


## Appendix O

### Task A Power Point Presentations

- SME Equity Financing
- Financing Policies for SMEs
- Promoting SMEs in China Through Legal Reform
- China SME Financing Basic Situation

Beijing Seminar on SME Finance  
October 30, 2001



## SME Equity Financing

Beijing Seminar on SME Finance  
October 30, 2001  
Robert D. Stillman, Thomas C. Gibson, David Lingelbach

### High Tech vs Traditional

- China has aggressive and effective program for supporting technology-based businesses:
  - Objective of leadership in high growth future areas
  - Opportunity for increasing value of production
  - Pride in building on intellectual accomplishments

### High Tech vs Traditional

- Support Programs for High Tech:
  - Research grants
  - Business incubators
  - Science parks
  - Incentives for returning scholars
  - Venture capital
  - Credit guaranties
  - Tax Concessions
  - Business assistance

### High Tech vs Traditional

- Very little government support currently available for traditional businesses:
  - Considered “old fashioned”
  - Thought to be low growth
  - Not given respect
- Financing is therefore still dependent on
  - Family
  - Friends
  - Informal sources

### Importance of Traditional SMEs

- Professor Yu notes that most industrial enterprises in China are SMEs
  - They produce 75% of industrial output
  - They employ 84% of industrial workers
- **Similar statistics in the United States:**
  - SMEs employ 53% of nonfarm workers
  - SMEs produce 51% of GDP
  - SMEs Created 76% of net new jobs 1990-95

### Potential of Traditional Business

- Outstanding growth potential of some traditional industries:
  - Of top 20 of the 100 “hottest growth companies” in U.S., 50% unrelated to technology; only 25% based on unique technology
- In WTO-based global markets, competitive advantage will be all important

## China's Competitive Advantages

- Entrepreneurial ability and tradition
- Excellent work ethic
- Productivity
- Favorable labor rates
- Domestic as well as foreign markets
- Worldwide reputation of quality and service
- Global contacts

## Need for Government Support

- Investors seek highest rate of return, considering the risk of the investment
- Concerns about investments in traditional
  - Possible Limited Growth potential
  - Competitive pressures
  - Difficulty in exiting the investment
  - Low Market value at time of exit

## Need for Government Support

- With incentives, these concerns can be overcome:
  - Funds supported by U.S. in the SBIC program invest 75% in traditional businesses.
  - Investors see lower risk and lower cost to invest
  - More predictable
  - More managers available
- Therefore, most governments have support programs to encourage investment in SMEs

## Objectives of Support Programs

- Encourage economic development by:
  - Increasing availability of equity financing to SMEs
  - Encouraging non-governmental investment
  - Creating sustainable investment funds
  - Demonstrating economic potential of investing in SMEs

## Government Support Programs

- Forms of Support by Other Governments
  - Direct investment by government
  - Investment in independent funds
  - Government loans or loan guarantees to investment funds
  - Leveraged equity investment
  - Loss insurance
  - Tax credits
  - Grants to investment funds to cover cost

## "Best Practice" from Experience

- Experience of other countries:
  - Government employees seldom make good investors
  - Investment decisions must be independent
  - Tax credits usually fail
  - To encourage non-governmental investment, must increase potential return or reduce risk

### “Best Practice”

- Ability of the investment manager is key
- To assure sustainability, manager must be compensated for profit and turnover
- Government typically limits investments to those meeting objectives of size and/or sector
- Only activity is direct investment in SMEs - open market investments not allowed

### “Best Practice”

- Program must be simple and transparent:
  - Published criteria for fund selection
  - Process of selection by government open and transparent
  - Administration honest and competent
  - Regular examinations to assure compliance
  - Fund managers expected to add value to their companies by assisting operating management

### Basic Support Principles

- To attract other investors Government takes a smaller share of the profits than its proportion of the investment
- If the fund makes a higher rate of profit than government receives, excess goes to the other investors
- To attract investors, government usually puts up 2/3 of the money
- Funds managed independently

### Potential Investors

- Investors must be able to have their money tied up for a long period of time in illiquid investments that involve high risk and high potential.
- In Europe, banks are the most important investors
- In the U.S. and other areas, pension plans, insurance companies, endowments, and wealthy individuals are most significant

### Potential Investors

- In China, if laws and regulations permit:
  - Wealthy individuals, domestic and overseas
  - Foreign corporations demonstrating support
  - Listed companies investing excess cash
  - Banks, insurance companies, pension plans
  - International development institutions
  - Municipal and provincial governments.

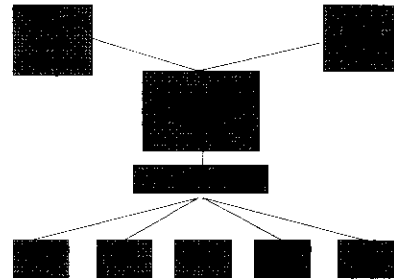
### A Proposal for China

- David Lingelbach will present a summary of a proposal for a support program we recommend for China. Presentation was prepared by Thomas C. Gibson, President, Institute for SME Finance
- We recommend SETC secure funding for a pilot program to demonstrate the effectiveness of this proposal.

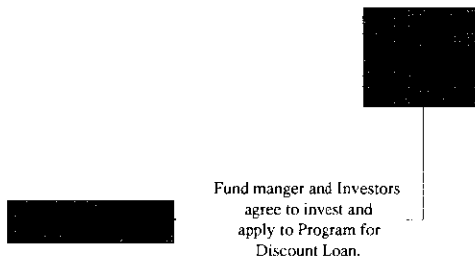
## Government Oversight

- An SETC Department must:
  - Establish regulations, based on experience of successful programs in other countries
  - Solicit proposals from fund managers
  - Evaluate these and select and license managers
  - Oversee relations with the pilot funds
  - Regularly examine operations for compliance
- Successful Examples Readily Available

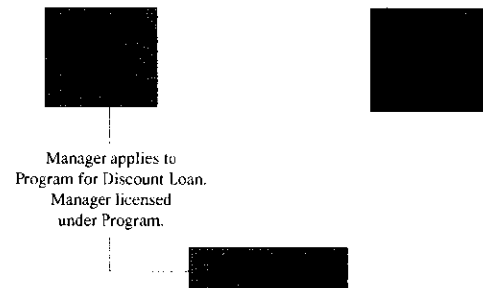
## Structure of the SME Equity Program



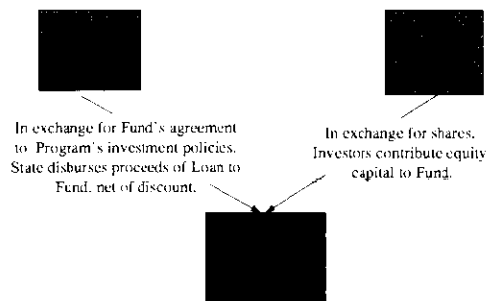
### Structure of SME Equity Program - 1



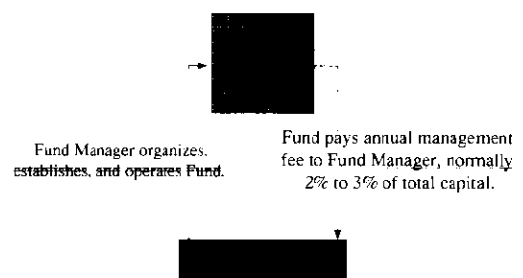
### Structure of SME Equity Program - 2

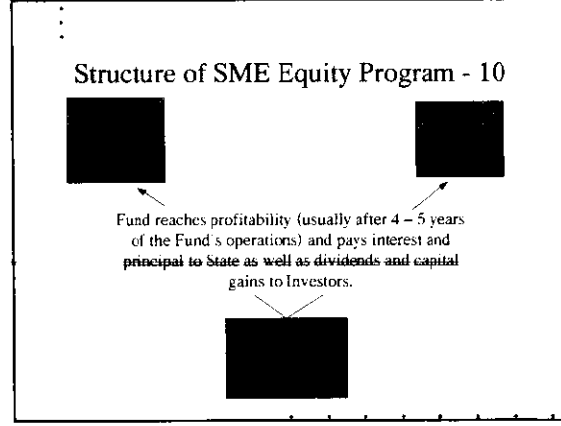
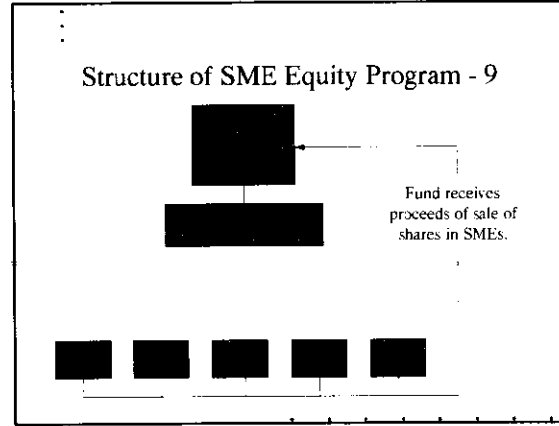
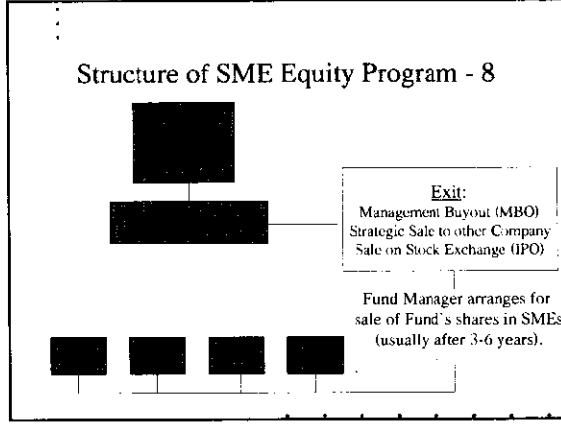
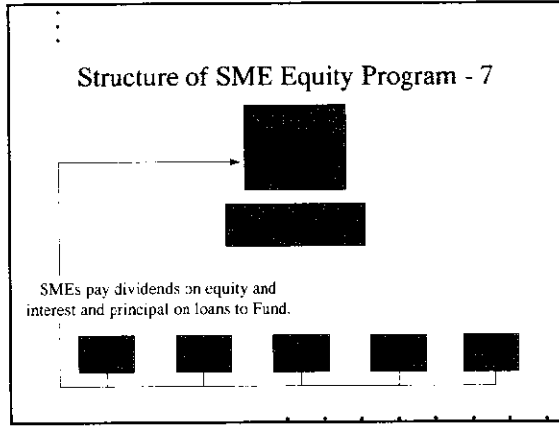
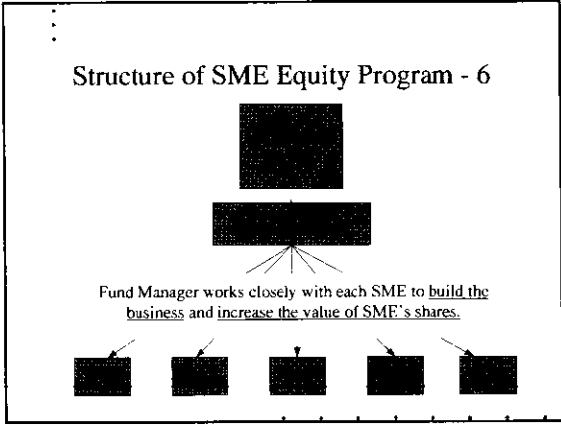
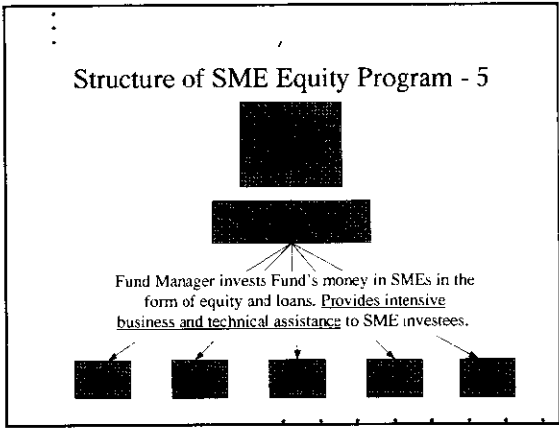


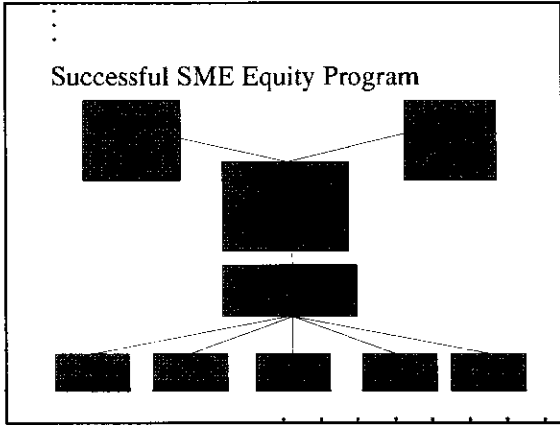
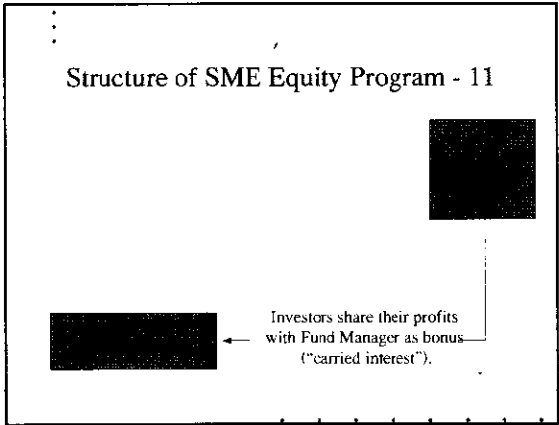
### Structure of SME Equity Program - 3



### Structure of SME Equity Program - 4







### Potential Investors:

*Who will most probably invest?*

- Municipal and provincial governments
- Large state-owned and independent companies
- Pension funds, banks, and insurance companies
- Foreign companies
- Wealthy individuals

### Potential Investors:

*Why will they invest?*

- Promote economic development...
- Enhance relations with local and national governments...
- Build new supply sources...
- Create alliances in a diversity of industries...
- Gain market information in a diversity of sectors...

*... while receiving acceptable returns.*

### Potential Fund Managers

*Who will be interested in managing SME Funds?*

- Investments professionals seeking to establish a "track record" in order to raise larger venture capital funds.
- Larger local funds seeking to expand the pool of potential investments.
- Banks seeking to expand their presence in the SME market.
- Large companies making specialized investments for research and development purposes.

### Management of the SME Equity Program

*What are the principal responsibilities of the agency administrating the SME Equity Program?*

- Refine and publish the guidelines and policies of the Program.
- Review applications and license Fund Managers.
- Disburse proceeds of the Discount Loan.**
- Monitor the performance of the Funds and Fund Managers.
- Ensure the timely receipt of repayment of the Discount Loan.

## Licensing of Fund Managers

### *What are the principal criteria for eligibility for Fund Managers?*

- Reputation for integrity.
- Track record of success in business or finance.
- Ability to identify enough good investments.
- Ability to perform effective due diligence and analysis.
- Familiarity with investment structures.
- Ability to monitor investments and provide non-financial assistance.
- Ability to find buyers for shares in the equity of investees - "exiting".

## Licensing of Fund Managers

### *What must a potential Fund Manager do to be considered?*

- Verify commitments of capital from Investors.
- Prepare a plan, including:
  - examples of potential investments
  - size range of investments
  - investment strategy (instruments to be used)
  - areas for added-value (business assistance)
  - exit strategy
- Describe the governance structure of the Fund (board of directors).
- Verify the qualifications of the management of the Fund (detailed resumes of key managers, hiring criteria for other staff).

## The Fund

- |  |   |
|--|---|
| <i>How large should the Fund be?</i>                   | Minimum RMB 100 million in total available capital.       |
| <i>How much must the Investors contribute?</i>         | Minimum of RMB 35 million.                                |
| <i>What should the legal form of the Fund be?</i>      | Independent company with limited liability for investors. |
| <i>How many investments will a Fund normally make?</i> | 15 to 25  |
| <i>What is the normal life of the Fund?</i>            | Minimum of 10 years.                                      |

## Investment Policy

- |   |  |
|---|--|
| <i>How large should the investments be?</i> | RMB 1 million to maximum RMB 10 million per SME.   |
| <i>How should the Program define SMEs?</i>  | Maximum 250 employees in manufacturing, 100 in non-manufacturing.<br>No more than 3 years old.<br>Owned and operated primarily in China. |

## Other Principal Policies

### *What other regulations and restrictions does the Program impose on the Fund and Fund Manager?*

- Idle money must be held only in cash deposits or equivalents to cash, not invested in stock markets.
- The Fund may not invest more than 15% of its total in any single investment.
- The Fund may not invest in any businesses owned or managed by persons related to the Fund Manager or doing other business with the Fund Manager ("conflict of interest").

## Operations of the Fund: Job of the Fund Manager

- |   |  |
|---|--|
| <i>What are the responsibilities of the Fund Manager?</i> | <ul style="list-style-type: none"><li>- raise equity capital from Investors</li><li>- apply for the Discount Loan</li><li>- organize and establish the Fund</li><li>- identify potential investments</li><li>- perform analysis and due diligence</li><li>- structure investments</li><li>- provide intensive assistance to investees</li><li>- provide reporting to Investors and the Program's administrators</li><li>- arrange for exits from investee SMEs</li></ul> |
|---|--|

## The Discount Loan

### *What should be the terms of the Discount Loan from the State to the Fund?*

10-year maturity, single principal payment at maturity.

Interest rate set at nominal, 5-year bank deposit rate for enterprises.

Loan proceeds disbursed with interest for first 5 years deducted.

Payment of interest only during years 6 – 9.

Loan may be pre-paid after 5 years to reduce interest payments.

Up to 2:1 match with Investors' equity.

## The Discount Loan (continued)

### *For Example:*

Face value of Discount Loan: RMB 100 million

Year	1	4-5	6	7	8	9	10
Interest Rate on Discount Loan:	3%	3%	4%	4.5%	3.5%	4.5%	5%
(figures below in millions RMB)							
Amount of Discount Loan disbursed:	77						
Interest payments:	23	0	4	4.5	3.5	4.5	5
Payment of principal:							100

## Returns: Revenues to the Fund from Investments

### *What are the sources of revenues to the Fund from Investments?*

Typically: financing fees  
interest on loans  
loan principal  
dividends on equity  
proceeds of the sale of equity (exits)

### *How important is the sale of shares in investees to the performance of the Fund?*

In a typical fund which achieves a 20% return on its investments, 50% to 80% of its total revenues must come from exits from equity.

## Returns: To the State

### *If the Fund performs well:*

The State receives a low rate of interest plus the principal of the Discount Loan.

### *If the Fund performs poorly:*

The State still receives interest plus the principal of the Discount Loan.

## Returns: To the Investors

### *If the Fund performs well:*

The Investors receive the rate of return on the portfolio, enhanced by the difference between the rate of return on the portfolio and the low rate of interest on the Discount Loan.

### *If the Fund performs poorly:*

The Investors must pay the interest and principal on the Discount Loan to the State.

## Returns: The Fund Manager

### *If the Fund performs well:*

The Fund Manager receives 20% (!) of the profits earned by the Investors on their shares (the "carried interest"), usually after the Investors receive a minimum acceptable return of 6% - 8% (the "hurdle rate").

### *If the Fund performs poorly:*

The Investors do not receive their hurdle rate, then the Fund Managers have worked only for their management, which normally only covers their costs.

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### Returns: Typical Examples\*

Return of investment portfolio: (before management fee)	20%	20%	2%
Interest on Discount Loan:	4%	4%	4%
Leverage ratio:	1:1	2:1	2:1
Annualized Return to State on Loan:	4%	4%	4%
Annualized Return to Investors:	30%	40%	negative
Annualized Return to Fund Managers: (when "carried interest" is added)	150%	200%	negative

*\*Assumes that Investors invested 98% of the Fund's equity and the Fund Manager invested 2%.*

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### Summary of Fundamental Principles

1

Equity investment in smaller and younger companies is generally perceived as too risky by Investors.

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### Summary of Fundamental Principles

2

When an SME Fund can offer returns which justify the level of the Investors' risk, then SME Funds can become an attractive class of asset for Investors.

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### Summary of Fundamental Principles

3

If the interest rate of State's Discount Loan to the Fund's is lower than the returns on the Fund's investment portfolio, then the returns to the Investors will be above the rate of return on the portfolio and can be acceptable even when adjusted for risk.

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### Summary of Fundamental Principles

4

If the Program offers the attractive incentive of a carried interest to the Fund Managers, then highly-motivated and highly competent Fund Managers will be attracted to the SME Equity Program and will make it work!

## Financing Policies for SMEs



Beijing Seminar on SME Finance

October 30, 2001

Summary: ADB TA 3534-PRC

Robert D. Stillman

## Objective

To increase the number and strength of SMEs in China that will:

- Expand the economy
- Create new jobs in businesses that are competitive in a global economy

## Project Results

The end product of the project is to be recommendations to SETC of action that can be taken by the Government of the PRC that will increase availability of debt and equity financing to small and medium sized enterprises in China

## Study Dimensions

- Debt and Equity financing:
  - Debt is money borrowed from a bank or other lender.
    - Must be returned after a specified time.
    - The borrower pays the lender Interest, which is an agreed percentage of the loan, at regular intervals.
  - Equity is money invested in the business that does not need to be returned.
    - Investor is paid by realizing the profit of selling his investment at a higher price in the future.

## Study Dimensions

- Debt and equity financing of
  - Small and Medium sized Businesses not based on technology - Traditional SMEs
  - SMEs based on advanced or exclusive technology. Equity investing in these is called Venture Capital.

## Study Dimensions

- Credit Guarantee Companies. These can agree to repay all or part of loans or interest if the borrower cannot pay.
- Debt and equity financings are controlled and limited by the Legal and Regulatory Framework in which they operate

## Project Components

- Legal and Regulatory Framework
- SME Equity Financing
- Venture Capital Equity Financing
- Credit Guaranties and Reguaranties
- Overseas Study Tour

## Methodology

- Recommendations are based on applying international best practices to China
- Domestic Consultants study and report on the current situation in China
- International Consultants report on international best practices
- Jointly they develop recommendations

## Current Government Support

- Government supports equity and debt financing for Technology-based businesses
  - Credit guaranty companies
  - Venture capital companies
- Virtually no government support for Traditional business

## Broadening the Support Program

- Initial support focused on technology-based business, to build future competitive position in markets of the future.
- With admission to WTO, there is additional challenge of being competitive in global markets for traditional industries.
- China has important competitive advantages in many traditional industries

## Fundamental Challenges

- How to balance:
  - economic development and
  - investment return
- How to assure SUSTAINABILITY
- How to attract non-governmental financing
- How to find or create trained managers

## China vs Western Models

- Sustainability requires profits and turnover of investments, and sharing of risks of loans
- Western models have private capital or private banks to manage the process
- Government funding by China risks total focus on economic development, which may not produce sustainable program

## Legal and Regulatory Framework

- Current laws and regulations discourage financing of SMEs:
  - Laws on Organization and operation of investment funds and credit guaranty organizations
  - Laws on formation and capitalization of corporations
  - Laws relating to exits from investments
  - Bureaucratic regulations and administration

## Need for SME Equity Support

- Without special incentives, capital will not flow to SMEs from organized investors
  - Difficulty of exiting investment
  - Lack of interest by public markets
  - Need for “financial engineering”
- Government policy has limited support to technology investments

## Support for SME Equity

- Most governments offer support to stimulate SME investment, by reducing risk or increasing potential investment return
- Most governments and development institutions now invest through independent funds rather than their own.
- Independent managers are paid from profits, and have sustainability as major objective.

## Best Practices - SME Investment

- Fund capital comes from non-governmental sources, “leveraged” by Government money
- Government targets investments - usually just size and age of investee companies
- Funds agree to follow guidelines, and are managed by independent managers
- Fund manager uses creative investment structures to encourage later exit.

## Types of Government Support

Governments support equity investment in a number of ways, either by:

- Direct Government-managed investments
- Investment in Funds managed by others
- Loans or guarantees to funds
- Investment on preferred terms
- Loss Insurance
- Tax Credits or advantages

## Best Practices

- Most countries have stopped trying to invest in SME themselves, and have moved to supporting independent funds
- Tax benefits often have produced undesired results, and are not widely used
- Direct investment by govt does not increase return or decrease risk of other investors
- Therefore best practice has been to support independent funds with loans or preferred equity

### Examples

- Oldest and largest equity support program is U.S. SBIC program
- Australian Innovation Investment Fund is based on U.S. model, but is simpler and more beneficial to non-governmental investors
- Israel Yozma model gave investors a chance to leverage success.

### Equity Support Recommendation

- Pilot Program to offer loans or equity financing to SME equity investment funds
- Guidelines of size and age of companies
- No investing in open market securities
- Program open to seed and early stage investments in technology companies
- Other rules of U.S. or Australian programs.
- Training program for Fund managers

### Credit Guarantee Programs

- Objective is to increase bank loans to SMEs
- About 300 guarantee companies in operation, funded by cities and provinces
- Most target technology businesses
- Many guarantee fully collateralized loans, which are very low risk
- Many guarantee 100% of bank loans, rather than sharing risk

### “Best Practice” of Guarantees

- Program purpose should be clear:
  - Risk sharing between guarantor and bank
  - No risk to bank
  - No risk to either due to heavy collateral
- Guarantee terms should match SME needs for short, medium, and long term debt
- Credit risk analysis must be applied
- Program data monitoring is critical

### Concerns about Guarantee Funds

- Program and portfolio data often not available
- Inconsistent credit standards and assessment capabilities
- Limited regulatory requirements or oversight
- Adequacy of capitalization to support guarantees

### “Best Practices in operations

- Report will include sample operating policies for:
  - Loan origination
  - Loan monitoring
  - Liquidation of guarantee
  - Oversight and review functions
- Report will include “scoring model” to evaluate risk of proposed guarantees

### Central Government Re-guaranty

- Central re-guaranty company can reduce risk and allow enforcement of uniform standards
- Report will detail framework for a guaranty company and a lender guaranty association
- Report will describe two tier oversight of credit guaranty operations.

### National Credit Reporting

- Credit reporting is important to SME operations and financing
- China does not have a functioning reporting system to provide credit information to lenders and suppliers
- Report will suggest a framework for a system to provide reliable data

### Ultimate Goal

Implementation of these recommendations should result in a sound, sustainable program to increase the availability of debt and equity to SMEs in China, both technology-based and traditional. This is our goal.

## Promoting SMEs in China through Legal Reform

*[for discussion only]*

Jun He Law Offices  
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October 30, 2001 Beijing

## Market Entry and Competition

- Permits to start a firm: 2(HK) /4.8 (mean) /6 (China)
- Days to start a firm: 5(Iceland) /40.2(mean) /30 (China)
- Relax "Scope of Business" limitation on business entities
- Open restricted markets for private firms (such as telecom, energy, finance)
- Scrutinize local protectionism
- Establish intellectual protection of trade secrets
- Adopt Antitrust legislation to protect and promote innovative SMEs against unfair competition

## Improve Debt Financing

- Improve access to foreign capital markets
  - current limitation on collateral (not more than 50% of net assets of non-financial enterprises, nor more than foreign exchange income)
  - foreign ownership of various collateral
- Strengthen banks' incentives
  - allow banks to charge transaction (and monitoring) costs
- Establish national credit report system
- Improve governmental support
  - Improve credit guarantee schemes and management of risks (risk sharing between guarantee agencies and banks)

## Improve Equity Funding

- Lift Company Law Article 12 limitation, which does not permit a company to invest more than 50% of its net assets in companies of limited liability and companies limited by shares
- Revise Trust Law
  - provide investment through a non-tradable trust
  - provide rights and obligations of investors, investee companies and fund managers
  - provide voting trust mechanism
- Encourage direct private investment or through mutual funds (also known as unit trusts)

## Flexible Business Entities

- Recognize Limited Liability Company (LLC)
  - limited owner liability
  - members or managers may control
  - free transferability of financial interests
  - flow-through tax entity
  - continuity of existence
- Recognize Limited Liability Partnership (LLP)
  - partners control; no continuity of existence
- Allow joint ventures between Chinese individuals and foreign entities
- Reduce minimum registered capital requirement

## Capital Structure

- Permit capital contribution in the forms of intellectual property, shares in other companies or credit rights
- Permit issuance of preferred stock
- Permit share options and warrants
- Permit quasi-debt securities (such as bonds convertible into shares or carry warrants)
- Permit pre-authorization of shares for later issue
- Permit increase of share capital with non-discretionary regulatory approval
- Permit repurchase or redemption of shares and holding of treasury shares for re-issue

## Corporate Governance

- Maintain corporate records such as board and shareholder meeting minutes
- Adopt generally adopted accounting principles
- Allow company to indemnify directors to the extent they exercise due care in their fiduciary acts
- Allow company to set up incentive stock option (ISO) plan
  - ISOs non-transferable
  - hold for at least one year to get long-term capital gain treatment
  - plan must specify total number of shares to be issued, class of eligible employees, and annual limit an employee may exercise

## Enhancing Shareholder Rights

- Protect shareholder rights (especially minority shareholders) by mandatory provisions in the Company Law and/or constituent documents of the company
- Protect right to bring derivative suit
- Protect voting covenants/ shareholder voting trusts
- Protect right to monitor related party transactions
- Protect "tender offer" (general offer) rights which require the Company to redeem the shares of minority shareholders upon a change of control, typically at the price offered for the control block

## Exit Strategies of Investors

- Exit alternatives:
  - IPOs/listings
  - private sale to a third party
  - trade sales (strategic sales/M&A); domestic and cross-border
  - exercise of put options
  - liquidation
- "Piggy-back rights" and "demand registration rights" are protected by US securities laws
- "Tag-along rights" and "drag-along rights" are also generally recognized in the US
- Reduce 3-year "lock-up" period of founders' shares

## Tax & Risk Assessment

- Set up simple and transparent tax system for SMEs (such as avoiding double taxation)
- Establish capital gains treatment (reduced tax rate) for incentive stock options; defer payment of taxes until the holder disposes of shares
- To reduce transaction costs for investors, laws and regulations shall require full disclosure of contingent liabilities of a company, such as back due taxes, social security contributions and environmental liabilities, etc.

## China SME Financing Basic Situation, Existing Problems and Policy Suggestions

1. Special Features of China's SME Financing in the Transitional Period
2. Characteristics of SME Loans
3. Problems of SME Financing
4. Basic Reasons why it is difficult for SMEs to borrow
5. Policy framework recommendation for improving the situation

1

## 1. Special feature of China's SME financing in the transitional period

Because of its unique development history, China has formed some special characteristics in its financing entities, lending entities, financing markets and environment for financing SMEs:



2

- Financing entities: enterprises are not independent financing entities to a large extent. In many cases, ownership is not clear, and many enterprises lack sufficient financial controls. Consequently, the risk and cost of financing to these economic entities are very high.
- The funds lending institutions: are mainly state-owned banks, which are in the process of becoming profit-making entities. Share-holding banks, city commercial banks and urban-rural credit unions are quite weak;
- The Financing markets and environment: These are hampered by limited financing sources, absence of general credit information, and an unsound and incomplete legal system

3

## 2. characteristics of SME loan

- Financial institutions are still the main financing sources of SME, however, SMEs in Eastern regions are less dependent on the financial institutions;
- Mortgage loan and guarantee loans have become the main types of SME loans;
- Polarization in SME credit activity is more and more distinct: those high-quality SMEs, whose products have market with high profits and good credit, become the objects for every financial institution to chase after. For these enterprises, the loan requirement can be satisfied in time, and the banks even compete to grant the loans by depressing interest rate. Little or no debt is available for those with a weak present condition, but good prospects.

4

- Loans for fixed assets are a lower percentage of their value, and the loan term for working capital has become shorter and shorter;
- Loan granted to legal persons will be decreased, and that to natural person will become a new method of SME financing.



5

## 3. The difficulty of SME financing

It is difficult for enterprises to borrow, and on the other hand, it is difficult for the banks to make loans to SMEs:



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**(1). The difficulty for the enterprise to gain loans, because:**

- It is difficult to mortgage.
- It is difficult to get guarantee
- Local banks have limited lending authority, and require complex formalities, with trivial details.



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**(2). The difficulty for the banks to grant loans, because:**

- SMEs's accounting system is not perfect, most of the accounting statement are inaccurate;
- Although the secured and guaranteed loan system has been adopted, but it is hard to put it into real effect
- For responsible lending officers, punishment is heavier than motivation.
- The root banks and credit unions do not have enough authorized power and credit amount.
- It is still hard to protect financial creditor's right. Financial environment is waiting to be improved

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**The "dilemma" in SME borrowing and bank lending is :**

- The enterprises can only provide a small fraction of the total amount of assets required by the banks as a basis for lending. The former makes it difficult for the enterprises to borrow and the latter results in the difficulty for the banks to lend.



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**4. The basic reasons why it is difficult for SMEs to find financing:**

- Systems of internal budget controls and cash accumulation are not in place, so the enterprises assets often go to the individual's pocket, and individual becomes the main depository source in China;



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**Structure of income and deposit of our country in 1997**

Unit	Total disposable income (Million Yuan)	Income structure (%)	Deposit (Million Yuan)	Deposit structure (%)
National total	7336.802	100.00	2998.858	100
Resident dept.	5012.132	68.13	1526.675	50.91
Enterprise dept.	2056.860	14.37	1083.970	36.14
Government dept.	1287.810	17.51	415.323	13.85

\*The increase in personal income has created an increase in personal savings, as a percent of total savings. Investment by individuals, however, is very low.

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**Deposit structure of the resident dept in our country, 1997**

Unit	Billion Yuan	(%)	Total financial invest.	Billion Yuan	(%)
Total deposit	1526.67	100.0	Total financial invest.	1117.741	100
Material investment	447.909	29.3	Ready cash	122.162	10.9
Fixed assets	342.942	22.5	Bank savings	749.604	67.1
Stocks/bonds	104.967	6.9	Securities	218.363	19.6
NET financial invest.	1476.39	98.8	Insurance reserve	27.876	2.5

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- While the resident's most assets flow into the banks (mainly the state-owned banks), there are few safe channels to flow out of the bank. Consequently the peculiar phenomenon arises as "too much water in reservoir, no water in farming land", or else the bank money is invested unsafely. Both of these are bad for the economy.



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- The banks have a high level of outstanding loans, and act as the most important financing source for the enterprises, while SMEs typically, have high levels of debt.



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### China's Macro money flow chart

Enterprises  $\rightleftharpoons$  Residents  $\rightleftharpoons$  Bank  $\rightleftharpoons$  Enterprises

High accumulation      High level of saving      High level of asset      High level of liability



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### 5. Policy suggestion on improving the situation:

- In a long time view, work must be done on economic system and system construction in order to motivate of SME's to accumulate their earnings, rather than distributing them. Individuals should be encouraged to invest, rather than putting all their money into the bank, by the organization of investment financing institutions, and creation of direct financing channels, and other means. At the same time, the present SME financing main channel – indirect financing system from bank must be improved.

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- In a short-term view, some effective measures need to be taken to make it easier for SMEs to gain financing.



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### These policy measure concluding:

- Continuously encourage SME's reformation, and their ability to retain their earnings.
- Encourage individuals to start up new enterprises and transfer personal, family and relatives' bank savings into investment. This will avoid funds overflowing to the banks:



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- Actively create conditions for SME to issue stocks and bonds, and widen direct financing channels;
- Reorganize existing bank structure and set up investment financial institutions
- Develop venture capital investment companies



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- Through marginal improvement, upgrade the bank's system and structure and strengthen the bank's support to SMEs.
- Positively develop small and medium financial institutions, and enhance the oversight and risk control of them.
- Actively develop an SME credit guarantee system



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- Set up and complete SME financing intermediary institutions; perfect SME comprehensive training system; popularize financial knowledge and increase SME overall financing ability.
- The government needs to enthusiastically optimize the financing environment, and set up a bank oriented to SMEs, in order to facilitate SME financing



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