is, then, responsible for full compliance whether or not it has delegated any of these responsibilities to guaranty companies or lenders. The Central Re-Guarantor should conduct initial and subsequent Reviews of the Provincial Re-Guarantors to assure that all policies and procedures are being followed. It is the responsibility of the Provincial Re-Guarantor to assure itself that any responsibilities delegated to others are also in compliance.

The Loan Processing procedures are located in Appendix H; the Loan Servicing Procedures in Appendix I; and the Loan Liquidation Procedures in Appendix J of this report.

**Note: It is highly recommended that the Policies and Procedures used in the Central Re-guaranty Program be made available to all participants making SME loans and that training sessions be held for cooperative lenders so that operating consistency will be attained at all levels.**

### **Loan Scoring**

Loan Scoring is a concept that has been practiced in varying ways in the financial industry for many years. The basic concept is one of attempting to quantify a decision making process that is traditionally judgmental and potentially inconsistent in nature.

The use of credit in China has not been as wide spread as in many other countries, minimizing the past need for the services of Credit Reporting Agencies. In those countries where credit has been an integral part of economic activity, information developed by these organizations has been of great value to lenders individually and to the development of new time and cost saving techniques in the field of lending. These systems have been applied to both consumer lending and to commercial lending.

It is important when beginning a discussion about Loan Scoring to assure that the concept is understood in a similar manner by all who are participating in the discussion. To this end some basic definitions and concepts are offered for the purposes of this discussion.

Credit Rating – a numeric or sometimes an alphanumeric value developed by Credit Reporting Agencies to reflect the manner in which an individual debtor has paid past debts.

Of the four scores or ratings referred to above, the Credit Rating has been in use the longest and has the most acceptance as a proven beneficial tool in decisions related to the granting of credit. For consumers most of whom are wage earners, the Credit Rating is a measure of payments histories of such debt as: home mortgage loans, car loans, student loans, credit card debt, and other similar debt. For businesses, the Credit Rating is based on such debt experiences as: supplier debt, bank loans, leasing facilities, and tax and legal filings.

The Credit Rating provides the foundation for a number of other quantitative tools being used today. And the reason can be tied to one of the most basic of considerations in traditional judgmental or analytical lending – character. Of all considerations in extending credit, the honesty, integrity, and experience of an individual in having satisfied past credit terms in a timely manner is paramount.

Credit Reporting Agency – an enterprise established for the purpose of assembling information about past payment habits of individuals and/or businesses on behalf of creditors. Sometimes a single company will serve both the consumer and commercial enterprise, while other times companies specialize in either consumer or business credit information collection services. Such organizations may be both the collector of credit payment information and the provider of that information to prospective lenders or the two functions of collecting and reporting may be performed by different companies. The process is basically two fold: creditors report payment experiences into the collector’s database and the reporter assembles the appropriate data relating to the applicant and reports it out to prospective lender. Accuracy and consistent reporting is essential and guidelines are strictly followed.

Credit Scoring – the process of using Credit Ratings and component data to develop a value thought to be of predictive value in determining the likelihood of debt repayment.

Credit Scoring is the most recent technique being used in SME lending activities. While Credit Scoring has been used for at least twenty years in some countries, it has traditionally been used only in the consumer market. Until just the last five years or so, it had been generally accepted that basing a credit decision on past debt payment histories might make sense when the majority of those debtors had relatively steady and stable sources of income, as wage-earners do. Businesses, on the other hand, by their nature are dynamic organizations where revenues and earnings may vary significantly from one period to another. As a result, with income not being as steady or as stable, a credit rating based on past debt payment experiences would not be as valid for businesses as it had been for consumers.

Credit Scoring advocates tout the system as being “predictive” as opposed to being analytical in that it uses very little financial information in developing its score and rather uses largely statistical data the developers feel is “predictive” of the debtor’s likelihood in repaying the proposed debt. A Credit Score is generally dominated by the debtor’s (principal owner’s for SMEs) Credit Rating and other factors may include such elements as: location of the business, age of the business and age of the owner, telephone exchange (identifying location), and years of formal education, among others.

Proponents of Credit Scoring also point to the fact that the elements upon which the scores are based are all verifiable, thus assuring the accuracy and the consistency of the scores. Further, the scores lend themselves to lender risk management systems where scores and score components can be monitored and changes made quickly to mitigate developing performance trends. Finally, Credit Scoring is extremely more cost efficient

and effective than traditional means of analyzing SME credit requests as well as being more responsive to the frequent time sensitivities of the owners of SMEs.

While some larger banks in the United States are presently using Credit Scoring systems for loans of up to \$250,000, most use such systems for smaller loans. Those that are particularly active in the systems, generally offer a wide variety of loan products with differing interest rates, maturities, collateral, and other covenants depending on the score. Many use the systems as quick and efficient means to approve smaller loans, but do not rely completely on such scores when declining applications. If an application scores a low value, it may receive some traditional analysis (requiring more information to be submitted) before the bank would formally decline the application.

At the present time wide spread credit reporting systems are not in place, nor has credit been widely available to consumers or to SMEs and so Credit Scoring systems must be considered premature. However, as the free economy continues to grow and standards of living increase, it would be worthwhile to begin to develop such systems as these, which will ease access to credit for consumers and SMEs alike.

Risk Rating – a numeric value assigned to an outstanding loan intended to reflect the risk of repayment, i.e. the risk of loss at that moment in time.

Risk Ratings are used by lending organizations in order to better categorize groups of loans that may ultimately have similar likelihood of resulting in loss. Each loan is periodically assessed and given a rating such that, at any one moment in time, the entire portfolio may be categorized in keeping the rating system in place. Thus, management will be continuously aware of the degree of risk in its loan portfolio and developing trends and patterns can be addressed and corrected, as needed.

In some countries banking regulators publicize the methods they use when evaluating or classifying banks loan portfolios. The Regulators interest stems from wanting to assure that banks are maintaining vigilance over their depositors' funds. When this is the case, banks normally use the regulator's methodology in order to facilitate discussion when examiners review the bank's operations. Whether a regulator's methods are employed or not, risk management efforts taken by lending companies such as developing a Risk Rating system is simply a prudent means of monitoring portfolio risk

Loan Scoring – the process of using Credit Ratings and other selective criteria to develop a value thought to reflect the degree of risk of loss at the point in time when a loan application is being analyzed. The elements used in a Loan Score can be identified, selected, and weighted by each individual institution developing such a method. The resultant score can be used for several purposes:

- As a means of making the final decision to approve or decline a loan application
- As a means to verify the likely decision based on traditional credit analysis techniques
- As a means to help monitor the level of risk present in a loan portfolio

Because a Loan Score simply reflects data with the only subjectivity contributed by a mere selection and an assignment of a weight, few lending institutions use a Loan Score as the sole means of making the credit decision in commercial loan applications.

More likely is its use as a supplemental means of assessing risk, which when coupled with traditional credit analysis, will provide a confirmation or verification of what may have been concluded through a financial credit analysis. If the confirmation is not obvious, a decision can be made to re-assess particular elements of the analysis where the score may be at odds with the analysis.

Other than at the time of loan application decision-making, the Loan Score is an excellent means by which to assist in monitoring the level of credit risk in a loan portfolio. Either as a single data point of input to a lender's risk management database or as the multiple components of that score, the score(s) is infinitely more useful than any attempt to incorporate parts of a traditional credit analysis into that same database. (See Section 6 for additional discussion of Program Oversight and review).

Traditional, prudent credit analysis is often discussed in terms of the five C's of sound credit: character, capital, capacity, collateral, and conditions.

Character relates to all of those factors that can be attributed to the individuals who own and manage the business. These address, first and foremost, the honesty and integrity of those individuals and their standing or reputation in their community as being trustworthy and people of their word, who will do their best to deliver what they promise. This is the essence of "character lending" – the practice of making relatively small loans on little more analysis than that of the individual's promise and which has in many places around the globe been a successful practice for individual and micro-enterprise lending programs.

Character also addresses the payment habits and patterns of those members of management who will be responsible for operating the applicant business in a manner as to generate sources of funds to repay the loan. And so, the significance of the Credit Rating is made clear.

Character, by extension, also relates to the experiences of the management team in the field of the applicant business. This experience may have been of a technical nature or in a management position, or both. Each is significant for different reasons and is traditionally a key consideration in assessing the feasibility of business plans detailing future plans and expectations.

Capital addresses the adequacy of invested funds when compared to the amounts of capital contributed by a company's creditors. The general thinking is that the more the owners have at stake in their business, the harder they will work to minimize the risk that they will lose that equity. Similarly, when adversity strikes, it is less likely that owners with a significant investment will give up the struggle and leave the creditors at risk.

And so, a reasonable proportion of equity must be present to help assure that sufficient credit will be available when needed.

Capacity deals with the ability of the company to do what it has said it will do – to accomplish its business plan in general and, specifically, to pay off the borrowed funds in the manner it said it would. This is the most wide-ranging of traditional credit analysis elements and is the area that requires most evaluation. There are many reasons for past failures and many reasons for past successes and they must be understood when assessing future prospects. Industry outlook, product line, pricing strategies, competition, and business plans must be assessed in order to appreciate the business's true financial needs and its ability to achieve its plans and make orderly payment on its debt.

Collateral, while not a consideration in evaluating a borrower's ability to repay its obligations through the operations of its business, clearly plays a significant role in assessing the risk of ultimate loan repayment. Prudent banking practices dictate that secondary means of repayment be identified in the event that developments occur that impede the ability of the borrower to generate the funds necessary for loan repayment through the normal course of its operations. Third party guarantees play a role in this area, but traditionally, collateral assets offered to secure the loan provide the best means to collect a loan when the borrower has been unable or unwilling to repay the loan through its operating income.

Valuation of collateral assets is an important consideration and it is this valuation process that is often poorly understood by the borrowing public, including SMEs. Many outside the circle of commercial lending think in terms of cost, market value, or book value when estimating the value of assets offered to secure debt. However, from a lender's perspective, these assets will generally not sell for these values when it is forced to sell them at the time a business and its debt obligations are being sold in a liquidation scenario. The popularly circulated idea that a lender requires 200% collateral, often means that the assets taken as collateral simply have a "liquidation" value of only half of the value attributed to them by the borrower.

Conditions represent the terms and covenants imposed on the loan by the lender and accepted by the borrower for the duration of the loan. These include: interest rate, maturity, collateral requirements, periodic financial statement submissions, and varied documentary requirements. Although it is contrary to the interests of both the lender and the borrower to place conditions in a loan agreement that effectively place impediments on the borrower's ability to repay the loan as structured by the conditions, it is a too common practice. Chief among such conditions is the requirement to pay off a loan in too short a maturity. This is often the case when a SME borrows funds to purchase machinery or equipment that may last as long as ten years, but where the lender – adhering to age-old bank practices – may establish the condition of a one year maturity. The SME is thereby placed in the difficult position of either not accepting the loan – and growing its business – or acquiescing to the illogical one year maturity in hopes that the lender will renew the debt at its maturity.

Loan Scoring IS NOT a substitute for detailed credit analysis. It is simply a means to quantify the traditional credit analysis performed by prudent lenders. Such quantification is helpful in verifying the results of the traditional, judgmental analysis. Additionally and very significantly, it greatly facilitates the tracking, monitoring, and comparing of loan characteristics as they pay out over their repayment terms.

The model proposed here is typical of the types of elements used in developing a Loan Score. Bearing in mind that the basic purpose of the score is help assess the degree of risk present in a loan application, it essentially answers the question of what is the likelihood of loss, if this credit request is approved. The decision then becomes: is this level of risk acceptable given the risk tolerance of the lender's expectations.  
Model

While subjectivity exists in the development of Loan Scoring models, the intent is to minimize that subjectivity and certainly to reduce the level of subjectivity present in the traditional, judgmental credit analysis process.

The primary subjectivity is found first in the selection of the Risk Factors themselves. These can be increased, reduced, or modified to reflect the lending philosophy of the risk management group. The secondary subjectivity is found in the weighting of the selected Risk factors; also, at the discretion of the risk management group. It is this group that selects, weights, and defines exactly how each of the Risk Factors will be scored.

Once these subjective determinations have been made, it is critical to assure that each loan is scored in the same manner. Management must decide upon precise definitions for each of the Risk Factors and these must be scored independently of any other considerations. For example, "management experience – overall" has no impact on "management experience – management;" "collateral" has no impact on "total debt to worth," and so on. Each score stands on its own.

One of the most advantageous characteristics of credit guaranty systems designed for SMEs is generally found to be their assistance in promoting longer-term financing for qualified borrowers. With this in mind, the model has been developed to score loan applications funding working capital needs and equipment purchases on a term basis.

### **RISK FACTORS**

These factors are considered to be the most significant in determining the ultimately risk of non-payment of a loan. The list can be reduced or expanded.

Debt Coverage – a ratio that measures the degree to which past and projected cash flows exceed proposed debt service requirements. Cash flow is traditionally defined as Earnings Before Interest and Taxes (EBIT) and is measured against "pro forma" or after loan disbursement annual payments of principal and interest on all long-term debt. Relates to Capacity in traditional credit analysis.

Collateral – valuation techniques must be standardized in Policy guidance with valuations based on net liquidation estimates after deducting any outstanding senior lien positions. Net valuation of all collateral assets taken as security is compared to the original loan amount and the resultant Loan to Value calculation is scored. Relates to Collateral in traditional analysis.

Total Debt to Equity – a ratio that measures the relationship between owners’ capital contributions and capital contributed by creditors. Relates to Capital in traditional analysis.

Age of SME – measured in years, or months if less than one year.

Credit History – SME – if available. From an independent commercial Credit Reporting Agency.

Credit History – Largest Stockholder – if available, from an independent consumer Credit Reporting Agency.

Management Experience – Overall Years in Industry – provides an indication of expected knowledge of technical issues related to the industry within which the applicant SME is operating.

Management Experience – Management Years in Industry – provides an indication of the expected knowledge related to management issues in the industry within which the applicant SME is operating. Management scores relate to Character in traditional analysis.

Industry Risk Rating – some countries have well developed industry classification systems that facilitate access to industry-wide statistics. However, even in the absence of such data, knowledgeable professionals in the field of commercial lending will frequently be able to assess risk levels in certain industries.

#### A. VALUE

Values assigned to each Risk Factor will either be represented by a ratio or an absolute numeric. Formulas used to determine values must be determined by the risk management group and must be calculated in the same manner for all loans.

#### B. SCORE

It is important that personnel assigned the task of scoring the Risk Factors adhere to the definitions laid down by the risk management group and that the scores be assigned consistently. Periodic audits and reviews should verify compliance.

#### C. WEIGHTS

Being one of the principal areas of subjectivity having significant impact on the final score, the importance of this element is clear. Keeping in mind that the purpose of this stage of the Loan Scoring process is to purely assess risk and not make a judgment, the weights are intended to help identify where that risk lies and to what extent. The judgment is addressed in a later stage.

D. SCORE

This numeric multiplies the Risk Factor Score times the Weight to arrive at the Score for each Risk Factor.

E. TOTAL SCORE

The sum of the Scores for all Risk Factors:

**LOAN SCORING MODEL**

<u>Score</u>	<u>Risk Factor</u>	<u>Value</u>	<u>Score</u>	<u>Weight</u>
	Debt Coverage – past 2 year average	%	1-5	20%
<u>Y</u>				
	- projected year 1	%	1-5	5%
<u>Y</u>				
	Collateral			
	Land and buildings	X		
	Machinery and equipment	X		
	Furniture and fixtures	X		
	Vehicles	X		
	Accounts receivable	X		
	Inventory	X		
	Cash and equivalents	X		
	Total	T		
	Loan to Value	%	1-5	20%
<u>Y</u>				
	Total Debt to Equity	%	1-5	10%
<u>Y</u>				
	Age of SME	X	1-5	10%
<u>Y</u>				
	Credit History - SME	X	1-5	10%
<u>Y</u>				
	- Largest Stockholder	X	1-5	10%
<u>Y</u>				

Management Experience			
Overall years in Industry	X	1-5	5%
Y			
Mgmt. years in Industry	X	1-5	5%
Y			
Industry Risk Rating	X	1-5	<u>5%</u>
Y			
<b>Total</b>		<b>100%</b>	<b><u>YT</u></b>

Notes:

1 – Scoring value of 1 through five: 1 = worst, 5 = best

X – Value

Y – Score

T - Total

YT – Total Score (5.00 maximum)

## **CENTRAL RE-GUARANTY PROGRAM**

We have spent much time on this particular issue. Presently, China's guaranty and re-guaranty programs are a mix of City and Provincial programs with no consistent approach to the services to SMEs. While some City programs and Provincial programs are sound, others are not. While some private sector guaranty funds are sound others are not. In some Provinces, no such programs with definable volumes are evident.

The above gives a patchwork effect to the implementation of assistance to SMEs and therefore we are recommending that a Central Re-Guaranty Program be established. To accomplish this, we are recommending that a private sector association be formed to support services being delivered to SMEs, including the Re-Guaranty Program.

We recommend that the following general criteria be used in the establishment of such a program:

- a. That the program be used to re-guaranty those loans included under Provincial programs, City programs, where Provincial programs are not in place or active, and private sector guaranty programs.
- b. That all participants entering the Central Re-Guaranty Program be mandated to use a set of credit criteria issued by the Central Re-Guaranty Association including Rules and Regulations and Operating Procedures in their daily operations. (This will institute uniform credit criteria that are not in use currently.)
- c. That the Central Re-Guaranty Program assume a maximum of fifty per cent (50%) of the risk taken by a lower level guaranty or re-guaranty organization on individual loans meeting the credit criteria established in the Central Re-Guaranty Program.
- d. That the participating entities pay a guaranty fee that reflects the risk being taken by the Central Re-Guaranty program on each loan being guaranteed. Such fees should be established based on the loss experience of the individual fund participating and the future estimated risk being taken. It is extremely important that uniform credit criteria and excellent management controls on the program be implemented.
- e. That each participant in the Central Re-Guaranty Program agree, in a formal Agreement, to adhere to all Legislation, Rules and Regulations and Standard Operating Procedures issued by the Central Re-Guaranty Association.
- f. If existing loans are included in the Central Re-Guaranty Program that an extensive review be made on the individual loans to assure that they meet the credit criteria established for the Central Re-Guaranty Program.

g. That those participating entities in the Central Re-Guaranty Program that have acceptable program systems, trained personnel and acceptable historical loss experience and in general are thought to be a good credit organization should be given delegated authority from the Central Re-Guaranty authority to approve loans without the authority reviewing each loan. These participants will be known as Preferred Participating Entities, (PPE). Those entities not meeting the delegated authority criteria must submit each loan to the Central Re-Guaranty authority prior to attaching the Re-Guaranty to the loan.

### **Association of Credit Guaranty and Re-Guaranty Companies**

We have discussed the feasibility and need for a Central Association of Credit Guaranty Companies with lenders, government officials and guaranty companies. There is a consensus that an association would be most helpful in the support of SME lending within the PRC.

The Central Re-Guaranty Association, (hereafter referred to as “CRA”), would perform the following duties:

- a. Develop and implement a re-guaranty program that would re-guaranty individual loans supported by Provincial Re-Guarantees, City guarantees or re-guarantees, where Provincial programs are not available; and the guarantees and re-guarantees of private sector guaranty companies.
- b. Enter into Agreements of Re-guaranty with the above entities that agree to abide by all Rules and Regulations and Operating Procedures set out by the Association.
- c. Determine the fees to be charged to the beneficial entities for the re-guaranty based on the expected risk being taken by the Association.
- d. Monitor the operations and risk being taken by the beneficial entities through a periodic review process.

It is recommended that the Association be established through a one-time grant from the Central Government that would be used to set up a trust. The trust funds would be invested in Government obligations with the earnings on such investment being used to support the operations of the Association, including the reserve for future losses in the re-guaranty program.

The Association would also be given the latitude to raise funding from the private sector in the form of grants that would expand the trust fund thereby allowing for the SME program to be expanded.

There would be several benefits from such an authority and its involvement in SME development being authorized in the PRC.

- a. Such an authority would place an umbrella over the extension of credit to SMEs within the PRC, implementing concise credit criteria nationwide.
- b. It would provide for an oversight body that could determine the risk band that is acceptable for such a program.
- c. By structuring the re-guaranty program to align with the SME goals of the government it will assure that SMEs will receive a fair share on a national basis of the support being given by government.
- d. It will improve the value of the guaranty being extended thereby giving greater assurance to the lending community and to investors in the private sector.
- e. It will provide for the expansion of the lending program by establishing the basis for a secondary market for the guarantees, introducing more capital in support of SMEs.

It would bring credit training to extenders of credit that in turn will improve the overall quality of credit being extended in the PRC.

- g. It will lower the capital requirements on participating entities, (due to the sharing of the risks), thereby increasing the amount of credit that each entity will be able to extend to the SMEs.

We have developed model Legislation, (Appendix K), Association By-Laws, (Appendix L), and Rules and Regulations, (Appendix M) for such an Authority.

## **LENDER AND GUARANTOR OVERSIGHT AND REVIEW**

This Section addresses the role of Lender Oversight and Review from the perspective of a Central Guaranty Program, viewing cooperative lenders as its participants. If a Central Re-Guaranty framework is implemented, the same concepts apply, but rather than addressing cooperative lenders as the participants, the Central Re-Guaranty Association, (Agency) will be dealing with Provincial Guaranty or Re-Guaranty companies, local guaranty or re-guaranty companies where Provincial organizations do not operate and private guaranty companies.

It then becomes the responsibility of these lower level Guaranty or Re-Guaranty companies to oversee and review the performance of its lenders (or local guaranty companies) in a manner similar to the manner exercised by the Central Re-Guaranty Agency.

The relationship that will develop between a cooperative SME lender and the Agency, as guarantor, must be one of close cooperation and respect for the interests of the other. The commercial lender and the Agency will possess differing interests stemming from the commercial lender's expectation of earning profits and the Agency's intent to provide for the common good of PRC citizens. With this in mind, the relationship between the two must be founded on the principle of mutual trust and respect in order that the interests of both may be achieved.

The Agency will not have the level of direct involvement with the Program's customers, the Small and Medium-sized Enterprises, as its cooperative lenders will. The critical task for the Agency will be to have communicated well with the SMEs in coming to an understanding of the credit needs of those SMEs and with the lenders in developing processes and systems of delivering its guaranty to those organizations. Loan programs and guaranty delivery systems need to have been designed with the needs of both the SMEs and the cooperative lenders in mind. The critical role of the cooperative lenders is to understand those Programs and policies and to carry out or implement those policies in a comprehensive manner.

The guarantor must educate its cooperative lenders about:

- Program purposes
- Required policies and procedures to be followed
- Credit standards
- Performance expectations

Once its Programs are fully implemented, the guarantor, (or the re-guarantor, as the case may be), has the responsibility to assure that its Programs are being carried out in the manner intended. Such oversight is necessary to determine the level of success being achieved by the guarantor as well as to provide a source of information upon which to base refinements to Program policies and standards. It will also provide critical information to evaluate the performance of its cooperative lenders.

In order to maintain a level of knowledge necessary to properly manage the risk in its guaranteed loan portfolio, the Agency is concerned with several cooperative lender issues:

- Financial health of individual cooperative lender's guaranteed loan portfolio
- Long-term sustainability
  - Confirmation of its use of prudent lending practices in making guaranteed loans
- Compliance with guarantor's policies and procedures

The health of a lender's portfolio can be determined through the ongoing monitoring of certain performance indicators based on data captured from routine reporting systems. Such data should include elements needed to calculate the:

- Currency Rate
- Delinquency Rate
- Purchase Rate
- Liquidation Rate
- Loss Rate

Note: see definitions under "Review" Section.

Assuming that information needed to calculate these rates is reported and stored in the guarantor's database on a fairly frequent basis, the Company will possess sufficient data for worthwhile and ongoing monitoring of an individual lender's portfolio performance.

The review of methods and techniques used by a lender in analyzing and evaluating SME loan applications will help to gain deeper insight into the strength of the performance indicators described above. While it is likely that strong performance indicators will be found to be supported by prudent credit analysis, a review of the techniques used can both verify this finding and also provide a means to identify "best practices" for distribution to other lenders.

## **MONITORING**

The process of developing a worthwhile monitoring system begins with the identification of data necessary to track and evaluate elements of the Program considered critical to its success. These elements will include identification data related to the lender and the SME, credit based data about the SME, public policy based data about the SME, and loan performance data. The collection of the data itself is a significant issue in that it must be sufficiently comprehensive to capture the data necessary to be worthwhile, but cannot be so burdensome that it might alienate lenders that may already be hesitant to becoming active SME lenders. Unless the lenders contributing the data understand the benefits of the system and have been party to the development of the system, the information they contribute may become suspect as to its accuracy and timeliness.

Data will be collected both at the origination of the loan guaranty and periodically during the life of the guaranty. Information collected at the outset will include identification elements and initial credit related data, while periodic reporting will be necessary to gain insight into the loan and the lender's payment performance.

Data collected at the time of origination should include:

- Name, address, and bank identification number of the lender,
- Name, address, and tax identification number of the SME,
- Amount of loan request,
- Total amount of Agency exposure in the loan,
- District, City, and Province where SME is headquartered,
- Industry code of SME's principal business activity,
- Amount of loan approved for guaranty
- Type of loan
- Interest rate
- Maturity
- Purpose of loan proceeds
- Loan Score (and selected Loan Score components – see Section on Loan Scoring)

Periodic reports (monthly, quarterly, etc.) submitted by the lender should include:

- Loan number identifier as State guaranteed loan
- Outstanding balance
- Last payment amount and date
- Next payment amount due and date
- Payment status for each loan guaranty outstanding (payment deferral, current, past due, in-liquidation, requested purchase, purchased)

The data captured will provide the information necessary to manage the level of risk present in the guaranteed portfolio as often as the data is required to be submitted by the cooperating banks. Evaluation of the data will help to identify and evaluate problematic trends by lender, geographic location, industry type, type of loan, loan score component, and by any other element captured and stored in the database.

Only with a strong commitment to prudent risk management practices will the Program be able to be responsive to the needs of the SME and lending communities as well as be able to spot and correct unacceptable trends and practices before they become firmly imbedded in lenders' guaranty practices.

## **REVIEW**

In order to assure that policies and procedures established by the Agency are being followed and that lender performance is in keeping with established standards, it is imperative to develop and implement review systems whereby compliance with established policies and practices can be measured.

Review functions include those that relate to information not captured in the database, but rather present in the lender's credit files. This information will be reviewed to assure:

- Compliance with established lending policies,
- Adequacy of credit analysis techniques,
- Adherence to prudent internal controls, and
- Compliance with accepted loan closing, servicing, and liquidation processes.

Monitoring lender and Program performance through the use of database monitoring systems is crucial to identifying early-warning signs of potential problems in Program implementation. But, often, identification of these signs will lead to the need to take a closer look at the elements appearing problematic. To the degree that these elements relate closely to the operations of the lenders, the only way to get a closer look at them may be by conducting a physical review of the lender documentation and practices. Additionally, certain elements of sound Program Oversight cannot be discerned through database observation alone and must be carried out through periodic physical examinations. These include those elements related to compliance with established policies, procedures, and prudent lending practices.

The Agency must decide which of its policies it considers critical to the success of its Mission and develop a formal review system to assure that these policies, at a minimum, are being followed. It is often found that poor record keeping, weak adherence to required standards, and overall careless operations are themselves early warning signals of impending carelessness in adhering to sound credit practices and thus lead to poor financial performance.

And so, a Review is used both to follow up on lenders that have been found through database monitoring and evaluation procedures to warrant a closer examination as well as to routinely and periodically assure compliance with established policies and practices.

## **GUARANTY LOAN PROGRAM REVIEW GUIDE**

**1. General Concept of Review.** There are several primary concepts that drive the implementation of this review process:

- The Review Determination Will Be Based on Performance. Monitoring of lender performance benchmarks will identify those lenders that will be prioritized for review purposes.
- The Review Will Be Policy Based. Portfolio performance as compared with established benchmarks will determine the frequency and priority of reviews. Case files will generally be reviewed for policy compliance, lender controls, and credit analysis.
- The Review Process Will Be the Same for Everyone. Lenders are all governed by the same basic policies, procedures, and prudent lending practices. Elements will be added or removed by the Director as experience is developed with the review process and as policy direction may shift.

**2. Outline of the Lender Review Process.**

- a. Timeframe. Each field office will review its lenders that demonstrate moderate loan volume within their first year of operation and thereafter within a 3-year cycle.
- b. Lender Review Selection. Based on a priority system to be established lenders will be selected for review by the number of benchmarks they fall below.
- c. Elements. The elements for each loan reviewed are designed to improve objective analysis by ensuring a “YES” or “NO” answer. This enables the review to be scored objectively and the results kept in a database system for further analysis.
- d. Exit Interviews. The Review Team will discuss the lender’s score and the results for given questions upon the completion of the Review.
- e. Best Practices/Excellence in SME Lending Awards. Lenders that have exemplary procedures or policies may be nominated by the review team for a “Best Practices” award from the Loan Programs Division. Lenders that pass all five benchmarks and are found to be “Substantially in Compliance” may be awarded an “Excellence in Guaranteed SME Lending Award.”

- f. **Corrective/Immediate Action Periods.** If required, lenders must submit action plans to Headquarters detailing how they plan to overcome the cited deficiencies. These may be required to be implemented within 90 days, or 30 days if the Agency is at substantial risk
- g. **Loan Selection.** The number of loans to be reviewed will represent a reasonable proportion of the loans recently guaranteed and presently outstanding. The minimum number of loans that must be reviewed is 5. Once the number of loans to be reviewed has been determined, the specific sample should include:
- Loans approved from the previous complete year.
  - Loans currently in liquidation (approved in any year, but not charged-off)
  - Loans in active servicing (approved in any year, but not in liquidation).
- h. **Random Sampling.** The simplest way to generate samples is to print out or display the lender's loan numbers generated during the previous complete year. Once the loan numbers are printed/displayed, simply pick a random number (say from 1 to 10) and select every nth loan. Make sure that the loans have been sorted by a factor other than loan number to ensure randomness. The same holds true when selecting loans in servicing or liquidation except that the loans that you select from in these cases need not be limited to those approved in the previous complete year.
- i. **Review Scheduling Priority.** Review schedules should be prioritized as follows:
- Lenders that exceed benchmark performance in only zero or one of the five benchmarks. For any lender into this category a review is required, regardless of the date of the previous review. Even if a lender had received a review the prior year, there must be another review if the lender falls in this category.
  - Lenders that exceed benchmark performance in only two of the five benchmarks.
  - Lenders that exceed benchmark performance in only three of the five benchmarks.
  - Lenders that exceed benchmark performance in only four of the five benchmarks.

- Lenders that exceed benchmark performance in all five benchmarks.
- j. Other than Benchmark Mandated Reviews. HQ may choose to mandate a review for any lender at any time regardless of the lender's performance according to the benchmarks. In order to assure consistent reviews procedures, however, these reviews must be conducted in the same manner set forth otherwise

F. 3. REVIEW SELECTION CRITERIA.

Five categories have been chosen to serve as benchmarks for a mandatory review. They are listed below with their definition and performance benchmark, which establishes parameters for satisfactory performance in all delivery methods of the 7(a) and 504 programs.

**Currency Rate**

**$\leq 75$  percent**

Percentage of loans that are 0 to 60 days past due in scheduled payments; deferments are not included even though these loans are technically current because deferred loans by their very nature have underlying problems that necessitated the deferment. Currency rates are based on the total outstanding ("active") loan portfolio – paid-in-full (PIF) loans and charge-offs are not included, but delinquent and liquidation loans are. "Active" equals all loans outstanding including "past due" and "in liquidation." PIFs and charge-offs are not included.

**Delinquent Rate**

**$\geq 15$  percent**

Percentage of loans over 60 days delinquent including those in liquidation compared with total outstanding ("active") loan portfolio; PIFs and charge-offs are not included. Liquidation is included in the delinquency total to give a true picture of a lender's problem loans – it also recognizes that lenders have different means of classifying severely delinquent accounts as being in liquidation, and when they are so classified.

**Purchase Rate**

**$\geq 15$  percent**

Percentage of loans purchased compared with total loans disbursed by a lender, consisting of the outstanding (active) portfolio plus Paid In Full (PIFs) and charge-offs.

**Liquidation Rate****>=10 percent**

Percentage of loans being liquidated (in liquidation status) compared with a lender's total loans outstanding (active portfolio). Loans are generally classified in liquidation when workout attempts have ceased and a lender begins enforced collection procedures to obtain recovery.

**Loss Rate****>=5 percent**

Losses (charge-offs/write-offs) will be calculated as a percentage of total loans disbursed, outstanding (active) portfolio plus PIFs and charge-offs. Losses are an important measure since a lender's currency rate may be high, giving a false picture of a healthy loan portfolio although the lender may have a high loss rate. Losses will be tracked on a cumulative basis (i.e., total losses on a lender's portfolio as a percentage of the total disbursements for all loans originated since inception of the Program), and subsequently on an annual basis by year approved (total losses by fiscal year compared with total loan disbursements for that fiscal year).

**4. Conducting the Review.**

**Spreadsheet Contents.** A spreadsheet is used to complete the review of the lender's practices. The spreadsheet should contain space for:

- Policy element being reviewed
- Indication of review result for each element
- Comment section

**Scoring Notes**

In order to maintain consistency of scoring, "N/A" answers do not count. If a question is answered "N/A" it does not count for or against the lender. Example: if there is a 100-question test and the answers of 6 questions were "N/A" then only 94 of the answers would be used in the scoring calculation.

The scoring can be weighted. Each question should be assigned a specific weight in accordance with the degree of importance associated with the element as determined by senior management. Eligibility and credit questions (Processing Section) are generally weighted more heavily than other questions.

While other questions may have a lesser weighting, the volume of these questions may be greater. The weighting may be structured to increase as the number of deficiencies cited

for the same element increases. A two-point question might deduct two points for the first error, four for the second, eight for the third, etc.

### **Reviewing Loans**

Review file documentation to enter a response to each question. When making comments, they should be kept brief and to the point. It is important to be consistent when responding to the questions for each case reviewed. The findings are only as good as the consistency of the individual responses.

1. A No is a No. The proper response for a question on the form must be “NO” if ANY PART of the question may be answered “NO” or if there is any part of the question that cannot be answered with a definitive “YES.”
2. Oversight Review Section. The review team will also conduct a review of the lender’s oversight capabilities. On the spreadsheet, this section is at the bottom of the question list. Completion of the Oversight questions is done once (not for every loan) and is only included on the “Oversight” tab.

**Exit Interviews.** When the Loan Reviews and the Oversight section are complete, conduct an exit review with the lender. These reviews must be limited to the actual results of the review. Review personnel must offer no conclusions/recommendations at this time, but they may convey the score as indicated on the “scoring” tab. Conclusions/recommendations must only be provided to the lender as part of the written review.

**Scoring.** The final score should provide a compliance rating based upon a 100-point, percentage-based scoring system. Below is a scoring grid.

**Substantially in Compliance.** The lender is found to be “substantially” in compliance. Lenders that have passed all five benchmarks and score in this range may be presented the “Excellence in Guaranteed SME Lending” award.

**Generally in Compliance.** The lender is found to be “generally” in compliance. Lenders scoring at this level may be required to submit a “Corrective Action Plan.”

**Minimally in Compliance.** The lender is found to be “minimally” in compliance. Lenders scoring at this level should be required to submit a “Corrective Action Plan.”

**Non-Compliance.** The lender is found to be “Non-Compliant” and must submit a “Corrective Action Plan.”

## LENDER REVIEW ELEMENTS

	<b>Processing/Forms/Eligibility/ Credit Analysis</b>

1	Is the Agency application form complete, signed and dated by the borrower?
2	Is the Agency guaranty request form complete, signed, and dated by the Lender?
3	Are personal financial statements present, complete signed and dated for all owners of 20% or more of the borrower, personal guarantors and others required?
4	Are the required business financial statements present, complete, signed and dated?
5	Were size determinations correct and analyzed according to the Agency policy (including affiliation determinations)?
6	Did the loan file document that credit was not available elsewhere on reasonable terms?
7	Was the personal resources test, applied and enforced according to the Agency policy?
8	Was the nature of business of the small business concern eligible for the Agency financing?
9	Was this loan to a PRC citizen or eligible non-citizen?
10	Was the purpose of the use of proceeds eligible?
11	If the project involved the refinancing of existing debt, was the Agency policy correctly applied regarding the eligibility of the debt refinanced?
12	If the loan involves a change of ownership was it eligible?
13	If the loan involved a franchise, does the borrower have the power to control the franchise?
14	Were you unable to detect any apparent conflict of interest related to the borrower on this loan?
15	Were you unable to detect any apparent conflict of interest related to the lender on this loan?
16	Did the new loan, coupled with any other outstanding the Agency loans, meet the allowable loan program limits?
17	Was the loan amount, guaranty percentage, maturity and interest rate of the loan consistent with the Agency policy?
18	Was repayment ability reasonably assured by historical cash flow, credible projections, or loan scoring?
19	Was adequacy of working capital correctly determined?
20	Was the adequacy of capitalization correctly determined?
21	Was the management ability of the borrower analyzed consistent with the Agency policy (or for <i>Express</i> , consistent with lender's non-government guaranteed loan policy)?
22	Was the basis for collateral adequacy properly supported and calculated consistent with the Agency policy?
23	If the loan was under collateralized, was the Agency policy followed for obtaining additional collateral, including personal guarantees as required?

24	Was a credit investigation performed and documented in the loan officer's report?
	<b>Due Diligence/Authorization/Closing</b>
25	Was the borrower's identification and legal name consistent between the authorization and the lender's documents?
26	If the authorization required guarantees, were they acquired according to the Agency policy and the authorization?
27	If required, was the borrower's injection capital verified?
28	Was the loan authorization constructed in accordance with the loan approval?
29	Was the signature of the lender on the authorization?
30	Do the terms of the Note match the authorization?
31	Does the Note have the proper signatures?
32	Do the lien instruments, including but not limited to Deed(s) of Trust or Mortgage(s), have the proper signatures?
33	For real estate collateral, is the Agency in the appropriate, perfected lien position?
34	If personal property was taken as collateral, is the Agency in the proper, perfected lien position?
35	If the authorization required an appraisal was it obtained and did it meet the conditions of the authorization?
36	Were insurance requirements specified in and met according to the authorization?
37	Was the Settlement Sheet completed correctly and in accordance with the authorization?
38	Was the guaranty fee paid, in the correct amount and submitted within the proper time frame?
39	If required, were any standby agreements signed properly and in order?
	<b>Servicing and Liquidation</b>
40	Were the insurance requirements up to date?
41	Were the financial statements current or can the lender document efforts to secure timely financial statements?
42	Were servicing and liquidation actions for this loan properly documented, supported and within the scope of the lender's unilateral authority? (If unilateral authority taken).
43	Did the lender have prior written the Agency approval for servicing actions outside the scope of the lender's unilateral authority?
44	Did the Agency receive proper notification of all servicing/liquidation actions taken as required?
45	If a liquidation case, was the liquidation plan developed and submitted in a timely basis?
46	If the loan was purchased, were the fees charged by the lender for servicing and liquidation customary and reasonable?

47	If a liquidation case, were status reports submitted on a timely basis as required?
48	If a liquidation case, were alternatives explored to avoid the acquisition of collateral?
49	If a liquidation case, were current appraisals used by the lender to evaluate collateral?
50	If a liquidation case where title of property was taken, was an environmental review done prior to the acquisition of title?
51	If a liquidation case, did the file reflect that workout attempts were explored where possible prior to commencement of liquidation?
52	If a liquidation case, did the lender pursue recovery from guarantors/obligors?
53	If a completed liquidation case, was the wrap-up submitted within the time frame to the Agency?
54	If a liquidation case, did the lender receive prior written approval for actions outside the scope of unilateral authority?
55	If a liquidation case, were required site visits performed in a timely manner?
56	If a liquidation case where there has been a purchase, have any funds collected been remitted to the Agency in a timely fashion?
	<b>Oversight/Policy/Controls</b>
57	Does the lender have a written statement of policy?
58	Does the lender have a normal geographic lending area and does the lender document under what circumstances they may provide lending outside this area?
59	Does the lender have a written policy of lending authority delegations?
60	Does the lender's written policy describe the fees that may be charged to the borrower?
61	Does the lender have a written policy for their portfolio review process?
62	Does the lender's written policy outline what collection actions may be taken against borrowers who do not make timely payments.
63	Did the lender document its procedure to ensure that loans are approved and authorizations signed by officers with the appropriate authority?
64	Did the lender document its procedure to assure that required closing documents are obtained?
65	Did the lender document its procedure for ensuring that items required after closing are collected?
66	Did the lender document its method of safeguarding collateral documents in the lender's care?
67	Does the lender maintain a schedule of any field visits required and document loan files when visits are completed?
68	Does the lender have a process for updating collateral filings, financial statements and insurance requirements? (Tickler system, etc.)
69	Does the lender have access to counsel available for processing, closing and servicing advice?

70	Did the lender document that it has the resources available for proper servicing and liquidation (if applicable) throughout the geographic area in which the lender makes loans?
71	Does the lender document its process to setup regular reviews of seriously delinquent loans?
72	Does the lender maintain its loan files in an orderly and accessible manner?
73	Is the lender's written policy consistent with the Agency policy?
74	Does the lender have a marketing plan to utilize and promote the Agency loans?
75	Does the lender have a marketing plan to reach the Agency's public policy goals?
76	Did the lender document its procedures to ensure that required forms are with the Agency applications?
77	Did the lender document its procedure to ensure that the Agency credit and eligibility requirements are complied with? (As evidenced by training manual(s), checklist(s), review procedures, etc.).
78	Did the lender document its procedure for ensuring that only allowable fees are charged to the borrower?
79	Did the lender document its process for ensuring routine portfolio reviews and borrower contact on the Agency loans?
80	Did the lender document its process for ensuring timely filing of the Agency required Lender Reports?
81	Does the lender have a process to ensure proper reporting to the Agency of servicing/liquidation actions taken?
82	Did the lender document its training procedure for staff involved in the Agency financing?

## **Credit Reporting System**

Although not part of the existing contract, SETC requested that we provide them with some information and recommendations on a Credit Reporting System. Pragma Corporation, at the present time, is developing such a system in Kazakstan.

It is very important that the PRC develop such a system. Successful credit programs have as their main foundation good and reliable credit information on borrowers. Creating such a system will assist in the expansion of lending to SMEs and will assist in building sound credit programs.

## **DEVELOPMENT OF A CREDIT REPORTING SYSTEM**

### **Background**

At the request of SETC and ADB we have included the following write-up and proposal on the establishment of a credit reporting system in the PRC. China, as is the case in many other developing nations, does not have a credit reporting system within its country.

It is necessary to understand the reasons why a credit reporting system is important to any country, what challenges that have been faced by countries trying to establish such a system and ways that such a system could be developed.

Many people believe that a credit reporting system is designed to keep track of only those persons or companies that do not pay their debts. However, a well-designed and operated system is used to track more than just those that do not pay. It is also used to have a record of those that honor their obligations, keep records on employment, and legal actions filed against companies and individuals. Credit reporting provides significant benefits to the financial system and the economy. Those benefits include:

- Allowing consumers and SMEs with good credit to open and expand credit lines.
- Providing Enterprises and lenders with reliable data and local credit services that assist in making sound judgments about credit.
- Decreasing loan losses and bankruptcies by providing crucial information needed for credit grantors to more accurately assess the profile of an individual or enterprise.
- Reducing risk-assessment costs by accessing the comprehensive information gathered by the credit bureau more quickly and accurately.
- Increasing borrower privacy protection by providing a systematic basis for lending without the hassle of lengthy support documentation.

- Designed to track the credit habits of individuals and companies so that a sudden buildup of credit far beyond the repayment ability of the debtor can be recognized.

Usually, where systems have not been developed credit extensions have been limited and credit losses are generally higher due to the lack of such credit histories.

Most times in those countries where a credit reporting system is not available, lenders cite the lack of credit extension to SMEs is due, in a large part, to the lack of credit information on the applicant. Lenders tend to be much more conservative in their lending when information is lacking and usually lenders fear the worse in an SME or individual rather than the best. Therefore the lack of information only hurts those that have good credit since, due to the lack of credit information, they are looked upon in the same manner as those with bad credit.

Also, a credit reporting system assists in raising the attention of the population to the importance of paying debts as agreed thereby raising the overall quality of credit within the nation.

As a country develops and becomes more engaged in international finance and in its endeavor to attract outside capital it will become more and more important that it develop a credit reporting system to show the quality of credit being extended.

Even before such international relationships, the quality of credit being extended has a direct bearing on the financial soundness of a Country, Province, or City. Indeed, currently the lack of such a system is having an adverse effect on the creation and expansion of individuals and SMEs in those countries that do not have such a system and it is affecting the quality of the credits being placed on the books of the credit grantors.

Many of the problems that developing nations face in increasing SME development could be solved through the implementation of a credit reporting system. SMEs must have access to credit to feed its growth and the lack of information prevents such growth.

### **CREDIT REPORTING CONTROLS**

It is important that all credit reporting systems have safeguards against unauthorized use of the credit information being accumulated. The intent is to limit the reports to those individuals and enterprises having a need to know for the express purpose of extending credit to individuals and enterprises, especially, SMEs. A set of principles and standards should be developed and placed in governmental law, regulation and policy.

Proper controls of credit data are very important in any credit reporting system. In many countries laws control the receipt and disbursement of such data. It may be necessary for the government to authorize, and in some cases require all credit providers to participate in a credit reporting system. A set of rules governing the process would also accelerate

the development of such a system. The system could be operated by a private sector firm or by a government entity.

It is in the interest of government that all credit grantors join in participating in the credit reporting system in their endeavor to improve the quality of credit being extended and to encourage increased SME lending through improved information to the lending community.

### **THE STRUCTURE OF CREDIT REPORTING SYSTEMS**

In developed countries, (such as the United States), credit reporting systems are usually installed by private enterprise where merchants and other credit extenders are joined together through intermediary organizations, (sometimes called credit bureaus). Credit bureaus provide credit grantors with a host of services at the local level such as account collection activity, electronic check verification, pre-employment screening, commercial and retail debt recovery services, skip tracing and of course credit reporting services.

Credit bureaus are usually tied to large depositories of information that track the information provided by many credit bureaus into one universal picture of the credit history of an individual or enterprise. The combination of the credit bureaus and the depository allows for local gathering of information as well as a tracking system that follows the individual or enterprise credit histories as they move from locality to locality.

As the information increases in the database, more information is available to the merchants and credit companies that have joined together to have available the maximum amount of information to evaluate applicants. The credit grantors report on the progress of the individual's payment histories from time to time, (usually, quarterly), so that the information on the debtors is kept current. The credit companies pay a small fee for each credit record that they request from the credit bureau and pay for any support services being provided by the credit bureau.

The flow of information to and from credit grantors and public records and provides for information to be given by the individual or enterprise and the ability of that individual or enterprise to obtain a copy of the information contained in their files. In this way, the individual or enterprise may check on the accuracy of the information and provide corrected information to be considered as part of the file.

### **MODEL OF CREDIT INFORMATION FLOW**

Most credit information systems track the following information for each debtor and member organization:

## **Demographic Information**

- Name of Debtor
- Unique Identifier Number or Reference Number
- Last know address
- Previous addresses for last 5 years
- Name of Employer
- Address of Employer (Up to 5 years history)
- Latest reported Income on individuals
- Latest Sales and Net Income on Enterprises
- Latest Summary of Financial Statements of Enterprise if available

## **CREDIT HISTORY INFORMATION**

- Latest information on credit extensions including high credit authorized, record of payments, creditor, amount of payment, current balance and a rating code for the historic handling of the account that reflects how well the account has been handled. Usually the code classifies the payment history in the number of times that the debtor has gone 30, 60 or 90+ days in arrears in payments.
- A record of inquiries from the various credit organizations. This tracks the number of times the debtor has sought credit and gives the credit central a record for rechecking with the various credit organizations that have made inquiries to see whether further credit was granted.

## **Public Information**

- A record of all liens and mortgages filed with the public recorder of record.
- A record of lawsuits and legal judgments filed against individuals or Enterprises.
- A record of all corporate charters filed with the licensing Agency along with trade names.
- Records of all criminal offenses that are on public record.

## **Creditor Information**

- In general, the system keeps track of all member creditors' inquiries, reports of experience with its customer base, and a record of all complaints of customers that are filed with the credit center.

## **Credit Reporting Systems Successes and Failures**

There have been some very successful reporting systems and there have been failures.

The United States has a very successful system, in fact have several systems that are owned and operated by the private sector. Such companies as Trans Union Corporation, Experian, Inc., and Equifax, Inc., have been in the credit depository enterprise in America for several years and have extensive databases. Independently owned and operated Credit Bureaus are located throughout the country and have a wide network that feeds information to the various depositories.

The service within the U.S. provides merchants as well as other credit grantors immediate access to individual and company's credit histories through computer linkage. In fact, an individual can obtain his or her own credit report over the computer so that they may check the accuracy of the reports that are being used by the various credit grantors in determining whether they are to receive credit.

Such access has heightened the interests on the part of individuals of their credit rating.

The U.S. has certain laws that protect the individual's and company's credit history from misuse. When an individual or company applies for credit they sign an authorization that allows the credit grantor to perform a credit review including obtaining a credit report and to report future payment histories to the credit bureau. In this way the individual's privacy is protected from unauthorized invasion by a third party.

The systems being used in the United States allow for fast credit review and provide much needed information to the credit grantor so that a proper credit evaluation can be made.

One of the most recent failures in establishing a credit reporting system was in Mexico. In 1995, after the 1994 economic crisis, three major U.S. credit bureaus were given permission by the Mexican government to start operations, however the major banks in Mexico opposed participating with the bureaus for fear that their good customers would be subject to being taken by a competitor. Since there was no requirement by the government for information exchange, the project was unsuccessful. The three bureaus have pulled out of Mexico.

Lessons that can be learned from other countries include such projects as USAID supported efforts in Uganda and Jordan. In Uganda a private credit reference bureau was established in 1999 in the Uganda Institute of Bankers. A small technical staff was hired to initially accumulate credit information from the public domain. Unfortunately, although the entity still exists, legislation has never been approved to allow private credit bureaus to operate.

The above points out the need for a complete review of a country's current situation and a determination made of the best approach to be used in establishing such a system and indeed whether or not such a system is needed taking into consideration the state of credit extensions in the country.

## **The Pragma Corporation's Proposal For Development Of Credit Reporting System for China**

### **The Project – Recommended Approach and Methodology and Work Program**

The sequence of the project tasks has been designed in this recommendation to assure proper decision-making at critical points throughout the total project.

With the above information in mind, we propose the following project to determine whether or not a central credit reporting system should be established in China; the approach to be used if a system is warranted and an assistance package that is designed to establish such a system.

Pragma believes, through existing work in China, that the sharing of credit information on a formal basis could significantly contribute to the expansion of the consumer and SME credit markets in China.

We have deliberately separated the overall project into phases. Continuation of the project from one phase to the next phase will depend on decisions made during a specific phase of the project. We recognize that the specific implementation steps being given in subsequent phases may change due to findings made in previous phases, however, we believe that laying out the total project allows one to have a vision of what would encompass a total project.

#### **A. Phase I of Project**

##### **Key Issue # 1**

Is the lack of personal and SME credit histories limiting the extension of credit within China and will it stall future economic growth within these sectors?

#### **Pragma's Recommended Approach to Address this Issue**

Pragma recommends a review of the methods used within the country in extending credit to individuals and Enterprises by the banking institutions and merchants. It is important to determine:

- a. How do merchants extend credit now and what credit checks are performed?
- b. How are credit checks done on Enterprises and

- b. Is there a difference in the manner that credit checks are made on SMEs and large enterprise?

### **Key Issue # 2**

Will the lending and merchant community support the concept of a credit reporting system and have a role in any future development of such a system? What are the opinions that they now hold regarding the trading of credit information? Would they voluntarily participate in a system? Is the lack of credit histories a factor in extending loans to individuals and SMEs? Would they support a government policy regarding the reporting of credit extensions?

### **Pragma's Recommended Approach to Address this Issue**

Pragma recommends an extensive survey and meetings with lender groups and merchants be undertaken to determine their views and attitudes towards the establishment of such a system. Pragma also recommends that, with the cooperation of the Government of China, an advisory panel be formed that would assist in the communication of views and recommendations.

### **Key Issue # 3**

Will the various levels of government within China support a credit reporting system?

### **Pragma's Recommended Approach to Address this Issue**

Interviews should be conducted to ascertain the views at all levels of government as to the need for a credit reporting system and what governmental involvement, in their opinion, is needed for such a system to be successful in China.

### **Key Issue # 4**

What is the current legal environment and what is needed in the way of laws, regulations and policies that will allow for the flow of information to and from credit grantors and at the same time protect the individual or enterprise information from unauthorized use.

### **Pragma's Recommended Approach to Address this Issue**

Pragma recommends a complete research of existing laws and regulations that affect such information be undertaken to determine what changes would be needed or what new laws are needed so that such a system could operate within the enterprise environment of China.

### **Key Issue # 5**

What is the best approach in structuring such a system in China and the related costs to establish and operate such a system including:

- The feasibility and costs of establishing a government operated system.
- The feasibility and costs of a privately operated system.

### **Pragma's Recommended Approach to Address this Issue**

Pragma recommends a detailed assessment of the potential of establishing a credit reporting system in China and the issues that must be addressed in the structuring of any such entity.

Feasibility reports should be done on the various issues relating to a publicly owned system verses a privately owned system, along with cost analyses. Costs and benefits of a technical cooperation agreement or joint venture with foreign partners that have experience in the development and the operations of such systems should also be undertaken.

### **DECISION POINT**

At this point in the project, a decision should be made on whether the information compiled in Phase I warrants the project to enter Phase II. Phase II is the development stage of the project where the findings of Phase I are expanded by the drafting, as needed, legislation, rules and regulations, joint venture agreements, computer programs, operating Manuals, training and perform related activity to bring the project to an operating level.

### **B. PHASE II OF PROJECT**

The exact process that would be undertaken in Phase II will depend on the information gathered in Phase I and the decisions made from such information and recommendations. However, the following is the general approach that would be undertaken. Phase II brings the project from a feasibility stage through the development and testing stages.

#### **Key Issue # 6**

Developing a legislative package that will address the needs of a universal credit reporting system is needed to assure participation and cooperation of the private as well as the public sector. It is also needed to assure the proper use of credit information being gathered on individuals and companies.

### **Pragma's Recommended Approach to Address this Issue**

Based on the needs defined in Phase I for laws, regulations and policies, drafts of the necessary documents should be completed to ensure proper written authorities and responsibilities regarding a credit reporting system.

We will design a set of governmental laws, rules and policies governing the collection; distribution and use of credit data should be designed. This will include a set of very specific principles and standards that all credit grantors and collection facilities will follow in granting credit and reporting of experiences with individuals and enterprises.

### **Key Issue # 7**

The development and implementation of a credit reporting system that addresses the need of Kazakhstan is critical for the success of the project.

### **Pragma's Recommended Approach to Address this Issue**

Based on the information gathered in Phase I, a review of the various systems currently in use in other countries and their appropriateness for implementation in China verses designing a specific system that will better serve the needs of the country should be undertaken. Any system should provide for a core of information to be exchanged, have easy access by credit grantors and debtors and be designed for easy expansion of areas and elements.

A committee or council of merchants, lenders and government officials should be formed to assist in the development of such a system.

If the findings and decisions in Phase I establishes a need for a joint venture, great care should be exercised in the designing of the venture and assist in its implementation to assure that the project will have continuous management and oversight.

The system should be tested in a small geographic area with limited merchant and other credit grantors participating to assure that the system is ready for countrywide implementation.

Training must be provided for all users of the pilot system and a public awareness program should be developed that will keep the public informed on the progress of the system and the importance being placed on personal and enterprise credit.

## **C. PHASE III OF PROJECT**

Phase III will bring the project to full implementation on a countrywide basis. Taking the results of the testing period and making systems and implementation adjustments as necessary the project will enter its final phase of expanding in preplanned steps to a nationwide system.

### **Key Issue # 8**

The development of a public awareness program is very important to the success of a credit reporting system.

### **Pragma's Recommended Approach to Address this Issue**

A public awareness program should be designed that will include information pamphlets designed to inform the public the importance of good credit habits, spot radio and TV public service announcements as well as Web based information programs.

### **Key Issue # 9**

There will be a need for an ongoing informational and training program to assist credit grantors, debtors and government officials in understanding credit reporting and the accompanying systems.

### **Pragma's Recommended Approach to Address this Issue**

An ongoing training package must be designed that will augment the systems and the overall project being delivered.

It should also include web based training courses in handling credit information that can be used by credit grantors in the training of their staffs.

### **Key Issue # 10**

There needs to be a specific implementation plan to bring the system nationally.

### **Pragma's Proposed Approach to Address this Issue**

A stepped implementation plan should be used with constant monitoring in the implementation phase of the project, providing technical support to the system as well as program management expertise.

### **SME Training And Technical Assistance**

We are recommending that a formalized training and technical assistance program be established through the formation of a private sector association. This association will be referred to as the Central SME Training Association, (hereafter referred to as "CTA").

Currently in the PRC there is a lack of training support to SMEs in the most basic areas needed to operate an enterprise successfully. In talking with credit extenders and government officials it was made clear that such a program is needed in the PRC and to date very little is being done. The establishment of SMEs and the growth of SMEs depend largely on the knowledge that is transferred to the general population and to existing SMEs on how to establish and operate an enterprise. Secondly, the establishment

of a CTA will create a point of contact for SMEs, Provincial governments, Cities and guaranty companies where the issues surrounding SME development can be addressed.

A CTA would develop and implement through a network of organizations and the various Provinces and Cities the following services:

SME related courses addressing the most basic requirements of establishing and growing an enterprise such as basic accounting requirements, the preparation of enterprise business plans; how to finance an enterprise; cost controls; marketing of products and services; personnel training; tax and licensing requirements; reading and understanding financial statements and teaching an understanding of local and national laws effecting their enterprise operations.

Assisting universities in establishing SME courses that address the unique needs of SMEs. Providing for the establishment of SME assistance centers where individual technical assistance can be obtained by SMEs.

Developing information packages that can be used in high schools to inform students of the value of having SMEs in the economy and early education on the benefits of private sector enterprise.

Conduct research on special needs of SMEs in such areas as SME incubator facilities, networking systems for specific industries where SMEs can share experiences with other SMEs.

As in the Re-guaranty Authority, we recommend that the CTA be established through a one-time allocation from the Central Government to a trust fund. The fund would be invested into Government Obligations with the earnings being used to support the work of the CTA. We recommend that the CTA be given authority to augment the trust fund with donations from the private sector thereby expanding the assistance to SMEs.

It may be necessary that for the first 2 or 3 years that a supplemental funding award be made by the Central Government to cover the administrative expenses of both the Central Re-Guaranty Authority and the Central Training Association for the initial set-up of the organizations. We also recommend that a partnership between Provincial, City and the State government be formed in sharing the development costs of such programs.

Thereafter we would recommend that a pre-set maximum percentage of the earnings from the investments of the trust be used for the overhead expenses of the organizations.

### **Model Legislation for a Central Training Program**

**Note: For the purposes of this model legislation, we have used the following titles as they relate to the formation of a small and medium enterprise training association.**

1. National Peoples Congress – the legislative body passing the legislation.
2. President of the Peoples Republic of China as the appointing official.
3. Central SME Training Association, (CTA) is being used in this text as the name of the organization managing and implementing the SME training program.
4. Director – The managing head of CTA.
5. Deputy Director – The Deputy to the Director of CTA.

## **Small and Medium Enterprise, (SME) Training Act**

### **Model Legislation**

**§1.** This Act may be cited as the “Small and Medium Enterprise Training Act.

**§2. a.** The essence of Peoples Republic of China’s system of private enterprise is open competition. Only through full and free competition can free markets, free entry into enterprise, and opportunities for the expression and growth of personal initiative and individual judgment can be assured.

The generation, preservation and expansion of such enterprise depend largely on the business education of those entities, including business management skills and technical training.

It is the declared policy of the National Peoples Congress that the Government should aid, counsel, assist, and protect, insofar as is possible, the interests of small and medium enterprises through business educational and training programs.

**b.** It is the declared policy of the National Peoples Congress that the Government of the Peoples Republic of China, through the Central Small and Medium Enterprise Training Association, (CTA), acting in cooperation with other Departments of the National Government and other relevant Provincial and City Governments, should aid and assist small and medium enterprises, as defined by the National Government in the area of business education and training in order to increase their ability to create new business opportunities and to expand existing businesses domestically and internationally. Such training should also be directed to financial enterprises so that greater understanding of the operation and financial structures of SMEs can be better understood and increased financial assistance provided to such enterprises.

**§3.** In order to carry out the policies of this Act there is hereby authorized an Association under the name of the Central Small and Medium Enterprise Training Association, (herein referred to as “CTA”), which shall be under the general direction and supervision of the Director and **(shall or shall not)** be affiliated with or be within any other Agency or department of the National Government. The principal office of the Association shall be located in Beijing China. The Association may establish such branch and regional offices in other places in the Peoples Republic of China as may be determined by the Association.

CTA hereby is authorized for the purpose of furthering the business education and training of the small and medium enterprise sector to develop and deliver various programs and services. Such areas of assistance shall include, but is not limited to the following:

- Individual business counseling activity to SME businesses, its owners and personnel concerning the management, financing and operation of those enterprises; management and technical assistance regarding small business participation in international markets, export promotion and technology transfer, delivery or distribution of such services and information and providing access to expert business consultants.
- Training, through group training courses, of SME businesses, its owners and personnel, financial assistance entities such as banks, guaranty companies, re-guaranty organizations and organizations supporting SME enterprises in the PRC. Such training shall include, but not limited to, financing of SMEs, cost controls, tax courses, personnel hiring and training, business planning, accounting, business promotion, export business and joint venture opportunities.
- General information programs directed to the general population on the benefits of SMEs to the national economy including courses in entrepreneurship opportunities as an alternative to employment in large businesses or State Owned Enterprises.

**§4.** CTA is authorized to make grants, (including contracts and cooperative agreements), to any Provincial or City government entity, credit or finance entity, any private or public institution of higher education and private consulting groups, to assist in the implementation of the programs and services authorized by this Act.

**§5.** CTA shall work in close cooperation with entities of State, Provincial and City governments and the SME community to serve as an active information dissemination and service delivery mechanism to the SME community and other service providers to that sector of the economy.

**§6.** CTA shall be under the general management of a Director who shall be appointed by the President, or his designee, and who shall be a person of outstanding qualifications known to be familiar and sympathetic with small and medium enterprises' needs and problems as they relate to counseling and training of such enterprises. The Director shall not engage in any other enterprise, vocation, or employment than that of serving as Director. The President also may appoint a Deputy to the Agency. The Director is authorized to appoint \_\_\_ Associate Deputy Directors to assist in the execution of the functions vested in the Association. The Deputy Director shall be Acting Director of

the Agency during the absence or disability of the Director or in the event of a vacancy in the office of the Director.

**§7.** CTA shall create an informational database that shall contain the following information:

The content of all courses designed and implemented by CTA including promotional material, schedules of courses, names and addresses of attendees, evaluation forms of courses filed by attendees, the costs associated with the design and implementation of such courses and other information that could be used in the evaluation of the courses being extended to the SME community.

The following information shall be compiled for all counseling activity:

- The name and address of the business or individual requesting counseling.
- The industry that the business represents.
- The type of counseling given.
- The amount of time spent in the counseling session.
- The result of such counseling including any referral made to an outside expert to assist the SME.

The data base shall also include:

- The name and addresses of all non-staff consultants used in the program.
- A history of all cases referred to such consultants.
- The cost of the consulting services.
- The results attained for such services
- Evaluation forms completed by the SME on all services provided by the consultants.
- Any other information deemed needed to properly evaluate the services being provided.

**§8.** There is hereby established in the Treasury a Small and Medium Enterprise Training Fund, which shall be available for educational and training functions, performed under this Act. CTA is also hereby authorized to augment these funds through fees charged to SMEs being provided services covered by this Act and to accept grants or gifts provided to CTA from domestic or international organizations and individuals. CTA is also hereby authorized to accept the services and facilities of any Provincial, City or local agencies and groups, both public and private, and to utilize such gratuitous services and facilities as may, from time to time, be necessary, to further the objectives of this Act.

**§9** Notwithstanding any other provision of law, CTA is prohibited from providing any assistance to any enterprise, concern or person engaged in the production or

distribution of any product or service that has been determined to be illegal or not in the best of interest of the government.

- §10.** CTA shall have the power to adopt, alter, and use a seal, which shall be judicially noticed. The Director is authorized, subject to any classification laws, to select, employ, appoint, and fix the compensation of such officers, employees, attorneys, and agents as shall be necessary to carry out the provisions of this Act; and define their authority and duties. CTA, with the consent of any board, commission, independent establishment or executive department of the Government, may avail itself on a reimbursable or non-reimbursable basis of the use of information, services, facilities, (including any field service thereof), officers, and employees thereof, in carrying out the provisions of this Act.
- §11.** CTA may make such rules and regulations, as the Director deems necessary to carry out the authority vested in the Director of CTA by or pursuant to this Act. In addition to any powers, functions, privileges and immunities otherwise vested in the Director, take any and all actions, (including the procurement of the services of contractors), when it is determined such actions are necessary or desirable in providing the assistance authorized under this Act.
- §12.** The President may transfer to CTA any functions, powers, and duties of any department or Agency of government, which relates primarily to the training and counseling of small and medium enterprises. In connection with any such transfer, the President may provide for appropriate transfers of records, property, necessary personnel, and unexpended balances of appropriations and other funds available to the department or Agency from which the transfer is made.
- §13.** If any provision of this Act, or the application thereof to any person or circumstances, is held invalid, the remainder of this Act, and the application of such provision to other persons or circumstances shall not be affected thereby.
- §14. a.** For year \_\_\_\_ and each year thereafter, there are authorized to be appropriated such sums as may be necessary and appropriate, to remain available until expended, and to be available solely for the purposes of implementing the provisions of this Act.

# CENTRAL TRAINING ASSOCIATION

## Model Rules and Regulations

**§1. Objective:** The CTA program creates a broad-based system of assistance for small and medium size businesses in the Peoples Republic of China by linking the resources of State, Provincial and City governments with the resources of the educational community and the private sector. Although CTA is responsible for the general management and oversight of the programs and services under these programs, a partnership exists between CTA and the recipient organizations that deliver the assistance to the SME community.

## **§2. Definitions.**

**Applicant Organizations:** An entity, described in Section 3 of these Regulations, which applies to establish and operate a network organization.

**Application:** The written submission by a new applicant organization or an existing recipient organization explaining its projected activities for a specified period of time and requesting CTA funding for use in its operations.

**Area of Service:** The geographic area in which an applicant organization proposes to provide services or in which a recipient organization provides services.

**Matching Funds:** Funds specifically reserved for the programs and services that comprise of no less than 50% of the total budget for a given period of time that has been raised by the applicant organization from Provincial, City or private sector contributions.

**Cooperative Agreement:** The written agreement between CTA and an applicant organization describing the conditions under which CTA awards funds and recipient organizations provide services to the SME community.

**Program Announcement:** CTA's annual publication of requirements, which an applicant organization must address in its initial or renewal application. This announcement should contain the various priorities that will be address in the coming period of time in the educational and training of SMEs.

**Program Income:** Income earned or received by the network organization from any activity performed by them.

**Project Period:** A specific time period that is covered by the Cooperative Agreement, which usually will be a period of one year.

**Recipient Organization:** The name given to an applicant organization after funding is approved by CTA and the applicant organization enters into a Cooperative Agreement.

**Training:** The provision of advice, guidance and instruction to groups of prospective and existing SME persons and entities whether by in-person group sessions or by such communication modes as teleconferences, videos, publications and electronic media.

**Counseling:** Counseling is a service to individuals or entities providing advice, guidance and instruction on specific topics, usually problem solving.

**§3. Eligible Entities:** The following entities are eligible to operate within the CTA network:

- a. A public or private institution of higher education.
- b. A college or school of business, engineering, commerce or agriculture.
- c. Other institutions of education approved by CTA
- d. Private sector organizations, associations, trade organizations and other organizations legally organized and approved by CTA as participating entities.

**§4. Area of Service:** The Director or designee shall designate in writing the Area of Service of each recipient organization. More than one recipient organization may be located in an area if the Director determines it is necessary or beneficial to implement the program effectively and to provide services to all interested SMEs.

**§5. Location of Recipient organizations:** The recipient organization must locate its center so that services are readily accessible to SME businesses and the locations of the centers will be reviewed by CTA as part of the application review process for each budget year.

**§6. Operating Requirements:**

- (a) The recipient organization must be an independent entity within the recipient organization, having its own staff, including a full-time Director.
- (b) The recipient organization must provide administrative services and coordination of all services being provided whether through its own resources or through outside resources.
- (c) The recipient organization shall be open to the public throughout the year during normal business hours. Anticipated closures shall be included in the annual renewal application. Emergency closures shall be reported to the CTA as soon as is feasible.

- (d) The recipient organization must have conflict of interest policy applicable to their employees, instructors, consultants and volunteers.
- (e) The recipient organization shall adhere to all laws and regulations issued at all levels of government.

**§7. Recipient Organization Services and Restrictions on Service:**

- (a) Services: The recipient organization must provide prospective and existing SME persons and entities with Counseling, Training and Specialized Services, concerning the formation, financing, management and operation of an SME, reflecting local needs. The recipient organization shall use its own resources, the resources of institutions of higher education and private consultants to provide services to the SME community. The recipient organization will also use the programs and services of the State, Provincial or local governments that assist SMEs. The recipient shall continuously assess and improve its programs to keep pace with the changing SME business needs. Each recipient organization will address the following Areas of Needs in their application. Each year CTA will issue such Areas of Needs and all applications will be judged on action plans submitted by each recipient organization. Area of Needs may include, but is not limited to the following:
  - (i) Accounting: Due to the extreme need for the improvement of knowledge in the field of accounting and accounting standards within the SME community, recipient organizations shall place a priority in this area. Each year, the recipient organization shall respond to a notice of need put out by CTA that will be used in the awarding of funding.
  - (ii) Access to Capital: Recipient organizations are encouraged to provide counseling services that increase an SME's access to capital, such as business plan development, financial statement preparation and analysis, and cash flow preparation and analysis. Recipient organizations are to prepare their clients to represent themselves to lending institutions. Their assistance should include helping clients to prepare a business plan, prepare financial statements, complete forms, which are part of a loan application and accompany an applicant appearing before a lender.
  - (iii) Special Emphasis Initiatives: From time to time, CTA may identify portions of the general population or industry to be targeted for assistance by the recipient organization. Support of special emphasis initiatives will be included in the application process and included in the Cooperative Agreement.

## **§8. Specific Program Responsibilities:**

- (a) **Policy Development:** CTA will establish program policies and procedures to improve the delivery of services by the Recipient Organizations to the SME community and to enhance compliance with applicable laws and regulations. In doing so, CTA should consult, to the extent practicable, with the Recipient Organizations.
- (b) **Responsibilities of Recipient Organization's Director:** The Recipient Organization's Director shall direct and monitor program activities and financial affairs of the Recipient Organization and the activities of all program delivery partners within the Area of Service approved by CTA. The Director shall have the responsibility of assuring that the services being delivered within its Area of Service are of good quality and within the requirements set out in the Cooperative Agreement.

- §9. New Applications:** An eligible entity may apply by submitting an application to the Central office of CTA. The application must set forth the eligible entity or entities proposing to operate the Recipient Organization, if approved by CTA; a list of on-staff expertise as well as third party partners that would be available in providing assistance within a stated Service Area. The application must also include a project plan that provides a recommended service level for a given year, a financial plan providing the costs of the assistance projected to be delivered and the amount and source of matching funds. CTA officials may request supplemental information or documentation to revise or complete an application. CTA shall evaluate all submissions, requests modifications as may be needed to fulfill the goals of CTA or decline any application filed.
- §10. Renewal Applications:** Recipient Organizations shall comply with the requirements in the annual Program Announcement issued by CTA, including format and due dates, to receive consideration of their renewal applications. CTA, in their sole discretion may grant an extension of the filing date. The Recipient Organization shall submit the renewal application to CTA at a location designated by CTA. The annual Program Announcement will include a timetable for CTA review and decision of all applications.
- §11. Application Decisions:** The Director of CTA, or the designee, may approve, conditionally approve, or reject any application. In the event of a rejection, the Director or designee shall communicate the reasons for rejection to the applicant. If the approval is conditional, the conditions and applicable remedies shall be specified as special terms and conditions in the Cooperative Agreement. In considering the application, significant factors shall include:
- (a) The applicant's ability to contribute Matching Funds;
  - (b) The ability of the applicant to deliver the needed services with quality personnel.

- (c) The degree to which the applicant has addressed the needs of the SME community within the Area of Service being covered by the application;
- (d) For renewal Proposals, the quality of prior performance and
- (e) The results of any examination conducted pursuant to these regulations.

**§12. Maximum Grant:** No recipient shall receive a grant under this program, which is in excess of \_\_\_\_\_ in any given year and shall not be greater than 50% of the total project costs for the same time period. The remaining 50% of the total project costs must be a cash match.

**§13. Matching Funds:**

- (a) The Recipient organization must provide total Matching Funds, (cash match), equal to the total amount of CTA funding.
- (b) All sources of Matching Funds must be identified as specifically as possible in the budget proposal. Cash sources shall be identified by name and account. All applicants must submit a Certification of Cash Match and Program Income executed by an authorized official of the recipient organization. The account containing such cash must be under the direct management of the Recipient Organization's Director. No CTA funding will be disbursed until such time as the cash matches included in the application has been deposited into the account of the Recipient Organization.

**§14. Fees:** The Recipient Organization may charge clients a reasonable fee to cover the costs of counseling, training or other services being provided to the SME community taking into consideration the local economy and the ability of the recipients to pay such fees. All such fees must be fully accounted for and deposited into a program income account to be used to further the services being provided to the SME community.

**§15. Program Income:** Program Income consists of any receipts accepted by the Recipient Organization whether for services rendered, gifts or grants of any kind, including interest income on any funds received by the Recipient Organization including matching funds or CTA funds. All program income must be used to expand the services to the SME community. A full accounting of the receipt and expenditures of program income must be made to CTA upon request.

**§16. Cooperative Agreement:** Upon approval of the initial or renewal application, CTA will enter into a Cooperative Agreement with the recipient organization, setting forth the programmatic and fiscal responsibilities of the recipient organization and CTA, the scope of the project to be funded, and the budget of the program year covered by the Cooperative Agreement.

**§17. Revisions and Amendments to Cooperative Agreement:** The Recipient Organization may request at any time one or more revisions to the Cooperative Agreement in a manner approved by CTA. Revisions will normally relate to changes in scope, work or funding during the specified budget year. Any requests for a reduction of program deliverables

must be accompanied by a reduction in program funding. Substitution of deliverables may be approved without a reduction in program funding when the level of work effort is comparable.

**§18. Suspension, Termination and Non-Renewal:**

(a) General: After CTA has entered into a Cooperative Agreement with a Recipient Organization; it shall not suspend, terminate or fail to renew the agreement unless SBA gives the recipient organization written notice setting forth the reasons. Such reasons may include, but are not limited to the following:

- (1) Disregard or material violation of these regulations;
- (2) A willful or material failure to perform under the Cooperative Agreement or under these regulations;
- (3) Conduct reflecting a lack of business integrity or honesty;
- (4) A conflict of interest causing real or perceived detriment to an SME, a contractor, or CTA;
- (5) Improper use of any funding connected with this program, including but not limited to funding supplied by CTA, matching funds and or program income;
- (6) Failure of the Recipient Organization to consent to audits or examination or to maintain required documents or records;
- (7) Failure of the Recipient Organization's Director to work at the Recipient Organization on a full time basis;
- (8) Failure to promptly suspend or terminate any individual employed by the Recipient Organization upon receipt of knowledge by the recipient organization and/or CTA that such individual is engaging in or has engaged in conduct resulting in a criminal conviction or civil judgment which could cause the public to question the recipient organization's business integrity.
- (9) Violation of standards of conduct as specified in these rules or those established by the recipient organization or
- (10) Any other cause not otherwise specified which materially and adversely affects the operation or integrity of the recipient organization or CTA.

(b) Non-Renewal Procedure. When CTA believes there is sufficient evidence that a Recipient Organization's nonperformance, poor performance or unwillingness to implement changes to improve performance, under the terms of the Cooperative Agreement or these regulations, CTA shall notify the recipient organization of an intention not to approve its renewal application. Notice can be submitted at any time during the budget period. The notice shall specifically cite the reasons for the intention not to renew. It must allow the recipient organization 60 days within which to change its operations to correct the problems cited in the notice, and to report to CTA in writing, regarding the results of such changes. The Director of CTA will review the changes made

and in its sole discretion determine whether a renewal is in the best interest of the program.

- §19. Oversight of Program:** CTA shall monitor and oversee the Cooperative Agreement and ongoing operations of any recipient organization to ensure the effective and efficient use of funds and the beneficiary impact on the SME community.
- §20. CTA Review Authority:** CTA or a designee is authorized to make programmatic and financial review of any organization participating in any of the programs being operated under these Rules and Regulations. This includes the authority to perform visits to Recipient Organizations, review of all records and client files and to analyze and assess all activities performed by the Recipient Organizations, its employees, contractors and/or partnership organizations.
- §21. Reports and Record Keeping:**
- (a) Records: The recipient organization shall maintain the records required by CTA. These include, but are not limited to, all financial records, personnel records, records of all service providers, complete and accurate client activity files, counseling and training files and other files that reflect the type and volume of assistance given. Recipient organizations will also implement and retain all records required by CTA from time to time during the course of participation under the programs covered by these Regulations.
  - (b) Reports: The recipient organization shall submit client service evaluations and performance and financial reports for CTA review to determine the quality of services provided by the recipient organization, the completeness and accuracy of its records, and actual accomplishments made by the organization compared to performance objectives.
  - (c) Performance Reports: Recipient organizations shall file written reports to CTA as contained in the Cooperative Agreement. Such reports are to be by the due date specified. Failure to file such reports in a timely manner will be grounds for program suspension, termination or non-renewal.
  - (d) Financial Reports: Recipient organizations shall provide quarterly and one annual financial report to CTA as set forth in the Program Announcement and the Cooperative Agreement.
  - (e) Availability of Records: All records of Recipient Organizations shall be made available to CTA for review upon request. CTA may perform audits and/or investigations during regular business hours and may copy any records, program or financial as it deems necessary.