

Appendix U

International Best Practices

Beijing Forum on SME Financing

International Best Practices

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China's entry into the World Trade Organization has dramatized the reality of a global marketplace, in which all nations compete, with success coming to those who apply their competitive advantages to provide products and services at the best level of quality, innovation, service, and price. China has proven its ability to compete, as evidenced by major trade surpluses with its trading partners. Looking to the future, the Central Government seeks to support critical sectors of the economy, to encourage further growth and technological development.

A particularly important segment of the economy is its Small and Medium Sized companies, referred to as SMEs. These currently represent over 99% of all commercial entities in China, and employing over 84% of all industrial workers. For the future, this segment is vital to the Economy, to Society, and to individual Chinese. Within this sector, a critical element is access to financing.

The State Economic and Trade Commission (SETC) and the Asian Development Bank, have asked a panel of International and Domestic experts to examine the SME sector, and to recommend laws, regulations, policies, and programs to encourage greater availability of financing. A team of Chinese consultants assembled by Dayue Consultants, Ltd has reviewed the current situation in China. A team of international consultants assembled by Pragma Corporation has reviewed international best practice in critical areas, and has made recommendations based on the contribution of both domestic and international consultants.

Importance of SMEs

In China, as in virtually all industrialized nations, SMEs are the primary source of new jobs. It is estimated that in recent years, most net new jobs created in China have been in the SME sector. SMEs are also leaders in innovations of products, processes, and services. The most dramatic of these are basic technological advances that produce entirely new products or markets. Much more often, however, innovation takes the form of smaller, marginal improvements that make a supplier competitive.

For society as a whole, the SME sector offers a training ground for management skills, and an opportunity for ownership of enterprises by individuals with limited financial resources. The most successful become the "angel" investors of other businesses, and the trainers and mentors of other new enterprises. This can provide the

home-grown sources of investment that are so important in other economies, as well as developing leaders for society as a whole.

China's Competitive Advantages

China offers a fertile ground for SME development. The vitality of these companies in China itself is mirrored by the success of overseas Chinese in developing SMEs wherever they have settled around the world. The entrepreneurial spirit that prompts a person to start a new enterprise, the support of family and friends, and collective contribution of a common endeavor are hallmarks of the Chinese way. Education is highly valued, and an ambitious work ethic is available from a labor supply available at relatively low cost. Access to foreign markets has dramatically increased, with better infrastructure and intermediaries with contacts in other countries. An increasing number of major foreign manufacturing plants have provided opportunities for SMEs to cluster around them.

The Central government and provincial and local governments have initiated very important programs to support the development of SMEs, especially those based on technology. Business incubators, business counseling services, and science parks have been encouraged or supported. Venture capital and credit guaranty companies have been organized and financed, usually by provincial and local authorities, with backing from the Central government. Special economic zones have been given a variety of incentives, and have been allowed to experiment with new laws and regulations.

Purpose of this Forum

In this Forum, consultants to SEC will summarize their suggestions on ways the Central government might apply the best practices that have been effective in other countries to give even greater support to the SME sector. These fall into the following major areas:

1. Legal and regulatory framework for SME financing
2. Credit support and other measures to enable SMEs to borrow
3. Increasing access to permanent investment
4. Training of investors and lenders to SMEs.

I will give a brief overview of all these best practice reviews, followed by a more detailed discussion of each by the consultants responsible for the individual area.

Legal and Regulatory Framework

A supportive legal and regulatory environment is critical for the financing and development of SMEs. This is now well recognized in China, and legislation is being drafted to remove many of the barriers that have discouraged financing of these enterprises. Our consultants believe the following are the most important areas to consider:

1. Laws respecting the formation and operation of private corporations, including the issuance of more than one class of stock.
2. Laws respecting the organization and operation of investment funds and credit guaranty organizations.
3. Commercial banking laws limiting the loan interest rate to smaller borrowers
4. Laws that limit lending between enterprises that are not banks, but rather new sources of financing
5. Laws regulating equity investment funds
6. Laws that restrict transferability of shares held by founders and investors who provide funds prior to public listing.
7. Regulatory approval requirements:
 - a. The number of approvals required
 - b. Time and difficulty of obtaining approvals
 - c. Honesty and transparency of regulatory approvals.

In general, we recommend that China adopt the principles that now represent best practice internationally:

1. Simplify the formation of companies and investment funds by eliminating barriers and regulations
2. Require disclosure of information to relevant parties
3. Protect the interest of stakeholders with general laws, such as:
 - a. Labor laws
 - b. Environmental protection
 - c. Contract laws to protect customers and suppliers
 - d. Laws to protect the rights of investors

Access to Financing: Loans

Growing businesses require both permanent equity investment and the ability to borrow for short-term needs or to finance facilities that will generate cash flow that can be used to repay the debt in the future. As discussed later, permanent financing for SMEs has historically been provided by family and friends of the entrepreneur starting the business. With a few exceptions, however, banks in China have not been willing to loan to SMEs. Banks are concerned about the cost of making and monitoring small loans, and

feel the interest they can receive from the borrower does not compensate them for the risk of possible loss should the loan not be repaid. Consequently, most loans to SMEs have come from informal sources that offer no legal protection.

To encourage banks to lend to SMEs, the Central Government has encouraged provinces and cities to establish credit guaranty companies, and some 300 of these are operating at the present time. These have indeed increased the amount of lending to SMEs, but with the following limitations;

1. Loan guarantees are generally not available to businesses that are not based on technology.
2. Each guaranty company operates independently, with no uniformity of practices or credit standards and regulations.

International best practices suggest the desirability of uniform and consistent rules and standards. This will increase the likelihood that the guarantees will result in loans that otherwise would not have been made, and that the companies will be sound and sustainable. Establishment of an association of guaranty companies would provide a forum for marketing and promotion of guaranties, and an institution that can share data and experiences as a basis for setting standards. It would also facilitate training programs that could be offered regionally.

The Central government can make a great contribution to effective operation of the credit guaranty network by offering a central re-guaranty that will take some of the risk of loss from the individual guaranty companies. The re-guaranty would provide an incentive to the local guaranty companies to adhere to established credit standards and practices.

It is essential that the managers of credit guaranty companies be trained in risk management and credit standards, as well as in operational management. We have recommended that a new project be funded by the Asian Development Bank or other development institution to develop a training program that could be offered to all the companies offering credit guaranties and to the loan officers of banks and other institutions they might guarantee.

To support a credit guaranty program, China needs better data on the ultimate borrowers. There are many models of credit reporting systems that are in successful use in other countries. These could be modified to meet the special needs of China, and our consultants have proposed a project to develop a system that could work here.

Where loans are guaranteed in whole or in part, other countries have developed secondary markets for the guaranteed portion. This allows the lender to liquidate a portion of its loans, often at a premium price, and to use the proceeds to make additional loans. Another possible addition to the program in the future would be development of a micro-loan program, specializing in very small loans to individuals.

Access to Financing: Equity

In China, permanent equity for SMEs comes from:

1. The entrepreneur's family and friends
2. Foreign investors, typically investing at a late stage of development, or
3. Government-funded venture capital funds (primarily for high tech companies)

There is virtually no investment by domestic private equity sources, such as wealthy individuals, foundations, insurance companies, or pension funds, all of which are major providers of venture capital in other countries. Government-funded venture capital funds sometimes also attract capital from large companies that have excess cash from the sale of shares in an initial public offering. Since these companies require a stream of current income and liquidity from their investments, their participation in venture capital firms is often coupled with open market investments by the venture firms. This is a practice that is virtually never allowed in other countries.

This shortage of domestic private capital for venture investing is not unique to China. Investment is a truly global enterprise, where investors seek the highest possible rate of return on their investment, consistent with the level of risk they are assuming. SME investments are difficult to evaluate, take time to mature, and are often difficult to liquidate. Consequently, most nations have established government support programs to encourage private investment in venture capital firms. These either increase the potential profit to investors, or reduce their risk of loss.

The oldest and largest of these support programs is the U.S. Small Business Investment Company program, a public-private partnership in which the U.S. government makes loans or loan guarantees to investment funds that are capitalized and managed by non-governmental sources. Other notable programs are those of Israel and Australia. Based on these experiences, we have recommended a pilot support program for China, to see if it will attract local equity. This will be discussed in detail at a later session of the Forum.

Training

China has initiated credit guaranty companies and venture capital organizations at an extraordinarily rapid rate. With the exception of a few foreign companies, there has been no place where managers could learn the business and develop over years of experience. Consequently there is a great need for supplementary training of those who are responsible for these activities. At present, very little such training is available, training that is practical and based on actual experience.

If current institutions are to operate well, and if China is to be able to expand these programs, it is essential that opportunities be developed for training. In order to provide an experience as similar as possible to actual work in the field, our training

specialists believe the case method of instruction is especially valuable. We hope that the Asian Development Bank and other development institutions will provide funding for the creation and offering of both concentrated and extended courses in the operation of credit guaranty and venture capital firms. Specific recommendations will be discussed in a later session of the Forum.

Recommendations

Our recommendations will be discussed in detail during the remainder of the Forum. They fall broadly into the following:

1. While China is properly focused on technology as the basis for its long-term growth, for more immediate impact we believe it should look to its traditional strengths and the tremendous competitive advantage in traditional industries. Consequently, we believe government support programs aimed at increasing availability of debt and equity financing to SMEs should be available to companies in traditional industries as well as high-tech companies.
2. To increase availability of loans to SMEs, we recommend the credit guaranty industry be strengthened by:
 - a. An association of guaranty companies
 - b. A national credit re-guaranty company
 - c. Development of a training program for managers
3. To attract non-governmental sources of domestic venture capital, we recommend a pilot program of government support for newly established venture capital organizations, based on regulations that have been used successfully in other countries.
4. To provide a more supportive legal and regulatory environment, we recommend changes to existing law and the addition of new legislation on
 - a. The Company Law
 - b. Investment Funds legislation
 - c. Laws affecting the ability of investors to sell their holdings
5. Development of training programs for:
 - a. Loan officers
 - b. Loan guarantee officials
 - c. Investment fund managers
 - d. Entrepreneurs