

ASIAN DEVELOPMENT BANK

TAR: PRC 36024

TECHNICAL ASSISTANCE

TO THE

PEOPLE'S REPUBLIC OF CHINA

FOR THE

DEVELOPMENT OF SMALL AND MEDIUM-SIZED ENTERPRISE

CREDIT GUARANTEE COMPANIES

June 2004

CURRENCY EQUIVALENTS

(as of 15 June 2004)

Currency Unit	–	yuan (CNY)
CNY1.00	=	\$0.1208
\$1.00	=	CNY8.2767

ABBREVIATIONS

ADB	–	Asian Development Bank
CGC	–	credit guarantee company
MOF	–	Ministry of Finance
GDP	–	gross domestic product
NDRC	–	National Development and Reform Commission
NPL	–	nonperforming loan
PRC	–	People's Republic of China
SETC	–	State Economic and Trade Commission
SMEs	–	small and medium-sized enterprises
TA	–	technical assistance

TA CLASSIFICATION

Poverty Classification	:	Poverty intervention
Sector	:	Financial
Subsector	:	Nonbank Financial Institutions
Thematic	:	Private sector development, Poverty Reduction

NOTE

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

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I. INTRODUCTION

1. The Government of the People's Republic of China (PRC) requested assistance from the Asian Development Bank (ADB) during the 2003 country programming mission to provide advisory support for the Small and Medium-Sized Enterprise (SME) Department of the National Development and Reform Commission (NDRC). In response to the request, a fact-finding mission¹ visited Beijing on 12–16 January 2004 to ascertain the objectives, scope, and implementation arrangement for the technical assistance (TA).² The TA logical framework is in Appendix 1. Since 1998, the Government has given high priority to SME development to stimulate economic demand and increase employment. However, most SMEs encounter difficulties in accessing finance. SME financing has been the key focus of government policies.

II. ISSUES

2. SMEs³ play a significant role in the economy. They account for almost half of gross domestic product (GDP), two thirds of industrial value added, 60% of exports, and 40% of fiscal revenue. SMEs also provide 75% of urban jobs. Private SMEs have grown faster than the larger state-owned enterprises. The industrial output of SMEs has been increasing at an annual average rate of 30%, compared to 20% for the industry as a whole. Despite the rapidly growing importance of SMEs, more than 80% have had difficulty accessing financial services and securing financing.⁴ SMEs are often less creditworthy than larger companies, usually lacking proper accounting and a sound business track record;⁵ quality assets for collateral; technical, marketing, and managerial skills; and access to markets.⁶ SMEs also lack market intermediaries that can provide business support and information services such as accounting, auditing, consulting, and marketing. Other types of financial intermediaries such as insurance, guarantees, credit information bureaus, and rating agencies have even less SME coverage. Lack of an adequate bankruptcy law that protects creditors is another factor that makes financial institutions cautious about lending to SMEs.

3. The banking services available to SMEs are limited. State-owned commercial banks are not geared to service SMEs, particularly private ones. The other banking institutions⁷ have limited coverage and financial products⁸ and depend heavily on collateral.⁹ The high frequency and short-term nature of SME loans, unfamiliar markets and complicated ownership structure, and lack of sufficient operational and financial data for loan appraisal have resulted in higher business development and administration costs for banks.¹⁰ The long process of recognition, registration, and evaluation of collateral presented by SME borrowers cannot meet their frequent

¹ The mission comprised Y. Qian, principal financial economist, and Lu Shen, financial economist of the Governance, Finance, and Trade Division of the East and Central Asia Department.

² The TA first appeared in *ADB Business Opportunities* (Internet edition) on 4 March 2003.

³ Medium-sized industrial enterprises are those with a maximum of 2,000 employees, CNY400 million assets, and CNY300 million sales. Small industrial enterprises are those with a maximum of 300 employees, CNY40 million assets, and CNY30 million sales.

⁴ According to a survey by the State Information Center.

⁵ Over half of SMEs surveyed lacked proper financial management, and over 60% had a credit rating of BBB or below. Over 80% of bank loans go to AAA- or AA-rated enterprises.

⁶ SMEs often produce on a small scale. Over half have only a single product line, and 70% do not have a stable customer base.

⁷ The country has a dozen joint stock commercial banks, 88 city commercial banks, and thousands of rural credit cooperatives.

⁸ The use of short-term and trade finance tools such as letters of credit, forfeiting and factoring, and credit renegotiation and reimbursements, etc. is limited.

⁹ More than two thirds of SME loans are collateralized and about 20% guaranteed.

¹⁰ SMEs borrow five times more frequently than large enterprises. However, the average size of an SME loan is only about 5% those for large enterprises, and the administration cost is about five times higher.

and seasonal demand. To reduce nonperforming loans (NPLs), many commercial banks have adopted a policy of permanently aligning the responsibility of loan performance to the loan officers. This has resulted in acute risk averseness at the subbranch and loan officer level, thus curtailing the amount of loans to SMEs.

4. To address lack of banking services, many local governments and business communities established SME credit guarantee companies (CGCs) beginning in the mid-1990s. By June 2003, the country had 966 guarantee and re-guarantee companies in operation.¹¹ CGCs have gained experience in the past few years, particularly in strengthening institutional frameworks and developing operational procedures. Some CGCs improved their risk management systems and governance structure. More flexible approaches to collateral were adopted by expanding the list of collateralable assets, including mobile assets, production materials, and intangibles. Some CGCs provide more value-added services such as market access and managerial training. However, serious challenges face CGCs and threaten the sustainability of their operations:

- (i) **Limited coverage.** Despite a large number of CGCs in operation, in aggregate they serve less than 10% of total number of SMEs and meet 1–3% of financing needs of SME borrowers.¹²
- (ii) **Limited financial and technical capacity.** Many CGCs are still quasi-governmental, with a limited capital base and lacking fund-raising channels.¹³ Most guarantees were for short-term working capital loans of 3–6 months, with the longest for 1 year.¹⁴ Most CGCs also require counter-guarantees or collateral.¹⁵
- (iii) **Limited risk management capability.** CGCs have difficulties in monitoring loan disbursement and obtaining cash-flow information during the life of the loan, and in assessing risks brought by operational uncertainties and moral hazard. In the case of default, CGCs usually lack adequate legal and regulatory protection for collection and foreclosure. Poor risk assessment skills also make it difficult for CGCs to properly set guarantee fees.¹⁶
- (iv) **Lack of risk-sharing arrangement with banks.** The creditworthiness of CGCs is perceived to be low and banks often do not recognize their guarantees. CGCs and commercial banks do not effectively cooperate to agree on risk-sharing ratios,¹⁷ multipliers, and means to share information on loan monitoring.
- (v) **Lack of a consistent regulatory system.** No explicit regulation or supervisory agency governs market entry, accounting, prudential standards, corporate

¹¹ Among which 305 were fully funded by the Government, 321 had government contributions, and 340 were purely commercial. In terms of corporate structure, 701 were formed as companies under the Company Law, 181 as quasi-government institutions, and the remainder as associations. Re-guarantee companies numbered 67.

¹² Cumulatively, these guarantee companies supported over 48,000 SME borrowers with a total of CNY126.7 billion, representing a multiplier of 4.4 times.

¹³ Total capital injection in these guarantee companies was CNY26.7 billion, of which the Government supported CNY12.2 billion. Cumulatively, slightly over 1,000 cases of payment default were associated with the total loan amount of CNY680 million, resulting in a net loss of CNY120 million. By the end of 2002, there were a total of 777 default cases, representing 1.5% of the total number of guarantees and resulting in CNY342 million of defaults.

¹⁴ Ideally guarantee companies should support long-term loans for fixed investment. Most short-term working capital loans can support SME sales and orders.

¹⁵ If comparing the total outstanding amount under guarantees of CNY51 billion with a total capital injection of CNY28.7 billion, the multiplier of the guarantee system nationwide is only 1.78, far less than in other developing and developed countries.

¹⁶ Government directives indicate that the guarantee fee should be no higher than 50% of the prevailing bank lending rate.

¹⁷ Guarantee companies commonly provide 100% of guarantee for principal and interest, and banks become processing agencies and free rider on risks. Over 60% of banks do not share risks with the guarantee companies. The average guaranteed ratio of SME loans is 93%, higher than in other countries.

governance, operational practices, and financial management of CGCs. The only regulation is the Provisional Rule on Risk Management for SME Financing Guarantee Agencies, issued by the Ministry of Finance (MOF) in 2001.¹⁸ A plan regarding establishment of an SME credit guarantee regulatory committee¹⁹ was not implemented due to recent government restructuring.

- (vi) **Lack of risk sharing mechanism through re-guarantees.** The existing re-guarantee companies have limited business scope and none have developed prudent operational procedures and risk management practices.

5. Despite the challenges and sometimes heated theoretical debates over appropriateness using SME CGCs as means to facilitate SME financing, based on comprehensive analysis and international comparative studies, the Government is convinced that CGCs can provide a lot of value added, partly due to market failures such as regulated interest rates, and partly due to CGCs closeness to clients to bridge the gap brought by asymmetric information. Institutionally, the SME Department of NDRC is responsible for policymaking for SME development.²⁰ As provided for by the Law on Promoting Small and Medium-Sized Enterprises,²¹ the SME Department has the main responsibilities of enhancing fair competition and healthy development of the SME sector, facilitating SME financing, developing international markets, improving the SME support system, and coordinating with other government agencies regarding SME development.

6. The SME Department is contemplating policy options that could lead to the establishment of a central re-guarantee company, aimed at expanding the service coverage and quality of SME guarantee companies, streamlining risk management, enhancing creditworthiness and operational efficiency of CGCs, and increasing the overall multiplier for the nation's guarantee system. Given that the credit guarantee is a hybrid operation sharing attributes with insurance providers and credit intermediaries, the Government is exploring the possibilities of establishing a hybrid SME guarantee regulatory and supervisory framework, comprising a closely coordinated group of central government agencies, including NDRC, MOF, China Banking Regulatory Commission, and China Insurance Regulatory Commission; and local self-regulatory organizations, mainly in the form of guarantee associations.

7. **Asian Development Bank's Operations and Strategy.** Developing the private sector and SMEs is a strategic objective of ADB's Country Strategy and Program. ADB's operational objectives are to facilitate SMEs' access to finance and to promote the development of the financing and legal infrastructure for SMEs. Through previous TAs, ADB has helped draft the SME Promotion Law and policies and regulations for the SME Development Fund based on

¹⁸ The rule has 23 articles. Article 7 requires the guarantee fee to be within 50% of the lending rate, and Article 8 stipulates that the guarantee multiplier should be 5–10 times against paid-in capital. The rule is made primarily for local financial bureau-sponsored guarantee companies, and is not applied to private CGCs.

¹⁹ The former State Economic and Trade Commission (SETC) had planned to cooperate with the People's Bank of China, MOF, local finance bureaus, and local government departments of industry and commerce to establish an SME credit regulatory committee. Exact terms of reference for such committee were not established.

²⁰ The SME Department was established within SETC. An intergovernment leading group on SME development was set up in 2000. The major responsibility of the former SETC is to manage state-owned enterprises and regulate sectors where they dominate. The Government reorganization in April 2003 abolished SETC and transferred its SOE management function to the newly established State Asset Supervision and Administration Commission, and the market regulation function to the newly established Ministry of Commerce. The SME function has been transferred to NDRC, which signified a major reorientation of the Government regarding SME and private sector development and financing policies.

²¹ Enacted in June 2002 with ADB assistance and became effective in January 2003. In March 2003, the Government issued the Provisional Definition of SMEs.

international best practice.²² ADB also helped the All-China Federation of Industry and Commerce to identify constraints faced by SMEs and the domestic private sector,²³ the output of which became an essential input into the PRC private sector assessment. ADB disseminated these findings and sought the views of government agencies and market participants on the design of potential reforms.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

8. The purpose of the TA is to help the Government formulate strategies and implement concrete programs to facilitate SMEs' access to finance by expanding the business scope of SME CGCs and establishing an effective policy, regulatory, and operational framework for SME CGCs. The TA will evaluate the feasibility of, and help establish, the central government re-guarantee company, which aims to optimize risk and capital allocations for the SME guarantee system nationwide, support the institutional reform and financial strengthening efforts, and strengthen the regulatory and supervisory framework for SME CGCs to ensure their financial integrity.

B. Methodology and Key Activities

9. The TA will

- (i) help establish and operate the central government re-guarantee company by
 - (a) developing a road map and a comprehensive strategy to improve SME credit guarantee operations and optimize risk and capital allocation through re-guarantee operations; and
 - (b) evaluating benefits and risks (including government contingent liabilities), and identifying operational modalities of the central government re-guarantee company, recommending institutional arrangements, formulating operational procedures, and implementing pilot programs of re-guarantee and co-guarantee operations with selected guarantee companies and evaluating the experience learned.
- (ii) support the institutional reforms and financial strengthening efforts of SME CGCs by
 - (a) developing standardized procedures and templates for various aspects of SME CGC operations such as financial controls, business plans, corporate governance standards, etc.; and
 - (b) recommending proper standards for accounting and audit that apply to guarantee companies, for better information disclosure, financial management, risk management, and supervision.
- (iii) recommend measures to improve the regulatory and supervisory framework for SME credit guarantee operations and establish procedures for SME guarantee

²² ADB. 2000. *Technical Assistance to PRC for Development of a Small and Medium-Sized Enterprise Credit System*. Manila; ADB. 2000. *Technical Assistance to PRC for Development of Financing Policies and Mechanisms for Small and Medium-Sized Enterprises*. Manila.

²³ ADB. 2000. *Technical Assistance to PRC for Private Sector Development*. Manila.

companies regarding market entry, accounting, prudential standards, corporate governance, operational behaviors, and financial management practices.

C. Cost and Financing

10. The total cost of the TA is estimated at \$790,000 equivalent, comprising \$390,000 in foreign exchange costs and \$400,000 equivalent in local currency costs. It is proposed that ADB finance \$550,000 equivalent, consisting of the entire foreign exchange costs, and \$160,000 equivalent in local costs. The TA will be financed on a grant basis by ADB's TA funding program. The Government will contribute \$240,000 in kind for office space, counterpart staff, transportation, and other services. Details of the cost estimate for the TA are in Appendix 2.

D. Implementation Arrangements

11. The SME Department will be the Executing Agency. A working group will be established under the leadership of director general of the SME Department, to work as the counterpart of the consultants. The SME Department of NDRC will provide the necessary office space, counterpart staff, transportation, and other services to the consultants and will arrange appointments for the consultants with relevant agencies and organizations. Domestic seminars and conferences will be held to bring stakeholders together to discuss TA implementation issues and findings. A limited number of senior policymakers from the Government, and financial regulators will participate in training in countries with prudent SME re-guarantee operations and an effective regulatory framework to identify factors for success and exchange views with foreign counterparts.

12. The TA is envisaged to require 10 person-months of international consultants (a SME finance and credit guarantee specialist [6 person-months] and a guarantee regulatory and supervisory specialist [4 person-months]) and 12 person-months of two domestic consultants with the same expertise [6 person-months each]. A separate budget is provided to engage resource persons to participate in seminars and conferences and to cover specific technical areas. The terms of reference for consultants are in Appendix 3. The consultants will be selected and engaged on an individual basis in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB on the engagement of domestic consultants. Equipment (notebook computers, fax machines, and photocopiers) will be procured by the SME Department of NDRC in accordance with ADB's *Guidelines for Procurement*. The advance payment facility procedure will be adopted to facilitate timely organization of training, seminars, and conference activities.

13. The consultants will submit (i) inception reports 2 weeks after their services start, (ii) interim progress reports at appropriate stages of TA implementation, (iii) draft final reports before the conclusion of the contract, and (iv) final reports 2 weeks after incorporating the SME Department of NDRC's and ADB's comments. All reports have to be submitted in English and Chinese. The TA will commence in July 2004 and will be completed in June 2005. Workshops will be organized near the end of the implementation period to invite comments from international and domestic experts in the field and disseminate the findings of the report.

IV. THE PRESIDENT'S DECISION

14. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of \$550,000 on a grant basis to the Government of the People's Republic of China for the Development of Small and Medium-Sized Enterprise Credit Guarantee Companies, and hereby reports this action to the Board.

TECHNICAL ASSISTANCE FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<p>Goal</p> <p>Facilitate access of small and medium -sized enterprises (SMEs) to financing.</p>	<p>Improved policy and operational framework for SME credit guarantee operations.</p> <p>Adoption of a regulatory framework in 2005.</p>	<p>Evaluation of technical assistance (TA) interim reports on key indicators and targets.</p> <p>Supervision by review missions.</p>	<p>Government places high priority on SME development.</p> <p>Sound recommendations are accepted and implemented.</p>
<p>Purpose</p> <p>Establish the central government re-guarantee company aimed at optimizing risk and capital allocations for the SME guarantee system nationwide.</p> <p>Support the institutional reform and financial strengthening of SME credit guarantee companies (CGCs).</p> <p>Strengthen the regulatory and supervisory framework.</p>	<p>Identification of key factors for success in optimizing risk and capital allocations, and strengthening of corporate governance for CGCs.</p> <p>Start of re-guarantee company operations in 2005 to improve SME credit guarantee operations.</p> <p>Establishment of a policy framework for financing, operation, prudential regulation, and supervision of guarantee and re-guarantee operations in 2005.</p>	<p>Progress reports by consultants and the SME Department of National Development and Reform Commission (NDRC).</p> <p>Supervision by review missions.</p>	<p>Related government agencies coordinate closely.</p>
<p>Outputs</p> <p>International comparative study and identification of operational modalities of the central government re-guarantee company.</p> <p>Standardized procedures and templates for various aspects of SME CGC operations.</p> <p>Improvement of the regulatory and supervisory framework for SME credit guarantee operations.</p>	<p>Institutional arrangements, operational procedures, and pilot programs of re-guarantee operations for selected guarantee companies in 2005.</p> <p>Adoption of regulatory measures for SME guarantee companies regarding market entry; prudential standards; and standards for corporate governance, operational behaviors, and financial management practices in 2005.</p>	<p>Progress reports by consultants and the SME Department of NDRC.</p> <p>Supervision by review missions.</p> <p>Various tasks completed on time.</p>	<p>High-quality preparatory work by the SME Department of NDRC.</p> <p>Quality of TA implementation by the SME Department of NDRC.</p> <p>Quality of the TA consultants' services.</p>
<p>Activities</p> <p>Recruitment of international and domestic consultants.</p> <p>Reviews and market studies.</p> <p>Organization of training seminars and conferences to disseminate policy recommendations.</p>	<p>Two international consultants for a total of 8 person-months, and two domestic consultants for a total of 12 person-months.</p>	<p>Progress reports by consultants and the SME Department of NDRC.</p> <p>Various tasks completed on time.</p>	<p>Counterpart support is available.</p>

COST ESTIMATES AND FINANCING PLAN

(\$'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank Financing^a			
1. Consultants			
a. Remuneration and Per Diem			
i. International Consultants ^b	240.0	0.0	240.0
ii. Domestic Consultants ^c	0.0	65.0	65.0
b. International and Local Travel	30.0	5.0	35.0
c. Reports and Communications	0.0	10.0	10.0
2. Equipment ^d	10.0	0.0	10.0
3. Training, Seminars, and Conference			
a. Facilitators (interpreters and translators)	0.0	20.0	20.0
b. Domestic Training	0.0	40.0	40.0
c. Overseas Training	55.0	0.0	55.0
4. Miscellaneous Administration and Support Costs	5.0	0.0	5.0
5. Contingencies	50.0	20.0	70.0
Subtotal (A)	390.0	160.0	550.0
B. Counterpart Financing			
1. Office Accommodation and Transport	0.0	100.0	100.0
2. Remuneration and Per Diem of Counterpart Staff	0.0	95.0	95.0
3. Contingencies	0.0	45.0	45.0
Subtotal (B)	0.0	240.0	240.0
Total	390.0	400.0	790.0

^a Financed by the Asian Development Bank's technical assistance (TA) funding program

^b Around \$30,000 is earmarked for additional international specialists and will be identified during TA implementation as need arises.

^c Around \$15,000 is earmarked for additional domestic specialists and will be identified during TA implementation as need arises.

^d Equipment to be purchased includes notebook computers, fax machines, and photocopiers.

Source: Asian Development Bank staff estimates.

OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

A. **International Consultants** (10 person-months)

1. **Team Leader and Small and Medium-sized Enterprise Finance and Credit Guarantee Specialist** (6 person-months)

1. The consultant will assume the role of the team leader and be responsible for the overall management of implementation of the component, timely delivery of good-quality interim and final reports, and recruitment and management source persons in various technical tasks. The Small and Medium-sized Enterprise (SME) finance and credit guarantee specialist, together with other international and domestic consultants, should take the lead in tasks related to policy formulation aimed at facilitating SME finance and enhancing the effectiveness of the credit guarantee and re-guarantee system. The specialist should possess deep knowledge of and sufficient experience in SME finance and guarantee in the People's Republic of China (PRC) and other countries in a similar development stage. Specifically the consultant will

- (i) review the Credit Guarantee Company (CGC) market in terms of demand and supply for guarantees, competitive landscape, and cost of capital by breaking down CGCs by various categories such as (a) region, (b) shareholding structure, (c) size and market niches, (d) performance, and (e) targeted customs.
- (ii) evaluate experiences learned and identify problems that impact on CGCs' financial sustainability, including policy, institutional, legal, and regulatory framework; and operational, financial, and management constraints facing the guarantee companies, taking into account different characteristics with regard to government-sponsored CGCs and private sector CGCs.
- (iii) develop a strategy for optimizing risk and capital allocations by introducing re-guarantees and co-guarantee schemes.

2. To establish the central government re-guarantee company the consultant will do the following:

- (i) evaluate benefits and risks (including government contingent liabilities) and assess the need for central government re-guarantee schemes for local SME credit guarantee operations and assess the level of funding required.
- (ii) conduct an international comparative study of re-guarantee schemes of different countries and identify key successful factors.
- (iii) help implement the central government re-guarantee program and help the central government re-guarantee company establish selection criteria for use of re-guarantee schemes, based on sound banking, commercial, and financial principles.¹
- (iv) identify operational modalities of the central government re-guarantee company, recommend institutional arrangements, and formulate operational procedures and standard contracts with SME CGCs, including

¹ Including financial criteria such as minimum equity contribution from borrowers, estimated financial internal rate of return, debt service coverage ratio, minimum return on assets, loan coverage ratio, adequate level of working capital, state ownership, and compliance with all government regulations, etc. Selection criteria include those for borrowers (e.g., size, legality, relationship with the CGC); lenders (e.g., types of financial institutions); and terms of loans and guarantees (amount, maturity, etc.).

- (a) how to determine the upper limits of re-guarantee amount for each CGC,
 - (b) rate for loss sharing between the re-guarantee company and CGCs,
 - (c) coverage of re-guarantee (e.g., whether to include interest or interest arrears),
 - (d) timing and procedures of re-guarantee payments,
 - (e) how to share the recovered amount between CGCs and re-guarantee company, with special attention to the cost paid by CGCs for the recovery,
 - (f) conditions for denial or postponement of re-guarantee payments,
 - (g) conditions and procedures for the cancellation of re-guarantee contracts, and
 - (h) how to monitor CGC activities (e.g., reporting requirements and on-site visits or notification to supervisory authorities in case of suspicious defaults or reporting).
- (v) perform financial analysis of the central government re-guarantee company with guarantee companies. In particular,
- (a) identify and confirm objectives and suitability of the re-guarantee and co-guarantee operations;
 - (b) prepare and assemble financial analysis data to provide a quantitative and qualitative examination of the re-guarantee operations, assess the adequacy of the funding plan, and advise application of conditions, or covenants that should be required;
 - (c) forecast for a period covering up to at least the end of the fifth year of the re-guarantee program; and
 - (d) calculate the financial internal rate of return.²

3. To support institutional reform and financial strengthening of SME CGCs, the consultant will do the following:

- (i) identify corporate governance issues for SME CGCs, and help adopt appropriate corporate governance structure and practices to ensure institutional sustainability and accountability.
- (ii) evaluate the accounting and internal control system of SME CGCs and develop a monitoring system to make available reports of financial conditions, external audit reports, and on-site inspection or examination reports policymakers and supervisory authorities;
- (iii) examine through a survey of CGCs the most prominent issues facing the operation and management of SME CGCs, with particular attention to solvency, liquidity, profitability, portfolio quality, operational efficiency,³ and credit appraisal capabilities. Examine SME CGCs' performance against internationally accepted standards and recommend any changes required to achieve financially sustainable operations;

² Measured as the discount rate that equalizes the present value of investment cash outflows associated with the project to the present value of the project's net operating cash inflows.

³ Indicators may include but not be limited to capital adequacy, multiplier, return on assets and return on equity, loss provisions, and maximum exposure to a single borrower or group of borrowers, maximum exposure to any sector.

- (iv) improve operational guidelines for credit analysis and provide a uniform set of norms embracing internal controls and prudential and operational standards;
- (v) help relevant central and local authorities determine minimum financial and operational criteria to be applied to different enterprises, adequate risk-sharing ratios, adequate risk-based guarantee and re-guarantee fees, appropriate security and collateral, and maximum default ratios for the sample guarantee and re-guarantee companies;
- (vi) evaluate effects of potential policy and regulatory shifts (e.g., interest rate liberalization, phasing out of preferential tax rates, adoption of Basle II capital accords by the PRC banks that have different risk weights on guaranteed loans) that might positively or negatively affect CGCs' operations;
- (vii) develop and implement a training program for the staff of pilot guarantee and guarantee companies, with emphasis on risk assessment, rating, pricing, and management concepts.⁴
- (viii) identify measures that can maximize SME financing availability through access to foreign capital and contributions of nongovernment sources.

2. Guarantee regulatory and supervisory specialist (4 person-months)

4. The specialist is expected to possess deep knowledge and sufficient experience of regulatory issues of SME finances in the PRC and other countries, preferably the Organization for Economic Co-operation and Development (OECD) countries. Specifically the consultant will do the following:

- (i) evaluate the existing regulatory and supervisory system for SME credit guarantee operations and identify critical areas for improvements.
- (ii) examine the rules played by the government auditor general, external auditors, credit-rating agencies, and other regulatory and supervisory agencies such as the industry and commerce administrations. Evaluate complementarity and substitutability with the new regulatory system.
- (iii) examine the merits of recognizing CGCs as formal financial institutions thus subject to supervision of financial sector regulator(s), and elaborate the potential benefits of establishment of an institutionalized supervisory framework.
- (iv) evaluate accounting and audit rules that apply to SME CGCs and assess the rules' adequacy to meet the needs for information disclosure; financial and risk management (e.g., for acknowledging actuarial costs of guaranteeing loans); and need for supervisory activities.
- (v) strategize a proper sequence to improve accounting standards and audit practices for SME CGCs and ensure that standards and practices are consistent with the regulatory and supervisory framework;
- (vi) review the procedures, conditions, and authorities of licensing CGCs, with specific focus on (a) minimum capital requirements, (b) fit-and-proper tests, (c) feasible business plans, (d) minimum requirements regarding corporate governance, and (e) licensing authorities' capability to assess the above contents. Recommend changes if necessary.
- (vii) define objectives that can be clearly stated and understood for the regulatory and supervisory framework, and establish a core supervisory program for SME guarantee companies, covering (a) capital asset ratio, (b) loan portfolio

⁴ Training courses will use case studies relevant to their own operations and appropriate for local conditions.

- evaluation and provisioning, (c) centralized debtors reporting system, (d) general ledger (accounting rules), and (e) reserves policy, among others.⁵
- (viii) review plans prepared by the SME Department of the National Development and Reform Commission to establish the SME credit regulatory framework, and recommend enhancements;
 - (ix) identify the most appropriate leading agency among financial market supervisors to cover SME credit guarantee companies,⁶ and elaborate on advantages and disadvantages of the chosen one in performing such tasks.⁷ Examine whether the new activities are in line with existing activities and estimate the need for additional financial and human resources for the regulators to assume the new responsibilities;
 - (x) help develop rules, procedures, and division of labor regarding on-site inspection of CGCs by different supervisory authorities. Help develop a monitoring system for off-site surveillance by supervisors, including financial reports, external audit reports, as well as other sources of information;
 - (xi) develop conditions, actions, and procedures for supervisory responses (e.g., administrative orders, suspension of businesses, revocation of licenses) for inappropriate business activities and inadequate financial operational situations of CGCs;
 - (xii) recommend appropriate revisions or enactment of special legislations to allow selected financial market supervisors to assume regulatory and supervisory responsibilities;⁸
 - (xiii) help prepare supervisory manuals with detailed explanations for regulations and procedures, and specific coordination mechanisms among supervisors regarding licensing, implementation of supervisory standards, on-site inspections, monitoring and information sharing, and corrective actions;
 - (xiv) recommend an effective coordination mechanism for better coordinated among central government agencies, including National Development and Reform Commission (NDRC), Ministry of Finance, China Banking Regulatory Commission, and China Insurance Regulatory Commission, and local self-regulatory organizations.

B. Domestic Consultants (12 person-months)

5. Domestic consultants with in-depth country and sector knowledge and good contacts with the Government and enterprises will be recruited. The domestic consultants will help the international consultants quickly become familiar with their tasks by translating various documents into English; researching and compiling a set of government policies, regulations, and procedures adopted; and ensuring that the output of the international consultants is appropriate. The domestic consultants are expected to possess sufficient experience in their relevant fields:

⁵ Other areas such as standards for administrators and directors, consumer protection requirements, disclosure guidelines, and prohibition of unsound practices are also important.

⁶ The PRC has a segregated supervisory system, comprising China Banking Regulatory Commission for banking, China Securities Regulatory Commission for securities, and China Insurance Regulatory Commission CIRC for insurance. Experience shows that in countries with a strong supervision tradition, banking supervisors are most likely to cover credit guarantee companies.

⁷ For example, the banking regulator has advantages in supervision skills and access to information, and can apply the same homogenous bank supervisory standards to guarantee companies, thus ensuring financial soundness and credibility. However, the disadvantages are additional workload, and costs and potential dilution of the focus of the banking supervisor.

⁸ These include Banking Supervision Law or Insurance Law, etc.

- (i) The **SME finance and credit guarantee specialist** (6 person-months) will help the international consultant do the following:
- (a) detailed review of SME credit guarantee fund operations and identify policy, institutional, legal and regulatory impediments;
 - (b) strategy formulation to strengthen SME credit guarantee operations and optimize risk and capital allocations through re-guarantees and co-guarantee programs.
 - (c) international comparative study of re-guarantee schemes of different countries, and identification of the key factors for their success; and conduct of training sessions.
 - (d) evaluation of the operational modalities of the central government re-guarantee company and assisting in implementation of institutional arrangement and operational procedures.
 - (e) review of SME credit guarantee operations in 3–6 guarantee companies as pilots, and implementation of recommendations to improve operational policies, procedures, and risk management systems.
 - (f) implementation of guidelines and the scoring system to monitor performance of CGCs that use re-guarantee schemes; and
 - (g) develop and implement a comprehensive training program for the staff of pilot guarantee/guarantee companies, with special emphasis on risk assessment, rating, pricing, and management.
- (ii) The **guarantee regulatory and supervisory specialist** (6 person-months) will help the international consultant do the following:
- (a) detailed review of existing regulatory and supervisory system for SME credit guarantee operations and identification of critical areas of impediments;
 - (b) examination of the rules played by the government auditor general, external auditors, credit-rating agencies, and other general regulatory and supervisory agencies such as the industry and commerce administrations;
 - (c) evaluation of accounting rules and audit practices that apply to guarantee companies, and assessment of their suitability for information disclosure, financial management, risk management and supervisory activities;
 - (d) examination of institutional strengths and weaknesses among financial market supervisors to cover SME credit guarantee companies;
 - (e) identification of needed revisions or enactment of special legislations to allow selected financial market supervisors to assume regulatory and supervisory responsibilities;
 - (f) assistance to NDRC's SME Department to establish the SME credit regulatory framework and recommend enhancements to the plan; and
 - (g) liaison among central agencies such as NDRC, Ministry of Finance, China Banking Regulatory Commission, and China Insurance Regulatory Commission ;and local self-regulatory organizations to establish an effective SME guarantee supervisory framework.