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Japan International Cooperation Agency (JICA)
Chinese People's Bank, People's Republic of China

THE STUDY
ON
REFORMING SME FINANCE SYSTEM
IN THE PEOPLE'S REPUBLIC OF CHINA

FINAL REPORT

January 2005

International Development Center of Japan
Mizuho Research Institute

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Preface

In response to a request from the Government of the People's Republic of China, the Government of Japan decided to conduct "The Study on Reforming SME Finance System in the People's Republic of China," which was implemented by the Japan International Cooperation Agency (JICA).

JICA sent a study team, headed by Dr. Jinichiro YABUTA of the International Development Center of Japan, to the People's Republic of China six times, between March 2003 and January 2005.

The team held discussions with the officials of the Government of the People's Republic of China and conducted related field surveys. After returning to Japan, the team conducted further studies and compiled the final results in this report.

My hope is that this report will contribute to the promotion of reforming the SME finance system in the People's Republic of China and to the enhancement of friendly relations between our two countries.

I want to express my sincere appreciation to the officials from the Government of the People's Republic of China for their close cooperation throughout the study.

January 2005

Tadashi Izawa
Vice President
Japan International Cooperation Agency

January 2005

Mr. Tadashi Izawa
Vice President
Japan International Cooperation Agency
Tokyo, Japan

Letter of Transmittal

Dear Sir,

We are pleased to submit to you the report for the Study on Reforming the SME Finance System in the People's Republic of China. This report compiles the results of the study, which was undertaken by the study team, and jointly organized by the International Development Center of Japan and Mizuho Research Institute.

While SMEs have been playing an increasingly great role in the growth of the Chinese economy, the development of the SME sector remains an important policy issue to the Government of the People's Republic of China. Among the many challenges for sound development of SMEs, the difficulty in procuring funds is recognized as one of the most fundamental problems yet to be solved. Therefore, this study was conducted with the objective of making recommendations for the improvement and reformation of the Chinese SME financing system, so that it will enable the expansion of SME financing. The study team presented recommendations from a broad perspective, based on the view that it is indispensable to consider both the lenders and borrowers to solve the multi-dimensional problem of SME finance.

During the implementation of this study, the study team conducted a wide range of questionnaire and interview surveys for SMEs, financial institutions and credit guarantee institutions in the target areas, so that the recommendations were made in sufficient consideration of Chinese conditions, SME needs and feasibility. In addition, discussions and knowledge sharing were accumulated among the people concerned, through a series of seminars and workshops held in Beijing and other target areas.

The overall work process of the study was maintained in close cooperation with our counterpart organization, the People's Bank of China. It should also be noted that the People's Bank of China took this opportunity to conduct their unique research on the Chinese SME finance system in parallel with this study, which contributed to the improvement of the quality of the study results.

We acknowledge and greatly appreciate the excellent support rendered by your agency. We would also like to express our deep appreciation and sincere gratitude to all the officials concerned from the Government of the People's Republic of China, particularly those from the People's Bank of China, and all the people concerned from financial institutions, credit guarantee institutions and SMEs, for their kind assistance during the implementation of our field studies.

It is our hope that this report will contribute to the development of SMEs in the People's Republic of China and promote further cooperation between the People's Republic of China and Japan.

Very Truly Yours,

Jinichiro YABUTA
Team Leader,
Study on Reforming SME Finance System in the People's Republic of China

THE STUDY ON REFORMING SME FINANCE SYSTEM
IN THE PEOPLE'S REPUBLIC OF CHINA

FINAL REPORT

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Summary and Recommendations

1.1 Summary and Recommendations: Possible Solutions to Financing Small and Medium Enterprises

1.1.1 Study Objectives

This report aims to contribute to institutional improvement and reform in financing small and medium enterprises (SMEs) in China. For this report, the study team has conducted field interviews and questionnaire surveys in conjunction with its counterpart, the research staff of the People's Bank of China. Based on these surveys and a review of Japanese experience with SME financing, the study team has made a set of recommendations. The study team believes that the recommendations are sufficiently realistic and, at the same time, in line with possible long-term structural changes in SME financing in China.

The recommendations comprise those for lenders (Strategy 1) and borrowers (Strategy 2). Through these recommendations, the study team expects that so-called relational banking will be established on the basis of a relationship of mutual trust between the lenders and borrowers.

The results of the questionnaire survey are described in Chapter 2.1 of this report.

Strategy 1: Improving the Performance of Lending Institutions and Promoting Institutional Reform

(1) Financial System Reform and Capital Market Development
(2) Improving SME Finance Environments and SME Lending Operations through Commercial Banks
(3) Establishing Financial Institutions for SMEs
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Strategy 2: Upgrading Managerial Capacity and Promoting Disclosure on the SME Side

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1.1.2 Report Structure and Recommendations

The report is divided into Part 1 and Part 2. Part 1 is an overall summary and recommendation. Part 2 describes the strategy-specific analysis and recommendations with reference to the following items:

2.1 The Present Situation and Prospects of Financing SMEs
2.2 Financial System Reform and Capital Market Development
2.3.1 Present Management and Financing of SMEs
2.3.2 Financial Issues of SMEs and the Roles of Financial Institutions for SMEs
2.3.3 Human Resource Development for SME Management
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Chapters 2.1 and 2.2 give an overview of present situation and prospects of SME financing.

Chapter 2.3 focuses on the managerial and financial problems of SMEs and examines possible public interventions such as financing, the provision of information and HRD in order to solve these problems. Chapters 2.4 and 2.5 examine the present situation and possible improvement/reforms with special reference to the lending practices of commercial banks and the credit guarantee system.

Strategy 1

Improving the Performance of Lending Institutions and Promoting Institutional Reform

This strategy is derived from the following policy considerations of the study team:

1. Promoting a market-based economy, reforming banking systems and improving the performance of banks

2. Strengthening strategic public support for SMEs such as capital market development, policy-based lending and a credit guarantee system

(1) Financial System Reform and Capital Market Development (refer to Chapter 2.2)

Financial needs of SMEs are different in accordance with the stage of development of the enterprise. Broadly speaking, there are two types of financial needs. The first type is the financial needs of initial stage enterprises. Lending to such enterprises tends to be the provision of risk money because their business prospects and management competence are not yet certain. Ordinary financial institutions are not able to satisfy such financial needs. The second type is for post-initial stage enterprises. Financial needs of such enterprises can be met by ordinary financial institutions since their business is usually on track and thus involves relatively low risk.

With these different financial needs in mind, the study team recommends:

1) Normalization of bilateral financial transactions
2) Managerial reform of banks including those that are state-owned and privately-owned
3) Development of lending schemes that correspond to the socio-economic conditions particular to China.
4) Acceleration of capital market development
5) Liberalization of fund raising by Chinese enterprises in the international financial market
6) Reformation of credit guarantee systems

(2)The Present Situation and Prospects of Financing SMEs (refer to Chapter 2.1) and SME Lending through Commercial Banks (refer to Chapter 2.4)

Financing SMEs as part of economic policy requires the financial institution to be in line with a spirit of voluntary trust being the foundation of the market economy. Therefore, financial business principles have to be reflected in and duly applied to the operation of commercial banks and control by the financial authorities. This has not yet been fully observed in the present financial institutions.

Under these circumstances, one can hardly design a safety net warranted by economic and financial policies because there is no clear distinction in the responsibilities between the market and government.

The classification of SME is no more than for practical use in policy implementation. A market economy would ideally call for economic activities to be least covered by a safety net. When a safety net is really effective, private commercial banks can expand their operations without worrying about whether their customers belong to an SME or are classified under a safety net.

The financial authorities and institutions should establish a system to monitor actual operations of financing, the needs on the borrowers side and the ideas on the lenders side, especially those from the operational level, so that they are reflected in financial systems and operational rules. Such a system would enable the safety net to function in a timely manner.

(3) Establishing Financial Institutions for SMEs (refer to Chapter 2.3.2)

This study has analyzed issues of financial needs and supply for SMEs based on the questionnaire survey and keeping in mind the possibility of establishing a public financial mechanism for the SMEs including a policy-based lending institution. In analyzing Japanese public financing, attention needs to be paid to the difference in SME policies between Japan and the U. S. despite their economies being closely linked with each other. The SME policy has been a part of industrial policies in Japan but part of social policies in the U.S.

Economic institutions are more prolific and economic policies are more micro-based in Japan compared to the U.S. in response to different industrial maturity and changing economic situations. Policies for financing SMEs have been effective in fostering industries by providing policy guidance and financial incentives.

A policy-based lending institution for SMEs, if created in China, would be effective in:

1) Supplementing private financial institutions as a buffer in the phase of tightening money and a safety net in emergency situations
2) Encouraging private institutions to finance SMEs through special lending schemes as incentives
3) Building the capacity of lending and appraisals for SMEs

Such policy-based lending institutions should fully take into account:

1) Cooperation and complementation with private financial institutions
2) Possible financial sources / burdens (especially on the government side)
3) Financial sources and policy incentives for the field that are complementary to private finance

(4) Reforming Credit Guarantee Systems (refer to Chapter 2.5)

Credit guarantee systems have been developed in two ways: under government initiative with the input of public funds and under private initiative with the mobilization of private funds. The government has encouraged credit guarantee institutions to be established all over the country. Their number has exceeded 1,000 over the past few years.

The SME Promotion Law was laid down in 2003. Credit guarantee systems are now graduating from experimentation. They have begun to be operated on a regular basis with the Act for Controlling SME Credit Guarantee, which is a set of subsidiary rules for credit guarantee systems as specified by the SME Promotion Law.

However, current credit guarantee systems have encountered various issues including increasingly divergent objectives, increased pressure for financial sources and a lack of full-time credit guarantee institutions. Taking these issues into consideration, this report recommends:

1) Screening and selective support of credit guarantee institutions
2) Establishment of nation-wide systems and networks for credit guarantees
3) Standardization of credit guarantee systems
4) Creation of a re-guarantee system

As a reference for carrying out these recommendations, the report presents a grand design and key target figures towards the reform of credit guarantee systems.・

Strategy 2

Upgrading Managerial Capacity and Promoting Disclosure on the SME Side

This strategy focuses on the improvement of the capability of SMEs to manage business and finance, and the promotion of disclosure. To this end, the strategy also refers to public support and human resource development.

(1) Improving Business Management, Financial Management and Disclosure of SMEs (refer to Chapter 2.3.1)

The report analyzes external and internal issues of the procurement and management of a Chinese SME. The analysis suggests that overcoming financial problems of SMEs requires not only the improvement and reform of the systems to finance SMEs but also the improvement of business and financial management on the part of SMEs. In particular, the report recommends:

1) Balanced finance to be appropriate to replenishment and the utilization of owned capital
2) Strengthened financial management based on cash receipt, disbursement and cash flow statements
3) Positive disclosure of managerial status and intensified relations with lending institutions

4) Strengthened public measures to support SMEs, including a policy-based lending institution

(2) Public Support and Human Resource Development for Upgrading Management of SMEs (refer to Chapter 2.3.3)

Management upgrading of SMEs requires human resource development for the following purposes:

1) Strengthening the management and human resource base for systematic and unified policy support to SMEs as a whole in the long term
2) Meet the shortage of managerial workforce resources of individual SMEs in the short term.

Thus in supporting the SMEs, the report recommends:

1) Establishment of a systematic and integrated approach for managerial support and workforce development
2) Further use of information technologies by SMEs
3) Further use and acquisition of patent by SMEs
4) Promotion of businesses with the external market and investments

1.2 Summary and Recommendations: Specifics

1.2.1 Current environment and future development of finance by SME's in China

We, Japanese Research Group ("Japanese Side"), conducted a questionnaire and hearing (as explained hereafter) regarding financing by SMEs in China. Working in close conjunction with the People's Bank of China (i.e. the Chinese Counterpart ("CP")), we collected data quantitatively and qualitatively.

Subject to the questionnaire and hearing were SMEs, financial institutions and credit guarantee organizations. The five research areas are: Beijing City (Zhongguancun), Zhejiang Province (Wenzhou and Taizhou), Guangdong Province (Dongguan and Shenzhen), Shaanxi Province (Xian) and Shangdong Province (Weihai). They had been chosen beforehand by JICA and CP for being areas regarded as representing typical characteristics in China.

Our questionnaire research was highly appreciated in China, which could be seen as evidence that our technical assistance has been successful. Moreover, our methods of procedure and analysis were especially appreciated for their unprecedented use in China.

Unfortunately, CP could not render its research and analysis complete without reiterating that a few key problem areas still exist. Consequently, these areas need improvement if a better estimation of lead times is to be achieved, and in order to conduct sampling in a broad area. In light of such circumstances, it is not sufficient to have only procedure and analysis technologies. We expect ongoing further efforts.

Reliability of statistical research needs a logical proof that samples represent the mother group. One cannot exclude a possibility that sampling might have been distorted by policy concerns or neglect of certain groups of strata. I really hope such possibility has little to do with our study. Statistics should properly reflect mother groups so that their reliability could be accepted by anyone in and out the country, thereby enhancing their credibility.

The Research Division of the People's Bank of China disclosed a comprehensive report consisting of 21,000 Chinese letters with names of the "Special Assignment Team" on the daily paper, "Financial News," on June 22, 2004. This report includes a summary and analysis on the results of the research, verification of hypothesis and primitive recommendation for policies abstracted from this analysis. In this recommendation, "result of technology transfer and exchange of experience and knowledge" can be found as supported by many kinds of materials disclosed by the Japanese Side, discussions between the Japanese Side and CP, and collaborations in research activities. In this sense, half of the original purposes of this research project have been accomplished at this time.

And the discussion program, "Dialog," under the title of "SMEs: Where does the money come from?" was shown on CCTV-2 (FOR ECONOMY, LIFE AND SERVICES) on June 27, 2004, which featured three panelists including Mr. Mu (chief of the Research Department of the People's Bank of China; CP), around 100 general managers of SMEs from all over China and Ms. Liu Ping. The results of our research were introduced at the very beginning of the program. This proves that our research project could not only be useful for the division of the People's Bank of China but also useful for the whole Chinese economy.

Ten years has passed from the beginning of reform of the monetary system for the market economy in China. But current monetary regulations are not suitable for an "economic system based on a market economy and private economy." The bank sector in China has to realize its own assignment in society of providing capital to those sectors that need funds based on its own decision on risk. On the other hand companies also have to make an effort to be reliable borrowers from the point of view of financial institutions. The relationship between bank and company should be based on interdependence and mutual reliance. The fundamental principle of a market economy must be "a society with voluntary sincerity." The modern market economy consists of competitions under rules based on society of sincerity. People who consider a rule to be unjust must debate to improve the rule.

Recommendation of improvements to the government should be a right and a duty of the nation. Furthermore a satisfactory safety-net must be prepared in a modern market economy. It is the obligation of the government or policy authorities to prepare the safety-net. The role of the government in a market economy must be concentrated to such roles as can be realized only by the government. Otherwise private potential cannot be fully used.

On July 16, 2004, the China Banking Regulatory Commission issued a "Guidance for lending operations at commercial banks" (商业银行授信工作尽职指引). Each of the articles of this detailed guidance is the basic fundamentals of bank lending. From now on, both the China Banking Regulatory Commission and the People's Bank of China have to regularly conduct audits on compliance of this guidance in each financial institution. In each financial institution, an independent audit team has to check compliance of the guidance in daily business.

Japanese banks also have their own territories. Some banks operate all over Japan and some operate in plural regions. Customers of such comparatively large banks are mainly bigger SMEs or medium-sized companies between large companies and SMEs.

In China, financial support to SMEs in a region should also be conducted by regional financial institutions that have working knowledge of the region, too. Branches of state-owned commercial banks that are not suitable as regional financial institutions for SMEs should be transferred to regional financial institutions. This could result in a policy to develop regional financial institutions.

1.2.2 Financial System Reform and Capital Market Development

(1) Financial Needs in SMEs

There are two different financial needs for SMEs. One is the need for risk money in the start-up of business and the other is the need for growth money to sustain development after take-off of the business. The former need is not met in the framework of the ordinary financial system, because businesses in the start-up stage contain various risks, which are not hedged by traditional financial measures since the uncertainty of the business is usually quite large. On the other hand, the latter need is satisfied through both traditional banking and the capital market system.

(2) Main Difficulties Facing SMEs in Meeting Financial Needs

1) Limited supply source of risk money

In China, the supply channel through venture capital is narrow and most risk money is supplied via the informal sector such as the business originator's relatives and friends. Venture capital requires profits high enough to match its investment risks. High profits could be gained only when the successful venture business is listed in the capital market and capital gains are available for investors who dispose the listed shares at a high price. It is necessary to develop such an environment in which venture businesses can list their shares on a stock exchange as early as possible, at latest within three to four years after origination.

2) Insufficient supply source of funds for business expansion

a) Underdeveloped capital market

As for corporate financing channels, there are two markets, namely the financial market (loan market) and capital market. In China, the financial market is still the main channel and the capital market remains underdeveloped. A substantial amount of bonds and shares are issued. However, the main financial products in the bond sector are government bonds and debentures of public financial institutions. The corporate bond market is almost negligible. Three reasons can be cited for this. First, the government controls the size of bonds issued. Second, the issuing procedure is complicated. Third, the requirements to be cleared in order to issue are too strict. These factors lead to high issuing costs. On the other hand, although the stock market is showing vigorous expansion, the channel is still too narrow for SMEs.

Even in both Japan and the U.S., where the financial system has been well developed, the capital market is not a major financing source for SMEs. However, this fact does not imply that the importance of the development of the capital market development as a solution for SMEs financial problems is only marginal. It is true that the principal beneficiaries of capital market development are large corporations rather than SMEs. However, if large corporations could easily access the capital market for their fund raising, these corporations would convert the financing source from the financial market to the capital market and, as a result, it would become easier for SMEs to raise necessary funds through the financial market.

b) Lack of diversified channels in the financial market

In the financial market, four state-owned banks hold more than a ninety percent share of total outstanding loans. Even though commercial city banks and regional banks exist in each city and extend loans to local enterprises, their source is too small to meet the great financial needs of SMEs. In this sense, Chinese financial channels are not diversified.

Further, four state-owned banks are still ridden with non-performing loans. Under such a situation, they tend to become reluctant in providing loans to SMEs whose credit risk is relatively high compared to large corporations. They would rather reduce their loan assets for SMEs in order to maintain their capital adequacy level at international standards.

c) Lack of new financial products and services for SMEs

State-owned banks are sometimes criticized for a lack of efforts to develop new financial products and services. As a result, the Chinese financial market remains to be a so-called “plain vanilla” market.

The most serious complaint of SMEs is in regards to “non-collateral” loans. It is quite natural for banks to request collateral against their loans to SMEs, because banks are intermediary institutions, which collect deposits and savings from depositors and lend them to borrowers, and they are not allowed to transfer direct lending risks to depositors. A recent survey by the Federal Reserve Board in the U.S. reveals that even in the U.S., while about 30% of loans to large corporations are those with collateral, around 80% of loans to SMEs still involve collateral,

A credit guarantee is a tool to support non-collateral loans. However the scheme is not well developed in China as indicated by the fact that the performance of credit guarantee institutions remain at low levels. In China, the ratio of guarantee to capital accounts is at the highest only 5 times, while in Japan it is 50 times. This is because the guarantee itself seems to be unreliable.

d) Crowding out by large state-owned corporations

State-owned banks could theoretically be a major source of finance for SMEs. On the other hand, these banks’ major clients are state-owned corporations. This is a mismatch for the financing of SMEs. State-owned banks tend to extend their loans to state-owned corporations partly because they feel it is their duty to do so but also because they believe their loans to these corporations are not vulnerable to bankruptcy while loans to SMEs are vulnerable to bankruptcy. In addition, state-owned corporations hold ample collateral, which can be extended to banks. Such a situation brings about the crowding out of SMEs by state-owned corporations from receiving finance.

e) Lack of specialty

There is much room to be improved in the strategy of state-owned banks for financing of SMEs. State-owned banks have begun to stress the importance of financing for SMEs and have organized a new section for financing SMEs. However, unlike Beijing City Commercial Bank, their efforts do not seem to bear fruit in establishing “financing for SMEs” as new branded products at this moment. This is due to a lack of specialty in financing for SMEs.

f) Lack of recognition of importance of disclosure

There are two types of transactions in the financial system. One is " transaction with no third party" and the other is "market transaction." In the former transaction, a financial institution, one party, extends funds to an SME, the other party. In this deal, the SME is requested to disclose its financial information only to the financial institution. So long as the institution is satisfied with the disclosure, the deal is going on. In a market transaction, however, SMEs have to please all parties participating in the deal by disclosing financial data and information. SMEs are not very earnest about disclosure of their financial data and information. This leads to the underdevelopment of the capital market.

(3) New Challenges in the Financing for SMEs in Japan

How to strengthen financing for SMEs is a hot issue in Japan, too. Many challenges have recently been undertaken in Japan. If China follows in undertaking these challenges with normalization of the" transaction with no third party between a lender and a borrower" which is stated later and appropriate disclosure of financial data on the borrower, they could add fresh dimensions to China's "plain vanilla" financial markets.

1) Non-collateral loan: Covenant finance

A complaint is often heard from SMEs that commercial banks always request collateral on loans. If SMEs are fully cooperative in the disclosure of their financial data, commercial banks will become comfortable with non-collateral loans since they can fairly evaluate the risks involved in these loans to SMEs.

A new type of non–collateral loan has been recently developed in Japan. The loan is called covenant finance. The concept itself is not new and the scheme has been applied for a long time in sovereign loans to developing countries. In the case of issuing of bonds without collateral, as well, the scheme has been followed. Under this scheme the banks do not request any collateral to SMEs but impose some conditions on their financial position. Even though the conditions differ depending on each case, they generally include leverage ratio (outstanding interest bearing debt / operating profit before depreciation and tax), interest coverage ratio (free cash flow / interest to be paid), debt-service ratio (free cash flow / principals and interests to be paid on debt), net assets, outstanding interest bearing debt, sales and ordinary profits.

2) Securitization of loan assets: Financial engineering in financing for SMEs

Securitization is an economic activity to convert financial assets into securities products and sell them to investors. Financial assets include not only bank loans but also trade receivables, high yield bonds, vehicle loans and lease receivables, commercial real estate loans, credit card receivables, computer and equipment lease receivables and loans to restaurant franchisees. The economic features are:

- Convert "transaction with no third party between lender and borrower" to "market transaction among securities issuer and investors"
- Transform simple financial transaction to a sophisticated transaction in which many participants are involved

- Convert simple loan products to more sophisticated products having various risk-return structures (for example, to produce “A,” ”B,” and “C” rated products from “B” rated loan products)
- Involvement by various types of institutions in various regions instead of the involvement of regionally limited financial institutions
- Risk dispersion: a type of credit derivative
- An important step of access to the capital market by SMEs
- Disclosure of financial data of SMEs to the market, even though it is indirect and partial
- A new tool for expanding the money supply by the central bank when the bank designates them as suitable securities for collateral of commercial banks’ borrowing from the central bank
- Local people’s contribution to the development of SMEs through investment on the securities products

Japanese commercial banks’ reluctant attitude to provide SME loans urged the Tokyo Metropolitan Government to launch the initiative. Facing SMEs’ difficulties in getting sufficient funds to carry out their daily activities, the Government decided to save these SMEs, which are one of the major economic sectors in Tokyo. These SMEs suffered from shortages in funds when the commercial banks were forced to maintain capital adequacy levels at BIS standards and refrain from expansion of their loan assets and, as a result, they begun to adopt stringent loan policies towards SMEs, whose credit risks are relatively high compared to large corporations

Since the first launch of securitized products, CLOs (collateralized loan obligations) and CBOs (collateralized bond obligations) amounting to 380 billion yen were issued in five installments with the collaboration of representative financial institutions. Being stimulated by the Tokyo Metropolitan Government’s initiatives and its success, other regional governments such as Fukuoka prefecture, Osaka prefecture and Chiba prefecture followed with similar programs.

In introducing the scheme to China, the following two conditions should be met. One is to secure as many investors as possible and the other is to secure high quality loans to be securitized.

3) A new type of equity investment company: Small and Medium Business Investment Consultation Corporation (SMBICC)

In the course of their business expansion, SMEs need injection of new capital. They face difficulty in gaining such capital with the exception of listing companies. In the start-up stage, they raise such capital via relatives and friends. Since necessary capital injection becomes large at the expansion stage, it is difficult for them to rely on their relatives and friends for the large amount of capital. As institutions that supply necessary capital to SMEs in their growth stage, there exist three equity investment companies called Small and Medium Business Investment Consultation Corporations in Japan. They were established with the assistance and support of the Ministry of International Trade and Industry (now the Ministry of Economy, Trade and Industry (METI)).

One of these three corporations, the Tokyo Small and Medium Business Investment Consultation Corporation (TSMBICC) was established in Nov.1963 and has invested about 70 billion yen in 1,300 SMEs since its establishment. As an equity investment corporation, it aims to maximize capital as well as income gains from dividends. However, it does not necessarily stick to listing of the SMEs invested in. Even when SMEs list in the stock exchange market, TSMBICC does not always dispose their shares to make capital gain. On the contrary, they continue to hold the shares as a stable shareholder upon the request of the SMEs.

4) Tokyo Stock Exchange: Mothers

Even in Japan, the stock market has been a narrow source of financing for SMEs. To overcome the problem, Mothers, a stock market for innovative SMEs was opened in 1999. The current number of listing companies is 110. A salient feature is that so long as the SME satisfies several conditions, they can list their shares in a short period of time. In the traditional Tokyo stock market, only corporations having operation records of more than three years are entitled to list .The most important condition is to disclose their financial records and to hold investors relations meetings every quarter.

(4) Strategies for Solutions to Problems

Since many problems are involved in the financing of SMEs and much time and many resources are required for their solution, it is necessary to design well-thought strategies by clearing the structural relations among these problems and clarifying the priorities for solutions.

1) Normalize the" transaction with no third party between a lender and a borrower"

The real and fundamental problem for financing of SMEs comes from the fact that a transaction between a lender and borrower is not always normalized from a viewpoint of international standards. The top priority to smoothen the financing for SMEs should be addressed to normalization.

To realize normalization, the borrower should maintain corporate governance and full disclosure of their financial data and have a spirit of serious commitment. The lender should also maintain their corporate governance and follow the best practices of loan operation. The government should develop infrastructures necessary for accelerating normalization such as developing a disclosure system for corporate information, a system for smooth disposition of collateral in the event of default and bankruptcy.

In normalization, it is advised that Chinese banks gain the assistance of international banks. There are many foreign financial institutions, which are specialized in financing for SMEs and record favorable performance. It is advisable for the Chinese government to give them free access to the Chinese market. They will stimulate domestic financial institutions through competition. They will bring in know-how in regards to SME financing, develop new products and services and a new business model for the SME financing business.

Only after normalization, can new products and schemes be developed in SME financing. For example, the credit guarantee ratio will be increased and syndicate loans will be easily introduced. In addition, new products such as covenant finance, scoring typed finance and loans based on fiduciary transfer of movable assets will be developed. In the capital market, new financial products such as private placement bonds with warrant or loans with warrant could be introduced.

2) Strengthen the management capability of state-owned banks

For expansion of SME loans, state-owned banks have to strengthen their financial position by injecting new capital and maintain their capital adequacy level at international standards. It is advisable to set up a new financial institution specialized in SME financing within the existing state-owned bank as one of its affiliates. It attempts to specialize in SME financing by separating the financing for SMEs from financing for state-owned corporations.

3) Create institutional finance

It is impossible to solve every kind of problem pertaining SME finance with normalization. This is because there exists a bias between the credibility of large corporations and that of SMEs. Generally speaking, banks tend to evaluate that loans to large companies are less risky than those to SMEs. Therefore under the economic situation in which the economy expands and every company rushes to financial markets to gain funds for expanded business, SMEs face crowding out by large corporations in terms of financing. To mitigate the situation, a special institutional finance scheme should be designed.

As one measure to strengthen SME finance, it is suggested to set up policy oriented financial institutions specialized in SME finance. However, since institutional finance requires a substantial amount of money, the institutions will be set up mainly with private funds, taking into consideration that the fiscal burden should be minimized. The government places some money as a catalyst by extending a part of the equity, dividend guarantee, a part of the loaned money and a subsidy on interest paid by SMEs under strict conditions.

Depending on the necessity and specifying the purpose, amount and term, the state-owned banks extend loans to SMEs. The funds will be supplied by the Ministry of Finance. The finance scheme should be only temporary because it is to be done for some specific purpose such as emergency loans to SMEs for coping with an adverse situation caused by a drastic change of currency value.

4) Accelerate infrastructure development for the capital market

One infrastructure to be developed is a disclosure system. It is not an exaggeration to say that the development of the capital market depends on the maturity and completeness of the information disclosure system. An equity investment institution’s function is necessary for SMEs at the organic growth stage that are not yet financially strong enough to list their shares in the traditional stock market. It is also necessary to develop and improve upon a special stock market for SMEs, where they can realize their listing in a shorter period of time.

5) Free access to the international financial market by Chinese corporations

Free access to the international financial market by large corporations facilitates SMEs to access the domestic financial market more easily because they will be able to raise necessary funds from not only the domestic market but also the international market, and it will serve to minimize the above mentioned “crowding out”. The similar phenomenon was observed in Japan in the process of deregulation during the latter half of 1980’s. If there is any restriction on access, it should be gradually lifted.

6) Reform of the current credit guarantee system

For strengthening the existing credit guarantee system and its better use, it must be reorganized and consolidated. In addition, a reassurance system should be created.

1.2.3 The financial problems of SMEs and implications for the establishment of financial institutions specialized in SME financing

(1) Problems in fund raising and financial management of SMEs in China

Problems in fundraising and financial management of SMEs in China will be summarized as follows.

1) Many SMEs have no experience of fund raising from financial institutions. Many SMEs in need of funds are not aware of banks' requirements on granting loans. Professional guidelines are needed for SMEs concerning various financing methods.
2) Almost all small businesses and newly established businesses are procuring funds for their business from private sources and not from financial institutions. Due to a lack of financial sources, SMEs tend to rely on their own funds or support from their friends and relatives.
3) In the case where SMEs have transactions with financial institutions, it is limited to short-term loans. It is not easy to raise long-term funds for equipment investment and operations.
4) The financing gap between SMEs and financial institutions will be explained by the Chinese corporate ownership system and land ownership system. SMEs have little property for mortgage. Furthermore it is difficult for SMEs to find proper guarantors.
5) SMEs are at the first stage of establishing a modern corporate system and internationalization.
6) SMEs' lack of credibility from financial institutions and lack of a credit information system.
7) Lack of intermediary organizations and consulting organizations between clients and financial institutions.

(2) Financial problems of SMEs in China

1) Almost all private SMEs are newly established businesses in and after the 1990s
2) Turnover periods of receivables are about 20 days longer than those of payables
3) Positive in business and investment mind without financial support
4) 29% of SMEs are operating without cash flow statements
5) 60% of SMEs are provided follow up advisory services after raising funds from financial institutions
6) Credit guarantee institutions are not favorable for SMEs in credit analysis procedure nor financing costs

SMEs depend heavily upon short-term financing. It tells, on the other side, the difficulty for them to raise long-term funds, which we will see also from the viewpoint of financial institutions. The long-term financing of SMEs is the field in which private financial institutions are most unwilling to be engaged.

The difficulty in raising long-term funds suggests that the lending in the field needs to be fostered from a point of view that involves the development of the national economy.

(3) Solutions over financial gap of SMEs

1) Sound accumulation of equity capital (capital and shareholder's equity fund)
2) Financial management based on cash flow statements
3) Disclosure of corporate management and strengthen relationship with financial institutions
4) Public support system for SMEs on financial management

(4) Implications for the establishment of government financial institutions specialized in SME financing

1) The financial structure of SMEs in Japan

The financial structure of Japanese firms depends heavily upon liabilities to outside sources, especially upon current liabilities. In addition, this tendency is much more evident in Japanese SMEs than in large ones. This is a reflection of the fact that SMEs are practically unable to issue stocks and debentures in the public securities market and have little capacity to acquire stable long-term funds through private financial institutions.

Japanese SMEs suffer from managerial weakness, being placed at the bottom of the economic "dual structure" with large differences in capital size, technology, productivity and wage levels compared to large corporations.

Besides, in the course of the postwar reconstruction and high-pitched growth, financial institutions have formed themselves into a very closed system. While the demand for funds has tended to exceed their supply in the business sector, including both large and SMEs, banks have allotted funds with first priority to large enterprises and generally regard SMEs as marginal borrowers especially when the money market is tight.

The Japanese economy has been possessed by such a financial structure that the connection between the large bank and its related group of large corporations has been strengthened.

In addition to the need of modernizing equipment and catching up with the progress of developed countries, the demand for funds is so large on the part of SMEs in adapting themselves to the new socio-economic situation that the financing of SMEs would continue to be important.

2) The importance of SMEs in Japan

After World War II, the various entrepreneurships of SMEs were the driving force behind Japan's fast-growing economy. SMEs are an indispensable part of the nation's industrial structure and have developed and diversified in response to environmental changes in the domestic and international economies.

The Japanese government was quick to recognize the economic importance of SMEs and adopted a number of key policies to support their development.

Private financial institutions serving SMEs include city banks, regional banks, second regional banks, credit associations and credit cooperatives. Since they operate on a commercial basis, they are not always able to provide SMEs with appropriate amounts of loans on favorable repayment conditions, particularly in the case of business start-ups.

To solve some of the problems involved, the government established several government financial institutions, including National Life Finance Corporations, the Shoko Chukin Bank and the Japan Finance Corporation for Small and Medium Enterprise (JASME).

Lending to SMEs by these institutions accounts for about 10% of all lending. Such lending tends to increase during recessions, when it is difficult for SMEs to obtain loans from private financial institutions. Government financing thus plays an essential supportive role in the SME business sector, especially during economic downturns.

JASME was originally established to mainly provide SMEs with long-term facility and operating funds.

In order to implement its management philosophy of providing both funding and information on how to use it, JASME endeavors to grow SMEs by continuing to supply information and advice on solving management problems from a fair and impartial point of view, not only when supplying funds but afterwards as well.

SMEs must have access to stable, long-term funding if they are to develop and grow smoothly because of the need to make timely and appropriate plant and equipment investments and strengthen their financial health on a continuing basis.

Compared with large businesses, the fund-raising options open to SMEs are limited because of difficulties in procuring funds from the capital markets and other problems.

Moreover, lending by private financial institutions tends to focus on short-term funding for one year or less, so there is not enough long-term funding available for SMEs. Against this background, it is necessary to establish government financial institutions specialized in the long-term funding that the private financial institutions find difficult to provide.

(5) Role and function of government financial institutions specialized in SME financing

1) Supplementing private financial institutions and stable supply of long-term and fixed-rate funds. Serves as a buffer and safety net for SMEs.

2) Providing various types of finance in accordance with the government's SME policy. Serves as a pump-primer for private financing.

3) Appropriate and efficient financing for SMEs as an expert in SME financing.

4) Providing information and advisory service to enhance relationship banking functions and to realize the development of SME.

5) Nationwide network with equal loan conditions for SME financing serves as a supplement to private financing especially in local areas.

6) Direct financing systems provide new financial opportunity for SMEs in addition to existing private financing, credit guarantees and venture business investing.

(6) Key factors for establishing government financial institutions specialized in SME financing

1) Supplementing and cooperation with private financial institutions not to distort private initiative and market oriented economy. Limited share and loan conditions in the SME

financial market.

2) Study of administration costs government budgets as a fund source. Study new fund sources such as bonds, private funds and overseas funds.

3) Introduce financial schemes in accordance with government SME policy. Provide loans to meet the needs of the times such as loans for new businesses, management innovation, environment protection and local economic stimulus.

4) Provide information and advisory services to SMEs with neutral and long-term approaches.

5) Cooperate with private financial institutions, local government and industrial cooperatives to enhance relationship banking and to establish an SME support network.

1.2.4 Human Resource Development Policy for Strengthening SME Management Capacity

(1) Major problems identified and necessary perspectives on human resource development

Public institutions should consider developing and implementing policies for human resource development for SMEs from the following two perspectives:

a) To design and implement systematic and uniform support including human resource development for SME business management, in order to form a solid foundation of human resources playing an important role in the development of the SME sector in the medium and long term; and

b) To make up for the lack of resources for management faced by individual SMEs, in the short and medium term.

(2) Human Resource Development Policies and Systems for SMEs in Japan

1) Support programs for SME management and human resource development

Taking into consideration the weak management bases of SMEs in comparison to large-scale enterprises, the Japanese SME policy attaches importance on supporting SMEs to secure "soft" resources such as management know-how, technology and other information. Based on this policy, support measures are organized systematically and consistently nationwide. The following two sets of measures are particularly important components of the policy:

a) Business support centers are established at various levels of government, i.e. national, prefectural, and local levels, so that SMEs can choose the appropriate center to consult with or receive support from, based on the nature of their business and their individual problems. Across the nation, 260 Regional SME Support Centers, 59 Prefectural SME Support Centers, and 8 SME / Venture Business Support Centers are to be established.

b) Human resource development for SME promotion, including training for persons responsible for SMEs support, is advanced on a national basis by the Institute for Small Business Management and Technology and by the Small and Medium Enterprises Management Consultant (SMEC) system. The nationwide schemes enable SMEs in any region to receive uniform and high-quality support services.

2)Outline of the Institute for Small Business Management and Technology

The Institute for Small Business Management and Technology is one of the main pillars of human resource development policies for securing SME management resource bases. The Institute is established by the Organization for Small and Medium Enterprises and Regional Innovation to provide practical training in advanced business management and specific subjects for SMEs, as well as training for persons responsible for SME support. The Institute is highly regarded as an organization that renders comprehensive support to SMEs, based on the national policy on human resource development for SMEs.

3) Training programs provided at the Tokyo Institute for Small Business Management and Technology

The Tokyo Institute for Small Business Management and Technology is playing a central role in the activities of the Institute, offering training to about 130,000 people to date.

For example, a wide range of programs have been prepared for training SME personnel at different levels and in different sections. Many programs are organized under a variety of themes, so that persons at all levels of the company such as executive, middle-management and staff can find programs that are appropriate for them. Thus, for individual enterprises that cannot afford to fully provide their own training in response to the various needs of the employees, the programs of the Institute will help them increase their overall knowledge and skill level.

In addition, the Tokyo Institute is providing a training course to foster Small and Medium Enterprises Management Consultants, in order that the candidate students acquire knowledge and methods on business diagnosis of SME management and to be able to propose appropriate measures for improvements in business activities. Since Small and Medium Enterprise Management Consultants are expected to have intensive and extensive knowledge on a wide range of SME management issues as experts in providing consulting services to SMEs, the program of the Tokyo Institute covers a variety of subjects that the students are required to take.

4) Effect of measures for securing management resources of SMEs

The Policy Evaluation Report produced by the SME Agency shows that the above-mentioned measures have played an important role in securing SME management resource bases in Japan. Regarding the support measures carried out by the three types of SME support centers, the majority of users were “satisfied” or “satisfied to a certain degree” with the services provided by the centers. In addition, a substantial proportion of users answered that their problems were “solved” or “solved to a certain degree” by receiving the services.

In regards to training programs for trainees from SMEs as well as government organizations by the Institute for Small Business Management and Technology, more than 90% of the participants highly evaluated the programs on the whole. About 80% of the lecturers in the Institute have been given high value by the course participants, in terms of their level of understandability and usefulness.

(3) Future orientation of SME management support and human resource development

1) Establishment of systematic and uniform support for SME management and human resource development

It is essential to develop and improve the human resource base in SMEs, for instance, by fostering people with high management capacity or technical skill, in order for SMEs to achieve further growth by acquiring competitiveness and to gain major recognition commensurate with the increasing size and role of the SME sector in the national economy. Establishment of a systematic and uniform support system would greatly contribute to the enhancement of the general level of human resources at SMEs. However, detailed structure and program design of the support system including the degree of uniformity and the division of roles between different administrative levels should carefully be considered in the context of the actual situation in China.

While sufficient time would be needed for establishing the most appropriate system for China, the following are the important items which can be promoted immediately: the diversification of the service menu for SMEs and the training of persons engaged in SME support. Enhancement of these immediate measures would be advanced in existing public support institutions such as SME Service Centers as a core.

2) Response to technological innovation and globalization

The trend of technological innovation and globalization has rapidly been changing the business settings of enterprises, including business models, the competitive environment, and geographical coverage. How SMEs with relatively scarce management resources can cope with these changes is a common challenge in many countries. In particular, it would be important to strengthen support for human resource development in SMEs in the following areas.

a) Support for IT-based systematization in SMEs

It is important that small-business owners themselves understand fully the effects and problems of IT-based systematization when they consider introducing it. Human resource development in IT should therefore be targeted at managers as well as the staff in SMEs by providing IT seminars or training programs and such. In this case, it is crucial to consider the characteristics of the enterprise in question, such as its line of business and the current progress of systematization.

b) Support for promoting utilization and acquisition of patents

Measures for developing human resources engaged in patent work should be steadily promoted in order to encourage patent acquisition by the SMEs that have developed original technology, and utilization of patent information so that SMEs can efficiently facilitate technology development.

c) Measures for globalization of SME business

While globalization encourages more and more SMEs to pursue business abroad, providing support to these enterprises would be needed more than ever by providing necessary information and strengthening human resources engaged in foreign business.

1.2.5 Procedure of Loan for SME's of commercial banks in China

The fundamentals of lending operations are "to understand the facts of the company," regardless of if the lender is a commercial bank or governmental financial institution. In other words, it is to let all the real facts be disclosed based on any phenomena and information mainly from the points of view of "personnel," "products" and "money." Lending procedures to large companies should be "thorough" in terms of correcting any missing parts of such fundamentals or fixing in advance the conclusion of appraisals. Moreover, any parts of the process to investigate "the facts of the company" with all the related phenomena and activities based on frequent visits cannot be neglected. Considering this, requirements in lending procedures to SMEs are no different to the usual requirements in lending procedures.

In Japan, private financial institutions have the largest share in the market of lending to SMEs among various kinds of financial institutions. In addition, the role of policy and governmental organizations is supplementary to such areas, as these cannot be supported by private financial institutions. Lending by governmental financial institutions, institutional lending by regional governments and lending guaranteed by credit guarantee corporations are also executed through private financial institutions.

Considering the above, in order to promote lending to SMEs it is required for private financial institutions to revise and improve lending procedures in private financial institutions. And in order to consider a policy to promote lending to SMEs, including establishment of governmental financial institutions, it is required to gain an understanding of lending procedures in private financial institutions and not to ignore the operations and benefits of private financial institutions.

We found an important fact, which should be a natural fact, that most of the workers of financial institutions correctly understand what is required by lending operations and they are making the best effort as far as policies and public practices admit. And a few small regional private commercial banks have already taken such requirements in their management policy. Unresolved issues are that such results of efforts have not yet reached management of large banks or governmental monetary policies.

The Chinese government has already started monetary policies and governmental bank audits based on what is called "global standards" including BIS regulation, etc. Procedures of credit rating or assessment on assets in Chinese commercial banks are not so different with those of Japanese banks. The governmental department in charge of banking policies, to begin with, has to grasp the daily operations of domestic banks and hear the opinions of lower workers. Then they should begin considering required reform. After that if any issues are unresolved, they should consider experiences in other countries.

In commercial banks, especially state-owned commercial banks and joint equity commercial banks, individuals should not excessively be responsible for results of operation. Assignments and responsibilities of a division or department should be clearly defined in procedures. And such procedures should, whenever necessary, be revised based on opinions by excellent workers. At consideration of introducing operation procedures from other countries, superficial observation is not to be recommended but rather detailed consideration on every operation is required. But we recommend that cooperation with foreign commercial banks should be based on commercial relationship considering confidentiality and compliance.

We would like to contribute to the development of the banking business in China by introducing skills of Japan and Western countries. But we do not think such skills should be applied to China as is. The Chinese must analyze the situation in China and improve skills as is suitable to China.

As introduced, Japanese banks developed a method to analyze facts of the company based on detailed cash flow long before the concept of cash flow projection was introduced from America. It is an excellent skill for lending to SMEs. In Hong Kong practices, "Local L/C" is adopted for domestic transport. Such skills are developed by bankers in charge of daily operations who made effort to construct practice to minimize risks based on local trade practices.

The people of Shanxi Province developed a system for promissory notes (山西票庄). Some researchers say B/S was used in the Yuan Dynasty (元). It is quite important not to ignore such traditions and to be dedicated to apply skills of such tradition to the modern economy. Private financial institutions (商号・銭荘) were committed to avoid risks and to improve operation control during the confused era from the last stage of the Qing Dynasty (清) to the establishment of the People's Republic of China. This history should be respected as the process of effort by the Chinese to construct a financing system and should not be ignored as an important event before the revolution. If commercial banks in China make an effort to improve the financing system, they should be a reliable partner of Japanese and Western commercial banks in China and international finance market.

1.2.6 Consolidation of the credit guarantee system in China

(1) Difficulties in the trial period

Credit guarantee systems in the People's Republic of China are new economic systems that were put in place during the 1990s.

In those days, the market principle was introduced to the Chinese economy, foundation and fosterage of SMEs were actively pursued in various places, and a family of private companies entered the economy, which had been based previously on conventional state enterprises. In the beginning, there were many people who started enterprises with funds borrowed from family, acquaintances or co-workers. Accompanying the growth of enterprises, also, was the increased demand for borrowing funds from financial institutions.

On the other hand, in the financial arena centered on state-owned banks, a new situation arose where private banks gained power and responded to SMEs active demand for funds. While a new system to combine SMEs and financial institutions was being developed, many credit guarantee institutions have been established around the country under the guidance of the State Economic and Trade Commission (SETAC) since 1998. SETAC dealt with matters in this period of new system establishment, under a slogan of “One Body with Two Wings." Concretely, they promoted two kinds of institutions: publicly funded government-driven credit guarantee institutions, and those using private funds and led by the private sector.

With concern drawn to credit guarantee systems, in response to this government's guidance, over 1,000 credit guarantee institutions were established in various locations in China in only a few years. This movement toward credit guarantee systems proceeded simultaneously with an effort to establish policies to foster SMEs, a new economic policy for the People's Republic of China. All were trial-and-error work for any person involved. Actions were hastily started before agreements and preparation had been fully completed in various aspects such as laws, system operation and arrangements of funds.

Naturally, malfunctions and discrepancies arose in various fields and came into the open. Particularly, small credit guarantee institutions were short of funds, and those with a low maximum rate of guarantee lost the ability to guarantee credit even in the early stage and fell dormant. Once the ability to guarantee credit declines, fund-raising becomes difficult and concerned people lose their bearings. Credit guarantee systems came to face such difficulties.

(2) Promotion based on law（依法）

In 2003, the SMEs Promotion Law (中小企業促進法), which is the basic law for policies for SMEs in the People's Republic of China was enacted, and the "trial period" is ending now at last. The SMEs Promotion Law recognizes both credit guarantee institutions established all over the country, which are established with government funds, and those established with private funds. As for the latter, shareholders expect, from the beginning of the establishment, profits and dividends to pay back the capital supply. The latter institutions expect profit earning by priority and are also engaged in other financial-related business, such as capital investments, intermediary services and procurance, from which high-rate profits can be expected.

In parallel with preparation and enforcement of the SMEs Promotion Law, the Division of Small and Medium sized Enterprises(中小企業司) recommended these two kinds of credit guarantee institutions to join the "national credit guarantee system for SMEs" (全国中小企業信用保証体系), and began efforts to grasp and restructure all credit guarantee institutions scattered around the country. Approximately 1,000 institutions have registered now, but there are also many unregistered credit guarantee institutions.

“The Regulations for SME Credit Guarantee Management”(中小企業信用保証管理弁法), which sets concrete provisions for execution of credit guarantee systems based on the SMEs Promotion Law, is being prepared now. Here, credit guarantee systems in the People's Republic of China mark a new epoch in the "trial period" and are entering an age of "promotion based on law."

(3) Present issues

Actual conditions of credit guarantee systems in the People's Republic of China were grasped from this investigation in a comprehensive manner for the first time. In this investigation, interview surveys and opinion hearings through local seminars, as well as questionnaire surveys, were carried out. The investigation was comprehensive and covered financial institutions and SMEs in addition to credit guarantee institutions. As a result, the following issues came into the forefront:

1) The object of systems is not defined

Credit guarantee institutions in the People's Republic of China are roughly divided into two kinds – 1) those in which government funds are injected, and 2) those in which private funds are injected. In fact, these institutions are further differentiated due to circumstances of the foundation and according to guidance, shareholders, and methods of providing capital. Such differentiation and diversification brought about differences in fundamental understanding and operating policies of credit guarantee systems, and operational discordance is arising among SMEs and financial institutions.

2) Tightness of funds

Small institutions cannot maintain guarantee funds with high liquidity and an appropriate maximum rate of guarantee. Furthermore, their business structure and work contents lack unity. Needless to say, they have encountered many internal problems. With smaller guarantee funds and a maximum rate of guarantee as low as about five times, undertaking even a small amount of credit guarantee leads to the "limit" of business activities. Moreover, it is difficult to introduce a large amount of additional funds and, as a result, many institutions have fallen dormant.

3) Credit guarantee institutions without other business

Actually, there is a mixture of institutions engaged solely in credit guarantee and those also engaged in other business. Although it is desirable to reorganize them, “The Regulations for SME Credit Guarantee Management” have yet to be enacted. Incidentally, expectations for credit guarantee institutions are great in the financial scene of smaller enterprises; nonetheless, functions of credit guarantee systems do not work practically because sufficient acknowledgement and evaluation have not been firmly established.

(4) Fundamental principles of credit guarantee

Only East Asian countries such as Japan and Korea have succeeded with credit guarantee systems as a social policy and have realized a massive amount of credit guarantee. A social system will become successful only if it is based on and suitable for conditions of the country, the society, and the economic climate. Fundamental principles of credit guarantee systems are, however, common. Philosophy and fundamental principles cannot be obtained until abundant experience in system operation is acquired. We hope that concerned people in China will pay attention to the "fundamental principles of credit guarantee" drawn from actual achievements in the history of the East Asian region, particularly, Japan.

Those to which attention should be paid especially are basic conditions of credit guarantee systems which are summarized in the following five items:

1) Public-service institutions covering the whole country
2) Institutions specialized in credit guarantee services
3) Institutions open to all SMEs and financial institutions
4) Institutions with strong creditability
5) Institutions with capable human resources

Work of credit guarantee institutions is unstable; therefore, it is financing for diverse smaller enterprises. This financing always contains "accidents and risks" such as bankruptcy, insolvency, and business depression. Credit guarantee work is work in the anticipation of, and on the assumption, of "huge expenses" of subrogated payment from the institutions own funds.

To continuously develop this work on the assumption of such risks, as a social system and as a stable business, the following must be developed: ① ability of appraisal and investigation to make appropriate decisions regarding management of smaller enterprises with few real assets that can serve as collateral, ② active involvement by financial institutions, ③ securement of ample funds for subrogated payments at all times, and ④ benefits which can be enjoyed from the system equally all over the country covered.

The ultimate objective for this purpose is realization of the "sea of credit guarantee." This means that a stable and continuous business shall be established according to the principle of large numbers where impacts of risks are relatively reduced by a lot of credit guarantee business achievements.

(5) Improvement of credit guarantee systems in the People's Republic of China: Recommendations

Based on the fundamental principles of credit guarantee, measures for near-term system improvement are observable through this study. However, the reality of credit guarantee systems in the People’s Republic of China is that they are still far from perfect.

1) Sharp distinction of credit guarantee institutions

There are already four kinds of credit guarantee institutions in the People's Republic of China, with consideration given to the main classifications only. Either through government finance or private funds, and whether they are engaged in credit guarantee affairs only or also engaged in other business are key elements for classification. Besides these, there are diverse corporate structures with various kinds of characteristics. In order to make steady progress from the "trial period" to the period of "promotion based on law," it is necessary to improve these business structures. More concretely, there is a task of clarifying the criteria for determining what should be developed preponderantly within the limited financial funds.

It is expected that credit guarantee institutions "without other business" (as targets of national fiscal support) will be sharply distinguished from others and they will be fostered when “The regulations for SME credit guarantee management” is established.

2) Formulation of a national system

Although credit guarantee institutions are operated as private businesses, often their social role is that of a public institution for public benefit.

Activities of credit guarantee institutions can stabilize the local economy and society, and provide economically beneficial effects to foster vital smaller enterprises and promote sound finance, both of which support an open economy for the People's Republic of China.

Credit guarantee systems should not be considered as mere organs for financial measurements in the local economy, but as important social systems and public-service organs. Benefit of the systems should be enjoyed equally over the whole country covered by the network.

Presently, there are about 1,000 institutions in existence located disproportionately throughout the People's Republic of China, while there are even places without any institutions. Specifically, it is expected that these institutions will be consolidated into 100 institutions with regional monopolies in provinces, autonomous regions, municipalities directly under the Central Governmant, principal cities or others as a target place for business transactions. These institutions will be newly established to span the entire region. Naturally, a nationwide umbrella organization to control them will become necessary.

3) Unification of systems

Unification of credit guarantee systems is inevitable since it remains a pressing matter of convenience for SMEs, convenience of utilization of guarantee for financial institutions, mutual qualitative improvement of credit guarantee institutions, and penetration of policies. For this purpose, it is necessary to: ① establish an umbrella organization through coordination between Division of Small and Medium sized Enterprises and the People's Bank of China, ② set up exploratory commissions with business people as central figures, and ③ standardize work contents, contracts, criteria and forms of credit guarantee affairs.

These operations should be linked with on-going planning of "The regulations for SME credit guarantee management" and there is only a little time left.

4) Reguarantee systems

Once credit guarantee affairs are started fully, current expenditure of subrogated payments corresponding to the size of credit guarantee is inevitable. As a result of this expenditure, liquidity of funds on hand of credit guarantee institutions will be damaged, which will affect the basis of credit guarantee systems. Therefore, active measures, in the form of reguarantee systems, for liquidation of receivables must be prepared in addition to introduction of additional funds and control of maximum rate of guarantee.

The current reguarantee system in Japan, called "credit insurance," is a system where guaranteed debts undertaken by credit guarantee institutions are inclusively reguaranteed. Meanwhile, a certain portion of the amount of subrogated payment is compensated when default occurs, and, eventually, liquidity of receivables held by credit guarantee institutions is maintained. As to collection through recovery of the indemnity right, the equivalent amount is returned to the reguarantee institution.

This reguarantee system has not been formulated in the People's Republic of China. It is reasonable to make haste with its formulation, taking the present time when the trial period of credit guarantee systems is coming to an end as the best opportunity.

(6) Ground design

Improvement of credit guarantee business in the People's Republic of China must be carried out resolutely, carefully, and boldly according to the plan with importance attached to the above-mentioned points. In so doing, it is effective to indicate an immediate ground design showing rough figures to concerned parties and interested parties. (A table of estimated calculation is to be presented in the text.)

Of course, it is a matter of the national policies of the People's Republic of China (now entering the period of promotion based on law) how credit guarantee systems in this country should be formulated and advanced. The following descriptions are our policy recommendations and expected values to overcome the present difficulties, based on the opinions of the specialists who carried out this Study, which have been obtained from the analysis of this Study.

1) The more than 1,000 existing institutions shall be reduced through reorganization and restructuring, and 100 institutions with a regional monopoly for each province, autonomous regions, municipalities directly under the Central Government, principal city or other area shall be placed to cover the whole country.
2) Institutions engaged solely in the credit guarantee business shall be fostered preponderantly.
3) A reguarantee system shall be set up.
    * Reguarantee rate: 70 - 80%; Reguarantee fee rate: 0.8%
4) Ten billion yuan as resources to support funds of credit guarantee institutions and five billion yuan as funds for foundation of reguarantee institutions shall be invested soon.
5) Contents of credit guarantee and immediate goals of percentage of main items
    * To achieve the credit guarantee debt size of 2 to 3 times that at present in about five years.
    * To realize maximum rate of guarantee of 10 times and further aim for 30 times.
    * Credit guarantee rate: 100%
    * Rate of increase of guaranteed debts: 120%; credit guarantee fee rate: 1.2%; rate of subrogated payments: 2%; rate of collection: 50%; expense rate: 1%; current ratio: 80%

Outline of the Study

1.3 Outline of the Study

1.3.1 Background and Objective of the Study

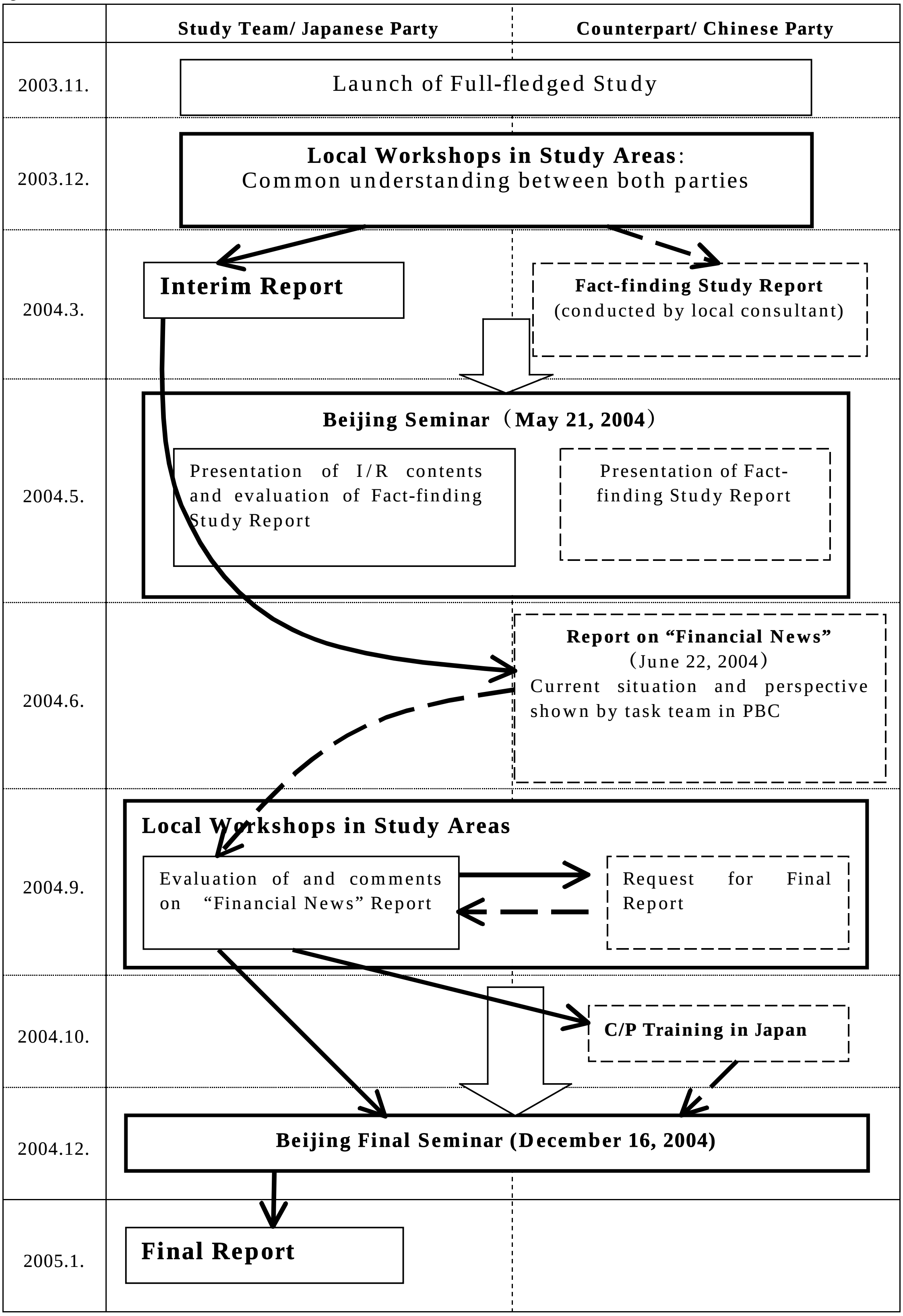
Small and medium sized enterprises (SMEs) account for 95% of the total number of enterprises, 60% of the increased value in industrial production and 40% of the total paid amount of tax on profits in the Chinese economy. SMEs in China widely cover light industries and supporting industries including food, textile, stationary, and IT software and hardware. It is expected that SMEs will play greater roles than ever before in the development of the Chinese economy, along with the shift from a labor force concentrated on agriculture to one concentrated on industry as a result of urbanization, the increased pressure on employment creation due to further reformation of state-owned enterprises in the city areas, the advancing and specializing of industries, and the softening of the economy. However, one major factor that is blocking the development of SMEs is the difficulty in procuring funds in conjunction with the credit crunch of lenders, which has in recent years appeared as an extremely serious problem for the Chinese economy. The People’s Bank of China began to tackle this problem by strengthening and expanding financial services for SMEs through a variety of measures. However, these efforts have ironically led to the expansion of non-performing debts due to inadequate risk management for loans to SMEs by Chinese financial institutions, which in turn has created a credit crunch.

The fundamental factor behind the difficulty in procuring funds caused by the credit crunch is the borrower. In other words, the risk of financing SMEs is too high. Simultaneously, backing systems are still inadequate to avoid or absorb such large risks. The problems concerning SME financing are complex and diverse including systematic problems, policy problems, lender risk management problems and SME management fragility. Consequently, there is a need to introduce comprehensive resolutions.

The objectives of this study are described in the following two points with due consideration given to the above conditions concerning SME financing in China.

- What kind of SME financing system reformation needs to be executed to construct a financial system that enables the growth of financing of SMEs? A proposal shall be provided after sufficient consideration of Chinese conditions, SME needs and feasibility.
- The transfer of knowledge and skills via this study to the policy representatives and affiliated support institutions of related Chinese institutions centering on the Chinese People’s Bank in order to support improvement of the capacities of parties related to the development of SMEs.

Figure 1.3.1 Work Plan



1.3.2 Task Implementation Methods

This study was implemented based on the work plan shown in Figure 1.3.1. The work items performed are as follows:

<First year>

In the first-year of the study, the following preparatory work was conducted in Japan.

(1) Collection and analysis of information and materials related to the SME financing system in China

Materials and information on the following items that could be obtained in Japan were collected, analyzed and organized.

1) Background and history behind preparation of the SME financing system in China

   - Economic and social background, changes in financial policy, system reformation, implementation of SME promotion measures, etc.
   - Various measures and legal systems related to SME promotion policies and SME financing

2) Results of the past study and research on SME finance in China conducted by Chinese or Japanese research institutions

3) Status of the support in the SME financing area of international institutions and other donors

4) Conditions in candidate locations for the study

   - Economic structure, industrial structure, social conditions, SME characteristics, SME financing characteristics, etc.

(2) Collection and analysis of information and materials related to Japan's SME financing system

In order to employ a summary of the SME financing system in Japan and focus on content that will serve as a reference for conditions and themes in China, information on the following items was collected and analyzed.

■ History of SME development

■ Overview on the history of SME promotion policies

■ History of SME financing policies

■ Implementation of the SME financing system

- Overview of the present system
- Organizational form, fund amounts and source of funds for each player
- Historical development

■ Implementation of measures concerning SME financing

■ Preparation conditions of economic infrastructure for supporting SME financing

- Financing screening environment for financial institutions
- Corporate accounting system
- Credit guarantee system

The above study results were organized and a compilation of materials was prepared for the kick-off seminar.

(3) Preparations for Holding the Kick-off Seminar

Materials were prepared for the kick-off seminar to be held in China during the second year.

(4) Establishment of an Overall Plan for the Study

The content, methodology, schedule, personnel, image of results, skill transfer items, transfer method and requests concerning the People's Bank of China (counterpart institution) concerning the overall study were compiled.

(5) Preparation for Fact-finding Study on SME Fund Procurement

An initial preparation was made for the fact-finding study on SME fund procurement. The study intended to survey the actual conditions of SME financing from the side of SME financing institutions (supply side) as well as SMEs (demand side). The study team examined detailed survey items and methods, including the employment of a local consultancy service for the implementation of the study.

(6) Preparation and Mailing of Inception Report

The Inception Report containing the study results for the preceding (1)-(4) was prepared. This report was mailed to the Chinese side in advance via the Japan International Cooperation Agency (JICA) China Office.

(7) Holding of Advisory Committee for the Study

For the purpose of effective implementation of this study, the Advisory Committee, established by JICA, was held. In the committee, the study team explained the basic policy and the work items of the study to the committee members, based on the inception report.

<Second Year>

In the second-year of the study, the study team conducted the following work items.

First Fieldwork in China

(1) Ex-ante coordination for the study

Since the launch of the second-year study was forced to be delayed due to Severe Acute Respiratory Syndrome (SARS), the study items and procedure (including planning of utilizing local consultants) were freshly discussed between the study team and the Chinese counterpart.

First Home Office Work in Japan

(2) Preparation for Second Fieldwork in China

In order to prepare for the starting of the full-scale study from the second fieldwork in China, the study team made necessary adjustments to the study content and the implementation system including preparation for the bidding work for employing local consultants.

Second Fieldwork in China

(3) Holding of Kick-off Seminar

A kickoff seminar was held on October 31, 2003 with the main themes of explaining the inception report and the exchange of views on the basic policy, content and methods of the study between participants. The participants included the study team, the Research Department of the People's Bank of China and personnel from the branches of the PBC in the targeted areas of the study. Ms. Mariko Watanabe, M Phil., Researcher of the Institute of Developing Economies, Japan, was invited as a lecturer to the seminar, where she presented the theoretical stance on implementing the study and her views on the present conditions of the SME financing system in China.

(4) Collection of Basic Information and Grasping of Current Conditions concerning the SME Financing System Reformation

In order to grasp the current conditions and issues of the SME financing system as a part of the analysis of current conditions of SME financing in China, the study team organized and analyzed public statistics and other materials and information collected in the fieldwork.

(5) Study on Current Conditions concerning Policies, Legal Systems and Measures concerning SME Financing and Implementation of Fact-Finding Study on SME Fund Procurement

For the purpose of identifying current conditions concerning policies, legal systems and measures concerning SME financing, the study team, in cooperation with the Chinese counterpart, conducted interviews with governmental organizations such as the Small and Medium Enterprise Department of the National Development and Reform Commission, state-owned banks including the Agricultural Bank of China and the Industrial and Commercial Bank of China and other financial and credit institutions. In addition, the study team interviewed SMEs, which stand on the demand side of SME financing.

The study team signed a contract with a local research institution on November 18, 2004, after negotiations with the institution followed by JICA's approval, on the implementation of questionnaire and interview survey for the fact-finding study on SME fund procurement.

(6) Preparation and Submission of Progress Report 1

The study team prepared and submitted Progress Report 1 in order to present the results from the study up until the second fieldwork and the current progress.

Second Home Office Work in Japan

(7) Organization and analysis of the second fieldwork

We organized and analyzed the results from the second local fieldwork, intending to make use of the results at the first workshop planned to be held during the third fieldwork.

Third Fieldwork in China

(8) Execution of Additional Studies

A study was conducted for obtaining additional information necessary to grasp the current conditions on the SME financing system in China, including interviews with the Beijing SME Service Center and small enterprises and financial institutions in the study areas.

(9) Holding of First Workshop

The first workshop, which was composed of a series of discussion type meetings in the study areas, was held for the purpose of explaining the study result up to that point and exchanging participants' views on the results. The "Japanese experience" in SME financing was also reported on this occasion. At the end of 2003, the workshop was held in Beijing on December 4-5, in Dongguan/Shenzhen on December 17-21, in Wenzhou/Taizhou on December 21-24, in Xi'an on December 24-26, and in Weihai on December 24-26. It was held separately for SMEs, banks, and credit guarantee institutions in each area.

(10) Evaluation of the Current SME Financing System in China and Examination of Emphasized Issues

Based on the study result up to that time, the study team evaluated the current SME financing system in China and examined priority issues for the development of the system in the medium term.

Third Home Office Work in Japan

(11) Preparation of Interim Report

The interim report was prepared based on the study results up until the third fieldwork.

<Third Year>

Fourth Fieldwork in China

(1) Explanation and Discussion of Interim Report

The content of the submitted interim report was explained to and discussed with the Chinese side.

(2) Holding of First Seminar

In cooperation with the Chinese counterpart, the study team held the seminar prepared during the third home office work in Japan, with the objective of improving the capacity of related Chinese parties to establish policies and plans for SME finance. The content of the interim report was presented and discussed.

(3) Studying of Desirable SME Financing System

Taking into consideration the results of the first seminar, the study team examined the necessary policies, legal systems and measure implementation systems for achieving the medium and long-term objectives to resolve the emphasized issues identified in the process of this study.

(4) Preparation and Submission of Progress Report 2

Progress Report 2 presenting the progress of the study was prepared and submitted.

Fourth Home Office Work in Japan

(5) Organization and Analysis of Fourth Fieldwork Results

The study team organized and analyzed the fourth fieldwork results including comments on the results from the Chinese side. Based on this, the team started preparing improvement proposals that would be included in the final report of this study.

(6) Preparation of Second Workshop

The study team conducted the preparation and coordination work of the second workshop and prepared necessary materials.

(7) Preparation for Counterpart Training in Japan

The study team held discussions with JICA to finalize the curriculums and organization for the counterpart training, taking into consideration the needs of the counterpart. The team then made arrangements for the training.

Fifth Fieldwork in China

(8) Studying of Specific Measures for Improving the SME Financing System in the Medium to Long-term

Based on the work results to this point, the study team examined specific and practical measures for improving the SME finance system in China in the medium and long term.

(9) Holding of Second Workshop

The second workshop was held for the purpose of explaining the study result up to this point and exchanging participants' views on the results. The workshop also had the objective of improving the capacity of related Chinese parties to establish policies and plans for SME finance. The workshop was held in Wenzhou and Xi'an in September 15 and 21, 2004, respectively. As special lecturers other than experts in the study team, two Japanese experts were invited to the workshop in both cities.

Fifth Home Office Work in Japan

(10) Holding of Advisory Committee for the Study

Based on the results of the study, the study team prepared an initial draft of the final report and explained it to the advisory members on the advisory committee.

(11) Preparation and Submission of Final Report Draft

Based on the results of the advisory committee, the final report draft was prepared and submitted to the Chinese side.

(12) Preparation of Result Sharing Seminar (Second Seminar)

The study team prepared for the second seminar for sharing results and created materials for it.

Sixth Fieldwork in China

(13) Explanation and Discussion of Final Report Draft

The content was discussed after explaining the final report draft mailed to the Chinese side.

(14) Holding of Result Sharing Seminar

The study team held a seminar for explaining the content of the final report draft in Beijing to broadly inform related parties of the results of this study, gain effective penetration of the study results and promote its application.

Sixth Home Office Work in Japan

(15) Preparation of Final Report

Necessary revisions were added to the Final Report based on the comments from the Chinese side and the comments of related parties from the above seminar for sharing results, and the Final Report was prepared.

1.3.3 Outline of Skill-Transfer Seminar and Workshop

This section shows the outline of the skill-transfer seminars and a series of workshops held as part of the study in fiscal 2004.

1) Outline of First Skill-Transfer Seminar

Seminar title:	Interim Report Meeting on JICA Study on Reforming SME Finance System in China
Organizers:	JICA study team for the study on reforming SME finance system in China and People's Bank of China
Collaborator:	Small and Medium Enterprise Department of the National Development and Reform Commission
Date:	May 21, 2004
Venue:	New Century Hotel, Beijing
Participants:	51 people on the Chinese side (from the People's Bank of China, Small and Medium Enterprise Department of the National Development and Reform Commission, China Banking Regulatory Commission, financial institutions, credit guarantee institutions, enterprises, International Finance Corporation, and news agents); 12 people on the Japanese side (from the JICA Beijing Office and the study team)

2) Outline of Second Workshop

Seminar title:	Interim Report Meeting on JICA Study on Reforming SME Finance System in China
Organizers:	JICA study team for the study on reforming SME finance system in China and People's Bank of China
Dates:	September 15, 2004 (Wenzhou); September 21, 2004 (Xi'an)
Venues:	Wenzhou International Hotel; Xi'an International Conference Center
Participants:	53 people on the Chinese side (from the People's Bank of China, financial institutions, credit guarantee institutions, and enterprises); 10 people on the Japanese side (from the study team and a visiting lecturer) in the Wenzhou workshop. 48 people on the Chinese side (from the People's Bank of China, financial institutions, credit guarantee institutions, and enterprises); 10 people on the Japanese side (from the study team and a visiting lecturer) in the Xi'an workshop

3) Outline of Second Skill-Transfer Seminar

Seminar title: Final Report Meeting on JICA Study on Reforming SME Finance System in China

Organizers: JICA study team for the study on reforming SME finance system in China and People's Bank of China

Date: December 16, 2004

Venue: Huarong Hotel, Beijing

Participants: 72 people on the Chinese side (from the People's Bank of China, Small and Medium Enterprise Department of the National Development and Reform Commission, China Banking Regulatory Commission, financial institutions, credit guarantee institutions, enterprises, Asian Development Bank, and news agents); 24 people on the Japanese side (from the JICA Headquarters and Beijing Office, Embassy of Japan, Bank of Japan Representative Office in Beijing and the study team, etc.)

1.3.4 Outline of Counterpart Training in Japan

Counterpart training in Japan was provided to three officials at the People’s Bank of China from October 11 to 23, 2004. The training was conducted in accordance with this study’s aim of increasing the capacities of those involved in SME promotion by transferring knowledge and skills to policymakers in related organizations. The study team prepared the training program and provided logistical support to JICA for the implementation of the training. The list of trainees and the program are shown at the bottom of this section.

The trainees highly evaluated the overall training program upon its completion. One particular comment from them was that the program enabled them to deepen their understanding of the basic philosophy, roles, and real conditions of Credit Guarantee Corporations and government financial institutions such as the Japan Finance Corporation for Small and Medium Enterprise, through a series of discussions during the visits to these organizations.

<List of Trainees:>

1) Ms. Liu Ping, Division Chief, Research Department of the People’s Bank of China
2) Ms. Liang Bing, Associate Researcher, Research Department of the People’s Bank of China
3) Ms. Zhang Hong, the People’s Bank of China, Xi’an Branch

<Training program: >

Month	Day		Organizations visited		Route	Stay
Oct.	11	Mon	[Public holiday]		Beijing→ Narita	Tokyo
Oct.	12	Tue	JICE [Common Orientation]	JICE [Specific Orientation]; JICA Economic Development Department		Tokyo
Oct.	13	Wed		Credit Guarantee Corporation of Tokyo, Shinjuku Branch		Tokyo
Oct.	14	Thu	Taiyo Toy	Daichu Denshi, Co., Ltd.	（Hanyu, Saitama）	Tokyo
Oct.	15	Fri	Bank of Japan	Japan Finance Corporation for Small and Medium Enterprise		Tokyo
Oct.	16	Sat	[Moving day]		Tokyo→ Sapporo	Sapporo
Oct.	17	Sun	[Holiday]			Sapporo
Oct.	18	Mon	North Pacific Bank			Sapporo
Oct.	19	Tue	Hokkaido Government; Sapporo Chamber of Commerce and Industry	Hokkaido Association of Small Business Entrepreneurs; Nikkokinzoku.Co.; Machimura Farm Ltd.		Sapporo
Oct.	20	Wed	[Moving day]		Sapporo→ Tokyo	Tokyo
Oct.	21	Thu	National Life Finance Corporation			Tokyo
Oct.	22	Fri	Evaluation Meeting; Completion Ceremony			Tokyo
Oct.	23	Sat			Narita→ Beijing	

1.3.5 Special Circumstances Arising During the Process of the Study

Due to a particular circumstance, this study was forced to fall way behind schedule from a very early stage, requiring the study team to make frequent revisions and adjustments of the work plans. The reason is that the launch of full-fledged study was impossible for several months since major cities and areas in China started to be put on the list of Severe Acute Respiratory Syndrome (SARS) hot spots from March 2003 forward.

The original plan of the study indicated that the full-fledged study in China (First Fieldwork) including discussion meetings on the Inception Report between the study team and the counterpart would be launched in May 2003. However, the World Health Organization (WHO) started to put major Chinese cities and areas including Beijing on the list of SARS hot spots from March 2003 forward, virtually halting the ordinary operation of administrative bodies including the counterpart organization, the People's Bank of China. In response to the WHO's designation of SARS-affected cities and areas in China, the Japan Ministry of Foreign Affairs issued recommendation against traveling to these areas and cities. Consequently, the preparation work for the contract on the second-year study between JICA and the study team was not initiated until the letter of work instruction was issued by JICA on July 17, 2003. Thus, the second-year study started in August 2003, after a delay of three months.

Since the study team effectively had no contact with the counterpart during the waiting period until the official start of the second-year study, the team was not able to confirm the counterpart's opinions on the study plan indicated in the Inception Report, which had been prepared by the team based on the results of the first-year study and sent to the counterpart. This made it indispensable that preliminary discussions between the Japanese and Chinese parties would be held again on the overall design of the study, such as revising the schedule, reconfirming the implementing system of the Chinese side and adjusting the scope of the survey that would be conducted by a local consultant. For this reason, prior to the initiation of full-fledged studies, an additional field mission to China for coordination, composed of members from JICA and the study team, was dispatched in August 2003.

In the course of the discussions held between JICA and the PBC during the additional mission, both parties reconfirmed to determine the implementing body of a fact –finding survey on SME financing, based on the technical proposals to be submitted by willing research and consulting bodies. The survey has been an important component of this study. It has consisted of questionnaire and interview surveys to SMEs, banks, and credit guarantee institutions. A method was adopted to be based on technical proposals for determining the survey implementing body, because this survey must be conducted by a local research or consulting body with highly specialized knowledge and capability in finance, a great deal of familiarity with lending practices, a good access to financial institutions and enterprises, the cooperative relationship with the appropriate divisions responsible for financing affairs in the central and provincial governments, and the capability to analyze the credibility of financial institutions and enterprises. In view of the fact that a technical proposal-based method had been adopted only rarely in selecting local consultants as part of JICA's development studies, the entire bidding process required sufficient time for the study team to carefully design, prepare, and implement the work, as well as for JICA to approve the terms of reference of the survey and to approve the result of the bidding. With the approval by JICA, the study team signed the contract on the survey with Financial Research Institute, an independent research institute for PBC on November 18, 2003.

It can be noted that the samples for the questionnaire survey are not considered to completely represent the whole population of China from the viewpoint of selecting reference districts and sampling. The reasons are as follows:

First, the districts for the survey had been selected and agreed jointly by JICA and the PBC and later given to the study team without allowing sufficient opportunities for it to verify detailed process of and logical reasons for the selection.

Second, time constraints did not allow a preliminary or test study to be conducted during the process of carrying out the questionnaire survey, since the second-year study including the questionnaire survey came under pressure to produce the study results based on an effectively five-month period of study from November 2003 to March 2004.

Against this background, the full-fledged study in China was started in late November 2003, about 6 months behind the original schedule. Considering the situation, the study team placed great emphasis on effective and efficient implementation of the study. For that purpose, the team made appropriate adjustments, as necessary, for the setting of the areas/issues of particular focus and the directions of the recommendation in the study, by reflecting the needs and requests suggested from the Chinese side during the course of the study as much as possible.

Main Part

Current Conditions and Issues of SME Finance System in China and Recommendations

2.1 Current environment and future development of finance by SMEs in China

2.1.1 The role of our project and response from public

We, Japanese Research Group ("Japanese Side"), conducted questionnaire and hearing as explained hereafter regarding finance by SMEs in China, closely cooperating with People's Bank of China that is Chinese Counterpart ("CP"), and collected data quantitatively and qualitatively.

The objects of questionnaire and hearing are SMEs, financial institutions and credit guarantee organizations. The research areas are 5 areas, Beijing City (Zhongguancun), Zhejiang Province (Wenzhou and Taizhou), Guangdong Province (Dongguan and Shenzhen), Shaanxi Province (Xian) and Shangdong Province (Weihai) that had been fixed beforehand by JICA and CP. They regarded these 5 areas as representing typical characteristics in China.

The number of samples is 850 SMEs, 75 financial institutions (including branches) and 75 Credit Guarantee corporations. CP had fixed contents of questionnaire after considerations and amendments based on the draft idea shown by Japanese Side.

Hearing research in five areas of qualitative research. These are quite helpful for our understand on issues in each areas collecting opinions directly from SMEs, financial institutions and credit guarantee corporations supported by excellent chairmanship by Ms.Liu ping, who is project manager in CP, and by local executives of The people's Bank of China in 5 areas.

And visiting SMEs in 5areas are also quite helpful for our understanding on Chinese SMEs through hearing how they consider, business models of them and common issues in Chinese SMEs.

The result of analysis on characteristics of samples based on these questionnaires, hearing was disclosed at the Seminar conducted at Beijing on the 21st May by CP.

Research Division of The people's Bank of China disclosed a large report consists of 21 thousand Chinese letters with name of "Special Assignment Team" on daily paper "Financial News". This report includes summary and analysis on the result of research, verification of hypothesis and primitive recommendation for policy abstracted from this analysis. "Financial News " is a kind of trade paper in the area of financial institutions under The People's Bank of China. And it is said to be quite rare that whole report could is disclosed on the paper.

And the discussion program "Dialog" with title of "SMEs; from where money comes?" was shown on CCTV-2 (FOR ECONOMY, LIFE AND SERVICES) on the 27th Jun. 2004, been attended by 3 panelists including Mr.Mu (The chief of Research Department of The People's Bank of China; CP), around 100 SMEs general managers from all over China and Ms.Liu Ping. At the very beginning of the program was introducing the results of our research. This proves that our research project could not only be activity in a division of The People's Bank of China but also the activity for whole Chinese economy.

2.1.2 Regarding the report by "Special Assignment Team" on "Financial News"

(1) Contents

Contents of the report disclosed on "Financial News" on 22nd Jun. 2004 are as follows.

Background

SECTION1 Basic situation of finance for SMEs

I. Basic Situation of SMEs
   1. Current Situation of SMEs
   2. Situation of production, sales and financial control of SMEs.
   3. Relationship between SMEs and financial institutions
   4. Relationship between SMEs and credit guarantee corporations

II. Basic situation of financial institutions for finance by SMEs
   1. Basic situation of financial institutions for finance by SMEs
   2. Basic situation of credit guarantee corporations for finance by SMEs

SECTION2 Characteristics of finance shortage for SMEs under recent trend

SECTION3 Points to be noted in the area of finance by SMEs under current situation

I. Faults in collective ownership on land could be big disadvantage for finance by SMEs

II. Risk of credit guarantee corporations could be too big to be ignored.
   1. Disadvantages are found in whole credit guarantee corporations caused by institutional problem
   2. Risk of guarantee has been accumulated according to development of credit guarantee corporations, and increasing with same trend as subrogation ratio and guaranteed liabilities.
   3. No such mechanism as reguarantee to compensate increased risk
   4. Problem of human resources in officers of credit guarantee corporations

III. Things to be considered regarding finance procedures in financial institutions
   1. No effective protection of lender's right
   2. Mechanism of business promotion and personnel administration should be improved
   3. Because of excess concentration of verification right in high level of financial institutions, any lending transactions to SMEs could not be found in マ リlevel.
   4. Financial support by small and medium financial institutions to SMEs is not satisfactory.
   5. Finance cost of SMEs is always higher than interest for borrowing from banks.

SECTION4 Analysis on Characteristics of finance shortage for SMEs in our country.

I. Institutional faults in indirect finance and decreasing efficiency because of the faults

II. Institutional faults in direct finance and decreasing efficiency because of the faults
III. System of capital market is not multi-layered
IV. It is difficult for private fund to step in to banks

SECTION5 Comparison with financial policies to support SMEs in developed countries

I. Fully equipped law system
II. Special division or financial organization of finance only to SMEs in government
III. System of credit guarantee for finance to SMEs
IV. Investment to venture capitals
V. Multi-layered capital market

SECTION6 Official policy design to support development of SMEs and related arrangement

I. To enforce protection of lender's right is fundamental to solve finance shortage for SMEs
II. To construct multi-layered system of laws and policies to support development of SMEs
III. To construct multi-layered finance system in banks
IV. To construct multi-layered capital markets
V. To prepare multi-layered investment companies specially for SMEs
VI. To increase capital of credit guarantee corporation and to construct multi-layered risk compensation mechanism.

SECTION7 Related arrangement to support development of SMEs

I. To construct system of credit information of SMEs
II. The central bank have to enforce macro-control on to financial services for SMEs
III. A new kind of mechanism of incentive and check

(2) Policy recommendation by "Special Assignment Team"

Contents of SECTION6 and SECTION7 on the report above are primitive policy recommendation based on analysis on current situation in China and comparison of system with that of other countries. In this recommendation, we can find "result of technology transfer and exchange of experience and knowledge" supported by many kind of materials disclosed by Japanese Side, discussions between Japanese Side and CP and collaborations in research activities. In this sense, half of original purposes of this research project have been accomplished at this time.

Explanations on Japanese policies are almost correct. But some explanations, for example, on financial support policies by CRA in U.S.A. could not completely be agreed.

2.1.3 Research by questionnaire

(1) Recommendation for CP regarding questionnaire research

Our questionnaire research was highly appreciated in China. It could be considered for our technical assistance to have succeeded. Because procedure and analysis technology were especially highly appreciated, as were not ever adopted in China.

But one may not consider the research and analysis to have completed without anything to be further done. As pointed before, our research contains a number of points to be refined for the estimation of lead-time to conduct sampling in broad areas, etc. It is not enough to have only procedure and analysis technology. I expect further efforts to be continued by those concerned.

Reliability of statistical research needs a logical proof that samples represent the mother group. One cannot exclude a possibility that sampling might have been distorted by policy concerns or neglect of certain groups of strata. I really hope such possibility has little to do with our study. Statistics should properly reflect mother groups so that their reliability could be accepted by anyone in and out the country, thereby enhancing their credibility.

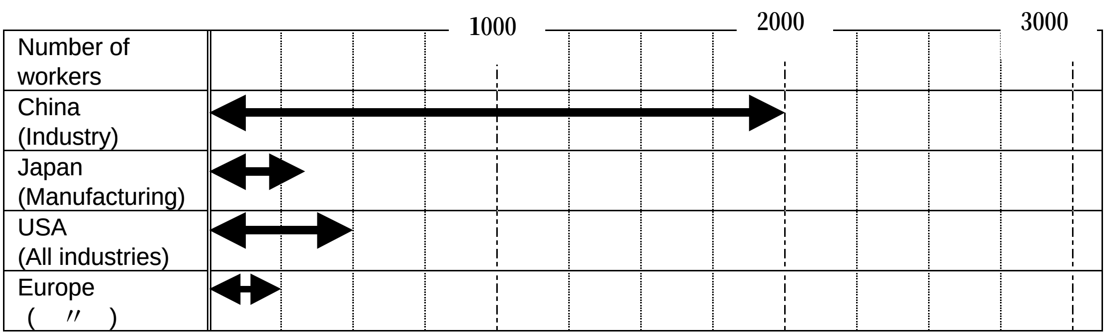
Reliability is required for any statistics from the viewpoint of not only the policy credibility itself but the reliability of the statistics that are used as a basis for making such policies. This matter holds true regardless of governance.

In order to encourage as many stakeholders as possible to participate in policy-making process and express opinions, the government is expected to release the information, to a largest extent possible, on the process of research so as to ensure a greater reliability. The reliability of statistics is also required for the government to clearly explain policy directions for the nation and the market.

(2) Comparison of criteria of SMEs on policies and mother group of research

Criteria of SME defined by Department of Small and Medium–sized Enterprises of National Development and Reform Commission shows object of policies supporting SMEs. I try policy comparison by comparing criteria of Japan and other countries.

It is only China and Japan that financial standard is adopted in criteria among China, Japan, U.S.A. and Europe. China adopts Sales and Total Asset and Japan adopts only Capital for criteria. Figure below shows comparison by number of workers, which is common standard, adopted in the four countries and region. (Please refer to Table 2.1.1-2.1.5)



It is clear at a glance, criteria of China covers much broader area than those of other 3 countries and region. Each countries and region have their own histories and backgrounds and have different policy targets. We cannot distinguish whether a criteria is reasonable or not without assessment of policy target or object to be supported. But criteria are important factor to explain specific policy target.

And even in a country, criteria could be different among tax authority, trade authority and monetary authority, as policy target could be different. But as far as criteria is constructed based on reliable statistics which could be easily understood by anybody, people should understand difference of policy targets among governmental authorities and degree of support. They should not be confused.

According to result of questionnaire research, average number of workers among 850 sample SMEs is 300. This means that samples are smaller SMEs in the criteria. Then I wonder if samples correctly represent mother group of SMEs defined by criteria. Otherwise could samples be correct set of actual SMEs? And does difference between a set of samples and criteria mean difference between policy object and actual SMEs?

In order to solve this kind of questions, and not to waste questionnaires collected, I strongly request both The People’s Bank of China and National Development and Reform Commission to conduct jointly further analysis. The first thing to be done could be plotting samples and criteria of SMEs in the space with 3 dimensions number of workers, sales and total asset.

Policy target can be understood only after disclosure of specific difference between target and current situation. If The People’s Bank of China and National Development and Reform Commission would like to newly establish policy-related financial institution specialized for SMEs, criteria of object and policy target should have to be established first based on these fundamental preparations.

Table 2.1.20 shows criteria adopted by Japanese governmental financial institutions specialized for SMEs for reference. Regional governments (Prefectures) also prepare many kinds of finance policies to support SMEs and they disclose criteria of object to be supported.

Any such policies above requires guarantee by credit guarantee corporation and such loan shall be executed at private commercial bank. It is important that governmental institution, credit guarantee corporation and commercial bank compensates functions each other. And governmental institution, credit guarantee corporation and commercial bank prepare booklets introducing these institutional loan systems in order for any SME to be able to obtain information.

(3) Successiveness and consistency of statistics

Successiveness and consistency of statistics are also important to maintain reliability. Reason why they are required is as follows.

We are often embarrassed to find amendment of statistics of previous year or sometimes all the figures before previous year without any explanations when checking macro statistics or financial report in China.

Economic system of the country and detail of business of a company are always changing. Sometimes they are completely changed because of institutional factor. We cannot avoid it. For example, it is quite difficult to compare latest financial result of a company with financial result of the previous year after institutional change in tax or accounting or after restructuring of business. As recently accountability of company is strongly required, financial figures of the previous year recalculated by latest accounting standard is usually disclosed. But this kind of recalculated figures is not official but just for reference. Only financial result based on accounting regulations as of standard date is official financial result.

Amending all the past figures based on latest regulations is result of sticking to successiveness. But such consistency could be missed that authorized financial result means at anytime actual state of a company as of standard date measured by regulations as of standard date.

Then how could we maintain successiveness and consistency? The only way should be disclosure of detail of contents of each figures considering practical requirement.

For example, various governmental or private organizations calculate “aggregated amount of loan for SMEs by all the financial institutions in Japan”. But these figures are not always same. This does not mean any of such figures are not correct.

Most reliable statistics on all the financial institutions in Japan are made by The Bank of Japan which is disclosed monthly to the public in “Financial and Economic Statistics Monthly”(「金融経済統計月報」). You cannot find any material which show “aggregated amount of loan for SMEs by all the financial institutions in Japan” itself. Required figures are practically spread in various materials “aggregated loan amount by XXX governmental financial institution”, “aggregated loan amount by YYY bank,” etc. Organizations or economists pick up required figures from such materials and aggregate.

Such too unreasonable way must be out of question, as loan by all the governmental financial institutions should be excluded. Detail of standard for aggregation could be different by policy of an organization or purpose of aggregation. That is the reason why reason and standard of aggregation or reference have to be disclose as detailed as possible.

SMEs in China could not be treated only with consideration of internal matters. Many SMEs in Japan have established local subsidiaries in China. Subsidiaries of large companies in Japan might be SMEs. And SMEs in China draw attention from overseas. APEC sub conference for SMEs was taken place in Qindao. Magazines on economic in Japan are full of such articles as how to find out excellent SMEs in China as a partner. The People’s Bank of China and National Development and Reform Commission are desired to construct jointly firm fundamentals for policy..

Figure 2.1.1-2.1.2, Table 2.1.6-19 show historical statistics on loan for SMEs in Japan after 1958. We would really like China to complete these kinds of statistics very soon.

《Explanatory Notes for Figures》

1. Comparison of criteria of SMEs among China, Europe, U.S.A. and Japan (Table 2.1.1-5)
As shown in the reference for each Figure, the annual reports of related authorities are referred to except for China.
Criteria by amounts are converted from RMB to Japanese YEN for easy comparison with that of Japan.

2. Historical loan outstanding for SMEs by types of financial institution in Japan (Figure2.1.1, Table 2.1.6-19)

Materials below are referred to for "Domestic Banks."

- 「Kinyu(金融)」 (Japanese Bankers Association 1958-1997)
- 「Kokumin Seikatsu Kinyu Koko Chosa Kiho (国民生活金融公庫調査季報)」(National Life Finance Corporation 1998-2003)

Definition of types of financial institutions

- Governmental Financial Organization Specialized for SMEs: Japan Finance Corporation for SMEs, Shokochukin Bank, National Life Finance Corporation
- Private Banks Specialized for SMEs: shinkin banks, credit cooperatives, mutual banks (until 1988)
- Domestic Banks: city banks, district banks, second district banks (from 1989 on), trust banks, long term credit banks

3. Historical movement of aggregated amount of loan outstanding for SMEs and guarantee obligation outstanding in credit guarantee corporations in Japan (Figure 2.1.2)

Materials below are referred to for guarantee obligation outstanding

- 「Chusho Kigyo Shinyo Hoken Koko 30 nenshi (中小企業信用保険公庫三十年史)」(February 1989)
- "Financial and Economic Statistics Monthly" (Bank of Japan)

4. Criteria of customer for governmental financial organizations specialized for SMEs in Japan (Table 2.1.20)

Websites below are referred to.

- http://www.jfs.go.jp/
- http://www.shokochukin.go.jp/
- http://www.kokukin.go.jp/

<Definition of SMEs: comparison among China, Europe, USA and Japan>

Table 2.1.1 China JPY M (1RMB=13JPY)

Sector	Classification	Number of workers		Sales		Total asset
Industry	SM	No more than 2,000	or	No more than 3,900	or	No more than 5,200
	M	No less than 300	and	No less than 390	and	No less than 520
	S	Less than 300	or	Less than 390	or	Less than 520
Construction	SM	No more than 3,000	or	No more than 3,900	or	No more than 5,200
	M	No less than 600	and	No less than 390	and	No less than 520
	S	Less than 600	or	Less than 390	or	Less than 520
Retail	SM	No more than 500	or	No more than 1,950	—	—
	M	No less than 100人	and	No less than 130	—	—
	S	Less than 100	or	Less than 130	—	—
Wholesale	SM	No more than 200	or	No more than 3,900	—	—
	M	No less than 100	and	No less than 390	—	—
	S	Less than 100	or	Less than 390	—	—
Traffic and Transport	SM	No more than 3,000	or	No more than 3,900	—	—
	M	No less than 500	and	No less than 390	—	—
	S	Less than 500	or	Less than 390	—	—
PostalBusiness	SM	No more than 1,000	or	No more than 3,900	—	—
	M	No less than 400	and	No less than 390	—	—
	S	Less than 400	or	Less than 390	—	—
Hotel and Restaurant	SM	No more than 800	or	No more than 1,950	—	—
	M	No less than 400	and	No less than 130	—	—
	S	Less than 400	or	Less than 130	—	—

Table 2.1.2 Japan (1999- current) JPY M

	Number of workers		Capital
Manufacturing	No more than 300	or	No more than 300
Wholesale	No more than 100	or	No more than 100
Retail	No more than 50	or	No more than 50
Service	No more than 100	or	No more than 50

Table 2.1.3 USA

All Sectors	Less than 500 workers

Table 2.1.4 Europe

All Sectors	Less than 250 workers

Table 2.1.5 Japan (-1998) JPY M

	Number of workers		Capital
Wholesale	No more than 300	or	No more than 100
Retail	No more than 100	or	No more than 30
Service	No more than 50	or	No more than 10

Figure 2.1.1 Historical loan outstanding for SMEs by type of financial institution in Japan

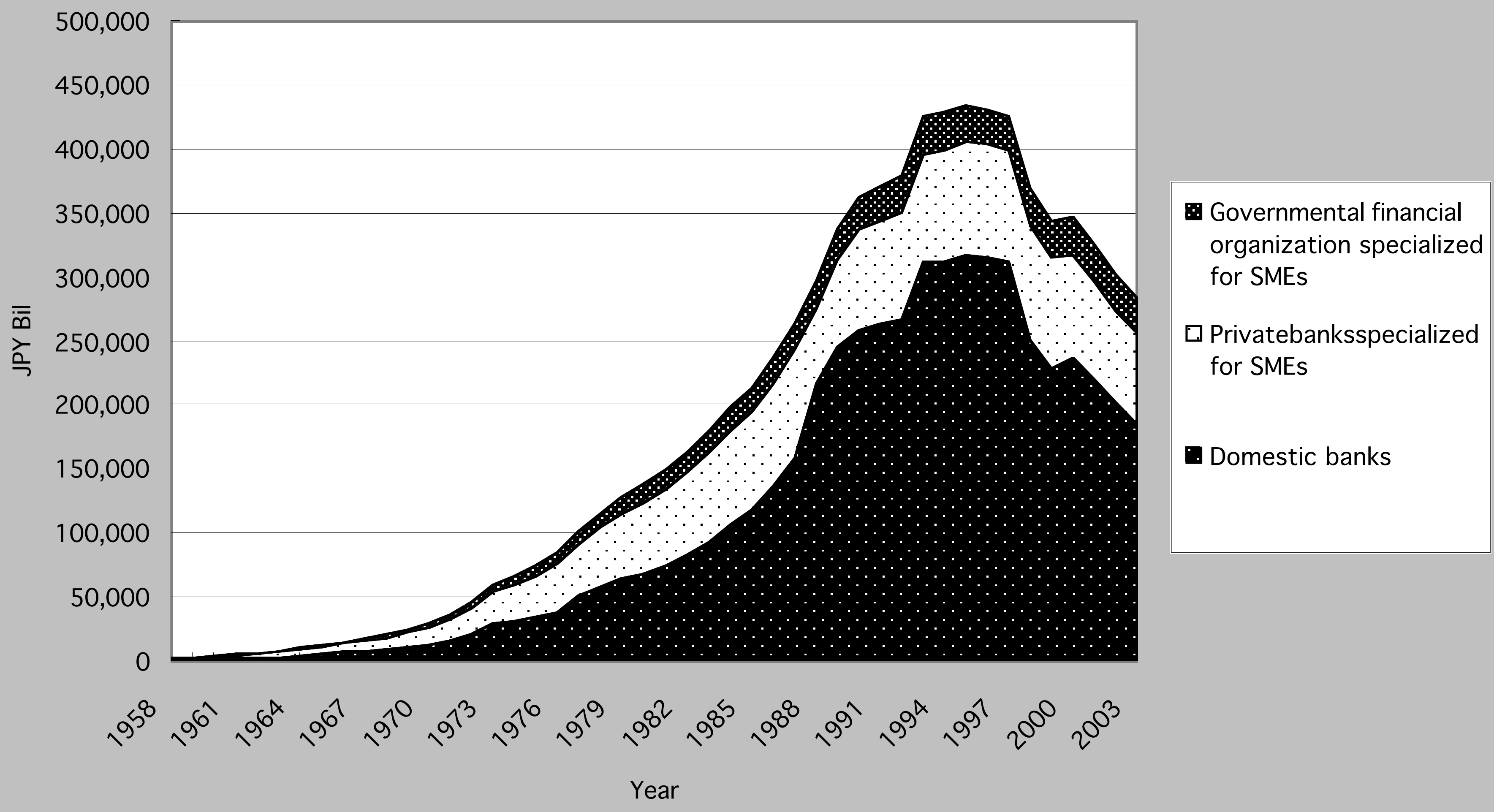


Figure 2.1.2 Historical movement of aggregated amount of loan outstanding for SMEs and guarantee obligation outstanding in Credit Guarantee Corporations in Japan

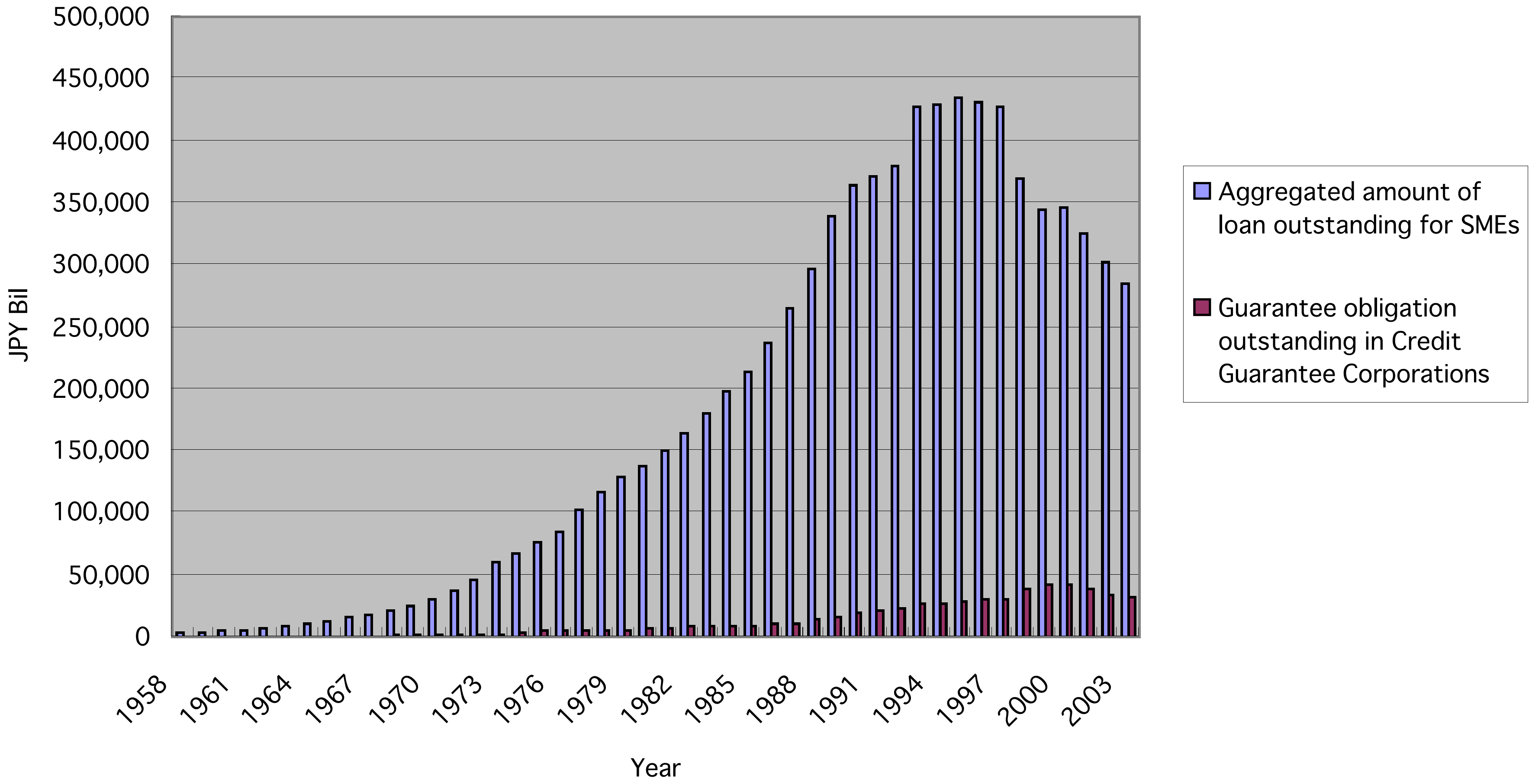


Table 2.1.6 Historical loan outstanding for SMEs by type of financial institution in Japan (1) (JPY Bil)

Fiscal Year	1958	1959	1960	1961	1962	1963	1964
City bank	918	1,099	1,236	1,408	1,512	1,712	2,300
Regional bank	871	1,036	1,237	1,491	1,738	2,093	2,633
2nd regional bank	0	0	0	0	0	0	0
Trust bank	67	80	96	120	99	125	201
Others	26	40	57	74	78	96	205
Domestic banks	1,882	2,255	2,626	3,093	3,427	4,026	5,339
Mutual bank	613	743	932	1,211	1,681	2,030	2,268
Shinkin bank	421	527	689	934	1,319	1,717	2,007
Credit Cooperative	88	117	160	224	314	419	525
Private banks specialized for SMEs	1,122	1,387	1,781	2,369	3,314	4,166	4,800
Shokochukin	106	142	180	225	271	331	415
JFCSME	106	129	148	177	213	248	300
NLFC	94	110	125	148	161	183	222
Governmental financial Organization Specialized for SMEs	306	381	453	550	645	762	937
Aggregated amount of loan outstanding for SMEs	3,310	4,023	4,860	6,012	7,386	8,954	11,076
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	77	94	124	172	235	296	398

Table 2.1.7 Historical loan outstanding for SMEs by type of financial institution in Japan (2) (JPY Bil)

Fiscal Year	1965	1966	1967	1968	1969	1970	1971
City bank	2,616	3,245	3,566	4,141	4,952	5,699	7,426
Regional bank	2,973	3,635	4,291	4,953	5,644	6,559	7,730
2nd regional bank	0	0	0	0	0	0	0
Trust bank	220	283	361	431	531	697	906
Others	250	371	482	562	678	787	857
Domestic banks	6,059	7,534	8,700	10,087	11,805	13,742	16,919
Mutual bank	2,681	3,141	3,645	3,686	4,436	5,276	6,425
Shinkin bank	2,402	2,932	3,531	4,163	5,281	6,647	7,574
Credit Cooperative	653	806	1,004	1,212	1,484	1,731	1,977
Private banks specialized for SMEs	5,736	6,879	8,180	9,061	11,201	13,654	15,976
Shokochukin	503	605	719	851	1,010	1,209	1,557
JFCSME	365	437	530	636	775	926	1,148
NLFC	275	341	400	488	590	707	887
Governmental financial Organization Specialized for SMEs	1,143	1,383	1,649	1,975	2,375	2,842	3,592
Aggregated amount of loan outstanding for SMEs	12,938	15,796	18,529	21,123	25,381	30,238	36,487
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	492	626	823	966	1,054	1,314	1,781

Table 2.1.8 Historical loan outstanding for SMEs by type of financial institution in Japan (3) (JPY Bil)

Fiscal Year	1972	1973	1974	1975	1976	1977	1978
City bank	10,098	14,368	15,202	16,550	18,199	25,046	28,857
Regional bank	9,850	13,202	14,386	16,075	18,181	22,344	25,475
2nd regional bank	0	0	0	0	0	0	0
Trust bank	906	1,760	1,977	2,247	2,532	4,260	4,989
Others	1,026	0	0	0	0	0	0
Domestic banks	21,880	29,330	31,565	34,872	38,912	51,650	59,321
Mutual bank	8,229	9,750	11,118	12,820	14,373	16,102	18,257
Shinkin bank	9,522	12,185	13,474	15,825	18,186	19,460	21,653
Credit Cooperative	2,294	3,099	3,521	4,162	4,767	5,124	5,621
Private banks specialized for SMEs	20,045	25,034	28,113	32,807	37,326	40,686	45,531
Shokochukin	1,890	2,342	2,939	3,470	3,992	4,503	4,784
JFCSME	1,280	1,684	2,077	2,428	2,806	3,121	3,267
NLFC	1,053	1,379	1,747	2,015	2,293	2,676	2,987
Governmental financial Organization Specialized for SMEs	4,223	5,405	6,763	7,913	9,091	10,300	11,038
Aggregated amount of loan outstanding for SMEs	46,148	59,769	66,441	75,592	85,329	102,636	115,890
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	1,920	2,378	3,507	4,435	5,088	5,553	5,777

Table 2.1.9 Historical loan outstanding for SMEs by type of financial institution in Japan (4) (JPY Bil)

Fiscal Year	1979	1980	1981	1982	1983	1984	1985
City bank	31,206	33,134	36,615	40,683	46,511	53,669	61,625
Regional bank	27,781	29,833	32,676	35,680	39,361	44,786	47,390
2nd regional bank	0	0	0	0	0	0	0
Trust bank	5,919	6,366	6,513	6,949	7,499	8,363	9,630
Others	0	0	0	0	0	0	0
Domestic banks	64,906	69,333	75,804	83,312	93,371	106,818	118,645
Mutual bank	20,021	21,659	24,033	26,224	28,347	29,201	30,614
Shinkin bank	24,564	26,417	28,330	30,563	32,871	35,136	36,573
Credit Cooperative	6,434	7,011	7,519	8,166	8,769	9,229	9,745
Private banks specialized for SMEs	51,019	55,087	59,882	64,953	69,987	73,566	76,932
Shokochukin	5,002	5,439	5,884	6,370	6,979	7,744	8,285
JFCSME	3,860	4,409	4,971	5,233	5,242	5,205	5,249
NLFC	3,461	4,035	4,413	4,662	4,775	4,907	5,034
Governmental financial Organization Specialized for SMEs	12,323	13,883	15,268	16,265	16,996	17,856	18,568
Aggregated amount of loan outstanding for SMEs	128,248	138,303	150,954	164,530	180,354	198,240	214,145
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	6,153	7,129	7,636	7,967	8,219	8,651	9,266

Table 2.1.10 Historical loan outstanding for SMEs by type of financial institution in Japan (5) (JPY Bil)

Fiscal Year	1986	1987	1988	1989	1990	1991	1992
City bank	75,313	88,849	102,733	119,889	126,553	126,433	128,223
Regional bank	51,136	56,928	64,508	74,003	77,288	79,856	82,142
2nd regional bank	0	0	36,488	36,302	37,911	39,409	39,670
Trust bank	11,013	12,621	13,635	16,015	18,129	18,430	17,943
Others	0	0	0	0	0	0	0
Domestic banks	137,462	158,398	217,364	246,209	259,881	264,128	267,978
Mutual bank	31,836	33,271	0	0	0	0	0
Shinkin bank	38,423	41,774	46,636	53,801	60,258	62,489	64,712
Credit Cooperative	10,185	11,138	12,505	15,162	17,979	18,060	18,322
Private banks specialized for SMEs	80,444	86,183	59,141	68,963	78,237	80,549	83,034
Shokochukin	8,849	9,322	9,730	10,285	11,019	11,348	11,591
JFCSME	5,081	5,086	5,533	6,625	7,354	7,849	8,440
NLFC	5,141	5,288	5,656	6,307	6,997	7,523	8,092
Governmental financial Organization Specialized for SMEs	19,071	19,696	20,919	23,217	25,370	26,720	28,123
Aggregated amount of loan outstanding for SMEs	236,977	264,277	297,424	338,389	363,488	371,397	379,135
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	9,936	10,774	13,381	15,988	18,595	21,217	23,345

Table 2.1.11 Historical loan outstanding for SMEs by type of financial institution in Japan (6) (JPY Bil)

Fiscal Year	1993	1994	1995	1996	1997	1998	1999
City bank	155,549	154,037	155,513	155,548	153,619		
Regional bank	95,562	97,476	101,172	101,628	101,694		
2nd regional bank	44,955	46,013	46,797	46,598	45,877		
Trust bank	16,641	15,170	14,497	12,946	11,126		
Others	0	0	0	0	0		
Domestic banks	312,707	312,696	317,979	316,720	312,316	251,454	229,854
Mutual bank	0	0	0	0	0		
Shinkin bank	65,600	67,916	69,898	70,201	70,408	72,845	71,071
Credit Cooperative	18,615	19,058	18,665	17,272	16,822	16,146	14,573
Private banks specialized for SMEs	84,215	86,974	88,563	87,473	87,230	88,991	85,644
Shokochukin	11,700	11,743	11,619	11,370	11,317	11,544	11,336
JFCSME	9,236	8,893	7,789	7,249	7,216	7,361	7,551
NLFC	8,901	9,230	9,020	8,906	9,158	10,158	10,285
Governmental financial Organization Specialized for SME's	29,837	29,866	28,428	27,525	27,691	29,063	29,172
Aggregated amount of loan outstanding for SMEs	426,759	429,536	434,970	431,718	427,237	369,508	344,670
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	25,782	27,356	28,524	29,256	29,370	39,539	43,177

Table 2.1.12 Historical loan outstanding for SMEs by type of financial institution in Japan (7) (JPY Bil)

Fiscal Year	2000	2001	2002	2003
City bank				
Regional bank				
2nd regional bank				
Trust bank				
Others				
Domestic banks	236,648	219,928	201,940	185,628
Mutual bank				
Shinkin bank	68,012	65,529	63,809	63,301
Credit Cooperative	13,811	12,378	9,308	9,238
Private banks specialized for SMEs	81,823	77,907	73,117	72,539
Shokochukin	10,920	10,605	10,269	9,987
JFCSME	7,595	7,560	7,556	7,618
NLFC	10,137	9,960	9,560	9,283
Governmental financial Organization Specialized for SME's	28,652	28,125	27,385	26,888
Aggregated amount of loan outstanding for SMEs	347,123	325,960	302,442	285,055
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	41,767	38,224	33,967	31,484

Table 2.1.13 Historical composition of loan outstanding for SMEs by type of financial institution in Japan (1)

Fiscal Year	1958	1959	1960	1961	1962	1963	1964
City bank	27.7%	27.3%	25.4%	23.4%	20.5%	19.1%	20.8%
Regional bank	26.3%	25.8%	25.5%	24.8%	23.5%	23.4%	23.8%
2nd regional bank	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Trust bank	2.0%	2.0%	2.0%	2.0%	1.3%	1.4%	1.8%
Others	0.8%	1.0%	1.2%	1.2%	1.1%	1.1%	1.9%
Domestic banks	56.9%	56.1%	54.0%	51.4%	46.4%	45.0%	48.2%
Mutual bank	18.5%	18.5%	19.2%	20.1%	22.8%	22.7%	20.5%
Shinkin bank	12.7%	13.1%	14.2%	15.5%	17.9%	19.2%	18.1%
Credit Cooperative	2.7%	2.9%	3.3%	3.7%	4.3%	4.7%	4.7%
Private banks specialized for SMEs	33.9%	34.5%	36.6%	39.4%	44.9%	46.5%	43.3%
Shokochukin	3.2%	3.5%	3.7%	3.7%	3.7%	3.7%	3.7%
JFCSME	3.2%	3.2%	3.0%	2.9%	2.9%	2.8%	2.7%
NLFC	2.8%	2.7%	2.6%	2.5%	2.2%	2.0%	2.0%
Governmental financial Organization Specialized for SMEs	9.2%	9.5%	9.3%	9.1%	8.7%	8.5%	8.5%
Aggregated amount of loan outstanding for SMEs	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	2.3%	2.3%	2.6%	2.9%	3.2%	3.3%	3.6%

Table 2.1.14 Historical composition of loan outstanding for SMEs by type of financial institution in Japan (2)

Fiscal Year	1965	1966	1967	1968	1969	1970	1971
City bank	20.2%	20.5%	19.2%	19.6%	19.5%	18.8%	20.4%
Regional bank	23.0%	23.0%	23.2%	23.4%	22.2%	21.7%	21.2%
2nd regional bank	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Trust bank	1.7%	1.8%	1.9%	2.0%	2.1%	2.3%	2.5%
Others	1.9%	2.3%	2.6%	2.7%	2.7%	2.6%	2.3%
Domestic banks	46.8%	47.7%	47.0%	47.8%	46.5%	45.4%	46.4%
Mutual bank	20.7%	19.9%	19.7%	17.5%	17.5%	17.4%	17.6%
Shinkin bank	18.6%	18.6%	19.1%	19.7%	20.8%	22.0%	20.8%
Credit Cooperative	5.0%	5.1%	5.4%	5.7%	5.8%	5.7%	5.4%
Private banks specialized for SMEs	44.3%	43.5%	44.1%	42.9%	44.1%	45.2%	43.8%
Shokochukin	3.9%	3.8%	3.9%	4.0%	4.0%	4.0%	4.3%
JFCSME	2.8%	2.8%	2.9%	3.0%	3.1%	3.1%	3.1%
NLFC	2.1%	2.2%	2.2%	2.3%	2.3%	2.3%	2.4%
Governmental financial Organization Specialized for SMEs	8.8%	8.8%	8.9%	9.3%	9.4%	9.4%	9.8%
Aggregated amount of loan outstanding for SMEs	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	3.8%	4.0%	4.4%	4.6%	4.2%	4.3%	4.9%

Table 2.1.15 Historical composition of loan outstanding for SMEs by type of financial institution in Japan (3)

Fiscal Year	1972	1973	1974	1975	1976	1977	1978
City bank	21.9%	24.0%	22.9%	21.9%	21.3%	24.4%	24.9%
Regional bank	21.3%	22.1%	21.7%	21.3%	21.3%	21.8%	22.0%
2nd regional bank	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Trust bank	2.0%	2.9%	3.0%	3.0%	3.0%	4.2%	4.3%
Others	2.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Domestic banks	47.4%	49.1%	47.5%	46.1%	45.6%	50.3%	51.2%
Mutual bank	17.8%	16.3%	16.7%	17.0%	16.8%	15.7%	15.8%
Shinkin bank	20.6%	20.4%	20.3%	20.9%	21.3%	19.0%	18.7%
Credit Cooperative	5.0%	5.2%	5.3%	5.5%	5.6%	5.0%	4.9%
Private banks specialized for SMEs	43.4%	41.9%	42.3%	43.4%	43.7%	39.6%	39.3%
Shokochukin	4.1%	3.9%	4.4%	4.6%	4.7%	4.4%	4.1%
JFCSME	2.8%	2.8%	3.1%	3.2%	3.3%	3.0%	2.8%
NLFC	2.3%	2.3%	2.6%	2.7%	2.7%	2.6%	2.6%
Governmental financial Organization Specialized for SMEs	9.2%	9.0%	10.2%	10.5%	10.7%	10.0%	9.5%
Aggregated amount of loan outstanding for SMEs	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	4.2%	4.0%	5.3%	5.9%	6.0%	5.4%	5.0%

Table 2.1.16 Historical composition of loan outstanding for SMEs by type of financial institution in Japan (4)

Fiscal Year	1979	1980	1981	1982	1983	1984	1985
City bank	24.3%	24.0%	24.3%	24.7%	25.8%	27.1%	28.8%
Regional bank	21.7%	21.6%	21.6%	21.7%	21.8%	22.6%	22.1%
2nd regional bank	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Trust bank	4.6%	4.6%	4.3%	4.2%	4.2%	4.2%	4.5%
Others	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Domestic banks	50.6%	50.1%	50.2%	50.6%	51.8%	53.9%	55.4%
Mutual bank	15.6%	15.7%	15.9%	15.9%	15.7%	14.7%	14.3%
Shinkin bank	19.2%	19.1%	18.8%	18.6%	18.2%	17.7%	17.1%
Credit Cooperative	5.0%	5.1%	5.0%	5.0%	4.9%	4.7%	4.6%
Private banks specialized for SMEs	39.8%	39.8%	39.7%	39.5%	38.8%	37.1%	35.9%
Shokochukin	3.9%	3.9%	3.9%	3.9%	3.9%	3.9%	3.9%
JFCSME	3.0%	3.2%	3.3%	3.2%	2.9%	2.6%	2.5%
NLFC	2.7%	2.9%	2.9%	2.8%	2.6%	2.5%	2.4%
Governmental financial Organization Specialized for SMEs	9.6%	10.0%	10.1%	9.9%	9.4%	9.0%	8.7%
Aggregated amount of loan outstanding for SMEs	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	4.8%	5.2%	5.1%	4.8%	4.6%	4.4%	4.3%

Table 2.1.17 Historical composition of loan outstanding for SMEs by type of financial institution in Japan (5)

Fiscal Year	1986	1987	1988	1989	1990	1991	1992
City bank	31.8%	33.6%	34.5%	35.4%	34.8%	34.0%	33.8%
Regional bank	21.6%	21.5%	21.7%	21.9%	21.3%	21.5%	21.7%
2nd regional bank	0.0%	0.0%	12.3%	10.7%	10.4%	10.6%	10.5%
Trust bank	4.6%	4.8%	4.6%	4.7%	5.0%	5.0%	4.7%
Others	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Domestic banks	58.0%	59.9%	73.1%	72.8%	71.5%	71.1%	70.7%
Mutual bank	13.4%	12.6%	0.0%	0.0%	0.0%	0.0%	0.0%
Shinkin bank	16.2%	15.8%	15.7%	15.9%	16.6%	16.8%	17.1%
Credit Cooperative	4.3%	4.2%	4.2%	4.5%	4.9%	4.9%	4.8%
Private banks specialized for SMEs	33.9%	32.6%	19.9%	20.4%	21.5%	21.7%	21.9%
Shokochukin	3.7%	3.5%	3.3%	3.0%	3.0%	3.1%	3.1%
JFCSME	2.1%	1.9%	1.9%	2.0%	2.0%	2.1%	2.2%
NLFC	2.2%	2.0%	1.9%	1.9%	1.9%	2.0%	2.1%
Governmental financial Organization Specialized for SMEs	8.0%	7.5%	7.0%	6.9%	7.0%	7.2%	7.4%
Aggregated amount of loan outstanding for SMEs	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	4.2%	4.1%	4.5%	4.7%	5.1%	5.7%	6.2%

Table 2.1.18 Historical composition of loan outstanding for SMEs by type of financial institution in Japan (6)

Fiscal Year	1993	1994	1995	1996	1997	1998	1999
City bank	36.4%	35.9%	35.8%	36.0%	36.0%	0.0%	0.0%
Regional bank	22.4%	22.7%	23.3%	23.5%	23.8%	0.0%	0.0%
2nd regional bank	10.5%	10.7%	10.8%	10.8%	10.7%	0.0%	0.0%
Trust bank	3.9%	3.5%	3.3%	3.0%	2.6%	0.0%	0.0%
Others	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Domestic banks	73.3%	72.8%	73.1%	73.4%	73.1%	68.1%	66.7%
Mutual bank	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Shinkin bank	15.4%	15.8%	16.1%	16.3%	16.5%	19.7%	20.6%
Credit Cooperative	4.4%	4.4%	4.3%	4.0%	3.9%	4.4%	4.2%
Private banks specialized for SMEs	19.7%	20.2%	20.4%	20.3%	20.4%	24.1%	24.8%
Shokochukin	2.7%	2.7%	2.7%	2.6%	2.6%	3.1%	3.3%
JFCSME	2.2%	2.1%	1.8%	1.7%	1.7%	2.0%	2.2%
NLFC	2.1%	2.1%	2.1%	2.1%	2.1%	2.7%	3.0%
Governmental financial Organization Specialized for SMEs	7.0%	7.0%	6.5%	6.4%	6.5%	7.9%	8.5%
Aggregated amount of loan outstanding for SMEs	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	6.0%	6.4%	6.6%	6.8%	6.9%	10.7%	12.5%

Table 2.1.19 Historical composition of loan outstanding for SMEs by type of financial institution in Japan (7)

Fiscal Year	2000	2001	2002	2003
City bank	0.0%	0.0%	0.0%	0.0%
Regional bank	0.0%	0.0%	0.0%	0.0%
2nd regional bank	0.0%	0.0%	0.0%	0.0%
Trust bank	0.0%	0.0%	0.0%	0.0%
Others	0.0%	0.0%	0.0%	0.0%
Domestic banks	68.2%	67.5%	66.8%	65.1%
Mutual bank	0.0%	0.0%	0.0%	0.0%
Shinkin bank	19.6%	20.1%	21.1%	22.2%
Credit Cooperative	4.0%	3.8%	3.1%	3.2%
Private banks specialized for SMEs	23.6%	23.9%	24.2%	25.4%
Shokochukin	3.1%	3.3%	3.4%	3.5%
JFCSME	2.2%	2.3%	2.5%	2.7%
NLFC	2.9%	3.1%	3.2%	3.3%
Governmental financial Organization Specialized for SMEs	8.3%	8.6%	9.1%	9.4%
Aggregated amount of loan outstanding for SMEs	100.0%	100.0%	100.0%	100.0%
Guarantee obligation outstanding in Credit Guarantee Corporations in Japan	12.0%	11.7%	11.2%	11.0%

Table 2.1.20

《Japan Finance Corporation for SMEs》

Criteria of scale to be financed by industrial sector

- Manufacturing, Construction, Transport, etc.; Capital of no more than JPY300M or workers of no more than 300.
- Wholesale: Capital of no more than JPY100M or workers of no more than 100.
- Retail: Capital of no more than JPY50M or workers of no more than 50.
- Service: Capital of no more than JPY50M or workers of no more than 100.

Sectors below are not included in criteria

Agriculture, forestry, fishery, finance, insurance, lease of residence and land for residence, medical and welfare, NPO, services against public policy, speculation

Characteristics of finance

- Super long term (longest 20 years)
- Fixed interest

《Shokochukin Bank》

The Shokochukin Bank lends principally to its member cooperatives – affiliated organizations of SMEs subscribing its capital – and to their member companies. The Bank also takes inquiries from joint investment companies and affiliated organizations established mainly by SMEs and SMEs' overseas subsidiaries.

Forms of loan transactions

- Funds for member cooperatives (for joint undertakings): The Bank provides funds necessary for joint undertakings by member cooperatives, such as joint production, joint processing, and joint sales operations. The Bank also responds positively to applications for loans required for organizational upgrade programs.
- Funds for member cooperatives (for loans through cooperatives): The Bank provides loans through member cooperatives to supply funds necessary for members' business operations.
- Funds for member companies: The Bank extends loans directly to member companies.

《National Life Finance Corporation》

- Borrowers: About 90% in transaction volume is enterprises with no more than 9 workers. About half is individual borrower.
- Scale of finance: 59%=no more than JPY5M/transaction. Average amount financed=JPY6.85M. Average amount financed per borrower=JPY6.19M
- Finance without collateral: 90% of whole transactions and 80% of whole amount financed

2.1.4 Construction of finance systems for SMEs in China

(1) Basic understanding

As bank lending has increased significantly since 2003, related governmental authorities adopted what is called "macro-control policy," including policies to restrict excess increases of bank lending. It is reported in China that results of such policies could apparently be found at the 2nd quarter of 2004 and that increase of money supply and bank lending could have been restricted reasonably. But large numbers of non-performing assets are presumed to have increased with significant increases of bank lending by 20-30% , bearing in mind experiences of Japan.

For the long term, the national economy is expected to develop consistently and will stabilize. The situation of「年々有余」(being able to enjoy an annual surplus) allows for stabilization in the economy and society.

Likewise with Japan, it was too warm a summer this year in China. It was reported that many regions in China suffered from shortage of electricity. For example, in Hanzhou City (of Zhe jiang Province) many factories were forced to cutback operations to four days a week. Incidentally, this proves that bottleneck has occurred in the infrastructure of the following economic sectors: electricity, transportation, and water. A similar phenomenon occurred in the 1980's at Zhu River Delta. As a result, many companies decided to prepare with the use of small in-house power generators. Since then, however, those generators have been disposed of due to improvement of the power supply.

Rapid development of an economy derives social cost (pollution, etc) as well as creating economic unbalance. Unbalance of the economy spoils the weak and SMEs in society. China is expected to construct an adequate, stable economic social system to maintain development for the long term.

When taking financial systems for SMEs into consideration, such systems expected to be maintained for the long term and stabilized. As China's economic system enters transition, past effective institutions in countries operation in a market economy should be considered from various points of view.

Ten years have passed since the beginning of reform to the monetary system in China's market economy. But current monetary regulations are not suitable enough for an "economic system based on market economy and non-governmental private economy." The banking sector in China must come to terms with its assignment in society – to provide money to various economic sectors – while basing its decisions on risk. On the other hand, companies also have to make an effort to be reliable borrowers from the point of view of the financial institution. Relationships between bank and company should not be a game of "win or lose." Rather, they should be partnerships of interdependence and mutual reliance. The fundamentals of a market economy must be a "society with voluntary sincerity". A world where the weak are victims of the powerful is primitive capitalism and only gives way to exploitation of a nation and its resources. This is not a suitable outcome for the modern market economy.

The modern market economy consists of competition by rule based on a society of sincerity. A famous saying in Japan goes, "should you obey the rules, the rules could protect you." But some people in modern society say, "you do not have to obey a rule if the rule is not right." People who take this stance must first make a valid argument in order to disprove the rule. Recommending improvements to the government is a right and duty of the nation.

Recommending improvements to the government is a right and duty of the nation. Furthermore, satisfactory safety nets must be prepared in our modern market economy, whose obligation it is the government and / or policy authorities.

(2) Revision of Lending Cord （貸出通則）

In China, Lending cord was issued in 1996 as a rulebook for bank lending. In April 2004, the China Banking Regulatory Commission disclosed a draft idea for revising it. This draft has included many revisions.

First, regarding collateral, the 10th article of the current Lending cord says, “a borrower shall submit collateral when it borrows money” (贷款人发放贷款，借款人应当提供担保). This article refers to the principles of Collateralism (lending that is based on the value of collateral). According to this principle, it is understood that without collateral bank lending cannot be executed. In turn, this caused a negative attitude towards bank lending. On the other hand, some banks understood that lending could occur with any level of collateral. This led to “non-performing lending” that was the term to describe lending based on the value of collateral without any substantial valuation.

It is natural for financial institutions to obtain collateral or a guarantee, as much as possible, in order to maintain safety when lending an asset. But bank lending should be executed for business. In this sense, the cancellation of Collateralism in the revision of Lending cord could be seen as the dawn of a new era in business finance.

Second, regarding private finance (finance without financial institution) banking collateral the 61st article of the current Lending cord says, “lending or substantial lending against national policies must not be executed among ordinary companies” (企业之间不得违反国家规定办理借贷或者变相借贷融资业务). This article was canceled in the draft of revision. As far as needs are recognized, private finance must not be prohibited. Prohibition of lending by CEO of a company with his own risk taking violates independent management. And if a company, which cannot borrow from bank, should enjoy financial support by related subsidiaries, risk to the entire monetary system could spread, as is the motive of diversification in the ways of finance.

The role of government in a market economy must be concentrated to such roles as can be realized only by government. Otherwise, private potential cannot be fully used. In terms of Marxism, “productivity can not be liberalized.”

(3) Issue of code for lending by commercial bank

On 16th July, 2004 the China Banking Regulatory Commission issued “Guidance for Lending Business at Commercial Banks” (商业银行授信工作尽职指引). This guidance is quite remarkable in that it expands the autonomy of lending for commercial banks and also sets rules of lending (加大银行自主审贷、规范商业银行授信工作、必将产生积极而深远的影响).

This detailed guidance consists of 57 articles that are all fundamental to the fundamentals of bank lending. Contents of the guidance are almost the same as basic procedures that Japanese banks have long adopted. Issues of such sensible guidance at this moment prove that problems that have occurred in bank lending are quite severe. But if this guidance was pursued, bank lending in China could be dramatically improved.

From now on both the China Banking Regulatory Commission and The People's Bank of China have to usually conduct audit on compliance of this guidance in each financial institutions. In each financial institution, independent audit teams have to check compliance of the guidance in daily business.

2.1.5 Institutional lending for SMEs

Noteworthy characteristics of a public system of finance for SMEs are: 1) special financial institutions for SMEs and, 2) public institutional finance. There are two kinds of special financial institution for SMEs. One is a governmental organization wholly owned by government. Another is a private institution that consists of Shinkin Banks (信用金庫) and Credit Cooperatives (信用組合). The latter are nearly the same as city credit cooperatives (都市信用合作社) more so than city commercial bank s (都市商業銀行) in China, considering their comparatively small business area. But the biggest difference is their shareholders. Shareholders of city credit cooperatives (都市信用合作社) in China are mostly in the public sector. Meanwhile, shareholders of Shinkin Banks (信用金庫) and Credit Cooperatives (信用組合) in Japan are all private entities. In Japan, commercial banks are held and managed by firms in the private sector, whether big or small. It is true governmental financial institutions also support finance for SMEs. But it is private financial institutions that face and make transactions with tremendous numbers of SMEs everyday, everywhere in Japan. An important role in finance for SMEs by private financial institutions is to make transactions with SMEs on behalf of governmental financial institutions.

The business result for such SMEs is satisfactory, as its financial position remains healthy and high creditability is maintained throughout their life spans. Many commercial banks and investment banks submit various proposals to improve their financial positions. And some freely admit that they have received distinguished financial services from such SMEs.

But if the financial position of such SMEs is not satisfactory and its business scale is small, it will face problems in finance. Objectively speaking, such SMEs find it difficult to raise substantial funds. Because of this, many are not well respected. "Institutional finance for SMEs" in Japan is the solution to the aforementioned problem. This system represents public support to SMEs, most typically and most substantially, and spreads them all over Japan.

(1) Institutional finance in the Tokyo Metropolitan Government

Here I introduce institutional finance in the Tokyo Metropolitan Government. In Japan , there are 47 prefectures (都道府県; equivalent to (省) provinces in China) all of which utilize similar methods of institutional finance. Institutional finance in the Tokyo Metropolitan Government works based on collaboration of three entities: Tokyo Metropolitan Government, Credit Guarantee Corporation of Tokyo, and private financial institutions appointed to be agents by the Tokyo Government. The purpose of institutional finance is to support SMEs, to obtain finance from private financial institutions, and to develop enough to obtain finance by them.

First, a prefecture's government makes a deposit with a bank, which are funds for lending by banks. This fund is then discussed and approved by a local assembly. Private banks can only lend to SMEs under conditions defined by the local government. This system of finance has various types of lending by purpose of fund ("Technology Development", "Environmental

Improvement", "Energy Saving", "Recycle of resources", "Restructuring of business", "Change of business", "Business foundation", "Entering to new business," etc.).

Table below shows deposits with banks and target outstanding of finance (2002). Around seven times of deposit amount is targeted as outstanding. Banks can lend with comparatively low interest with this fund.

Deposit with private financial institutions by Tokyo Metropolitan Government (unit: JPY 100M)		
Purpose of fund	Deposit Amount	Target outstanding financed
Technology Development	237	400
Foundation	150	300
Sipporting small companies	1,182	2,650
Management stabilizing	615	1,100
Plan	0	800
Fundamental enforcement	15	40
Disaster	8	10
Cooperative	12	40
Self control	0	4,700
General	0	4,960
Total	2,219	15,000

Credit Guarantee Corporation of Tokyo submits credit guarantees to financial institutions when SMEs borrow by institutional finance. Regional and central governments support credit guarantee corporation, too. Support by central governments is re-guaranteed to credit guarantee by a credit guarantee corporation. Guarantees provided by credit guarantee corporations make risk a measure of lending. This means that lending to SMEs with credit guarantees creates a good lending asset. That is why financial institutions, big or small, are eager to increase lending to SMEs; under the condition that needs for new funds by bank lending is not too large.

(2) Support to a bank lending foundation

As mentioned in the report by "Special Assignment Team", quite a few policies support bank lending to SMEs. The Tokyo Metropolitan Government prepares an institutional finance for foundation of SMEs. Other prefectures also have these kinds of policies in place.

It is a kind of ultimate policy that finance with low interest is admitted, as far as a business plan is reliable and reasonable, and even if no guarantor or collateral is submitted. Private financial institutions are also happy, as they can expect borrowers to develop into important customers in the future. This institutional finance prepares two types. One is for pre-foundation (Foundation 1) and another is for post-foundation (Foundation 2). Details are explained in Appendix 1-3. A projection chart at the foundation highlights the most important material. I do not think this material should be adopted in China. But, it could be worth considering for future reference.

(3) Importance of regional financial institutions

It was recently pointed out in China that regional financial institutions should solve problems on finance by forming SMEs. A "regional financial institution" refers to financial institutions specializing in SMEs and also financial institutions in a regional community. In Japan, Shinkin Banks maintains firm position in this sense because it has restricted business area.

In Japan, there are no restrictions for large banks to submit lending to SMEs. But in the term of rapid development, big banks basically preferred to lend to big companies and were not positive to lend to SMEs. That is why financial institutions that have a specific business area specialized for SMEs are required.

In big cities such as China, city commercial banks are established. On the other hand, state-owned commercial banks still spread tremendous number of branches all over China. Needless to say, city commercial banks and state-owned banks are in competition. Japanese banks also have their own territories. Some banks operate all over Japan and some operate in plural regions. Customers of such comparatively big banks are mainly bigger SMEs or medium sized companies between big companies and SMEs.

In China, financial support to SMEs in that region should be conducted by regional financial institutions, which are very knowledgeable in that region. Branches of state-owned commercial banks, which are not suitable as regional financial institution for SMEs, should be transferred to regional financial institutions. This could be a favorable policy for a regional financial institution to develop. And if it could not be reasonable for any vacancy of state-owned commercial banks that remain spread throughout China, transfer of all branches of three state-owned commercial banks to another could be a possible solution.

(Appendix 1)

<Foundation Support> Pre-Foundation Finance

Finance of fund require before foundation

◇ Qualification of Applicants

SMEs who are applicable to any as shown below at foundation. Intended Business shall be listed on object of credit guarantee.

(Category 1) Foundation

Individual person who does not operate business (as shown below)

① Shall have own fund (*) amount of which is more than this finance amount.
② Shall have specific plan to begin new business by person or artificial person established within 2 months.
③ Shall be licensed, if the business requires governmental license.

(Category 2) Spin-out

An artificial person who is within the criteria of SMEs. Only newly established parent company (SMEs) shall be qualified to apply.

① Shall have specific plan to establish new artificial person with whole or part of current business carried over.
② Shall be SMEs who is the biggest shareholder of newly established artificial person.

(*)Own Fund = A – B

A. Fund prepared for new business by founder

① Deposit evidenced
② Properly priced security Weighted as ruled by Credit Guarantee Corporation
③ Receivable related to tenant (Security deposit, etc.)
④ Fund to be injected as capital
⑤ Equipments for business purchased before application (except for property)
⑥ Other asset priced (except fro property)

B Debt

① Scheduled repayment amount during coming 2 years of resident loan with remaining life of over 2 years
② Scheduled repayment amount during coming 2 years of long term borrowing for purchase of equipments
③ Aggregated outstanding of other borrowing

◇ Condition of borrowing

1. Purpose of Fund : Working Capital, Equipment Capital
2. Ceiling : (Category 1) No more than own fund (but no more than JPY 25M)
   (Category 2) No more than JPY 15M
3. Term : Working Capital; no more than 7 years(including grace period of 1 year)
   Equipment Capital; no more than 10 years (including grace period of 1 year)
4. Interest Rate : Fix or Float

Fix	Within 3 years	No more than 1.9%
	3-5 years	No more than 2.1%
	5-7 years	No more than 2.3%
	Over 7 years	No more than 2.5%
Float		Short term prime of each bank + within 0.7%

5. Repayment : repayment with installments (grace period : within 1 year)
6. Credit Guarantee : shall be guaranteed by Credit Guarantee Corporation (信用保証協会)
7. Credit Guarantee Fee : as Credit Guarantee Corporation decided (0.5%-0.7%)
8. Guarantor : (Category 1) not required
   (Category 2) shall be guaranteed by president of parent company (joint and several)
9. Real asset collateral : not required

◇ Materials to be attached to application

(1) Application Form and common attachments
"Copy of application of tax payment" and "evidence of tax payment" is not required for (category 1)

(2) Materials below (one copy)

① foundation Plan(with qualified form)
② Official evidence of income
③ Official evidence of resident registration
④ Copy of license
⑤ Evidence of past business or management experience
⑥ Copy of property registration
⑦ Statements of deposit
⑧ Evidence of ownership of security
⑨ Evidence of receivable related to tenant
⑩ Evidence of expenditure for equipment purchased before foundation
⑪ Evidence of capital injection
⑫ Evidence of other own fund
⑬ Statement of borrowing

◇ Others

For (category 1), plural application shall be accepted for borrowing over JPY 15M.

(Appendix 2)

<Foundation Support> Finance at Foundation

Finance of fund require at the time of foundation

◇ Qualification of Applicants

Qualifications other than "Pre- Foundation Finance

・ Within 5 years after foundation

◇ Condition of borrowing

1. Purpose of Fund : Working Capital, Equipment Capital
2. Ceiling : no more than JPY 30M
3. Term : Working Capital; no more than 7 years(including grace period of 1 year)
   Equipment Capital; no more than 10 years (including grace period of 1 year)
4. Interest Rate : Fix or Float

Fix	Within 3 years	No more than 1.9%
	3-5 years	No more than 2.1%
	5-7 years	No more than 2.3%
	Over 7 years	No more than 2.5%
Float		Short term prime of each bank + within 0.7%

5. Repayment : repayment with installments (grace period : within 1 year)
6. Credit Guarantee : shall be guaranteed by Credit Guarantee Corporation(信用保証協会)
7. Credit Guarantee Fee : as Credit Guarantee Corporation decided
8. Guarantor, real asset collateral

《For artificial person》

Application Amount	No more than JPY 25M	Over JPY 25M
Guarantor (Joint and Several)	President of artificial person	President of artificial person And another or more
Real asset collateral	Not required	Required

《For Individual business》

Application Amount	No more than JPY 25M	Over JPY 25M
Guarantor (Joint and Several)	Not required	1 person or more
Real asset collateral	Not required	Required

◇ Materials to be attached to application

(1) Application Form and common attachments

(2) Materials below (one copy)

① Foundation Plan(with qualified form)
② Official evidence of income(for both applicant and guarantor)
③ Official evidence of income(for artificial person)
④ Copy of license
⑤ Evidence of past business or management experience
⑥ Copy of property registration
⑦ Statements of deposit

◇ Others

Plural application shall be accepted for borrowing over JPY 15M.

(**Appendix 3)**

Foundation Plan

YY MM DD

Here I apply to borrow Institutional Lending of “Tokyo Metropolitan Government <Foundation Support>” with foundation plan and required attachment.

Applicant

Address and Name

Description of borrowing (at execution)			Pre-Foundation / At Foundation		
Type of Foundation	Individual / artificial person	Name of artificial person			Capital; JPY thousand
Foundation Site			TEL		
Date of Foundation			Statement of Foundation		Attached / not attached
Business Type		Workers		Products	
Detail of business partner					

Attachments (related to foundation) 〇shows essential material.

〇	Official evidence of income (for both applicant and guarantor)		Statements of deposit
〇	Official evidence of resident registration (for both applicant and guarantor)		Evidence of ownership of security
	Copy of property registration		Evidence of receivable related to tenant
	Copy of industrial ownership registration		Evidence of expenditure for equipment purchased before foundation (pre-foundation)
	Copy of license		Evidence of capital injection
			Evidence of own fund
	Evidence of past business or management experience		Statement of borrowing
	Others ( )		Others ( )

1. Background of applicant (if applied for foundation, tick to columns. And please attach evidence.)

	Have experience	Term: Type of business: Type of assignment:
	Have managed	Term: Type of business: Type of assignment:
	Registration or registered industrial copyright	Type: Status: Date: Serial #:
	Qualified by law	Qualification: Date:
	Others ( )	

2 Progress of business)

(1) have ordered equipment, machinery, etc.
(2) have paid dump payment of land and outlet
(3) have paid security deposit to use land and outlet
(4) have procured products or raw materials
(5) have licensed
(6) application of license has been accepted
(7) Others

3. Working Capital(within 3 months)

	Amount (JPY Thousand)	Contents
Procurement of products and raw materials		
Personnel expenses		
Others		
Total	A in thousand JPY	

4. Equipment schedule

	Land, Building	Size of area	Owned / New building Purchase / rental	Fund required to acquire	Contract date	Acquired / completion date
	Land	m²		JPY Thousand		
	Building					
	Total	B (Required for acquisition)				

	Name	Type specification	Quantity	Unit price	Price	Buyer	Equipped / completion date
Equipments For Business							
	Total	C (in thousand JPY)					

5 Total fund required (A＋B＋C)

”Fund to be financed total” (D) on the next table.

6. Schedule of finance (Evidence shall be attached.)

Own Fund For Business	Deposit			Other than deposit	
	Bank	Type	Outstanding	Type	Amount
				Security	
				Other	
	Total of deposit (in JPY thousand)			Total of other than deposit (JPY thousand)	
Debts	Lender	Interest rate	Amount	Monthly installment	Term
	This finance	%			
	Total of debts (in thousand JPY			Fund to be financed total (a + b + c)	D

7. Projection of profit and loss

Expenditure		Revenue	
Procurement		Sales	
Outward payment		Other income	
Personnel expense			
Promotion cost			
Others			
Profit			
Total			

8. Buyer and supplier

Nam	Address	TEL	Amount per year	Collection
			(In thousand JPY)	

Name	Address	TEL	Amount per year	Collection
			(In thousand JPY)	

9. Scheduled own fund (for new foundation by individual)

		Contents	Amount (thousand JPY)
	Saving account		
	Time deposit		
	Security		
	Receivable related to tenant		
	Fund for capital injection		
	Equipment for this business		
	Other assets (except for property)		
	Total ①		
	Resident Loan		
	Long term borrowing for purchase of equipment		
	Other borrowing		
	Total ②		
Own fund total (①−②)			

10 Supplemental explanation

Any supplemental specific explanations on motivation of foundation, history of consideration, occupation before foundation, training of required knowledge, technology and know-how, and any other.

2.2 Financial System Reform and Capital Market Development

2.2.1 Financial Needs in SMEs

Financial needs in SMEs differ according to their stage of development, reflecting their distinctive economic activities. Table 1 compares the needs. The importance is that there are two different types of financial needs. One is the need of risk money for start-up of the business and the other is the need of growth money for sustainable development after take-off of the business. While the latter needs are met by both the traditional banking system and capital market system, the former needs are not met in the framework of the ordinary financial system. This is because businesses in the start-up stage contain various risks, which are attributed to the uncertainty of the business and can hardly be hedged by any financial measure.

Table2.2.1. Financial Needs in SMEs by Their Stage of Development

Development stage	Start-up (1-3 years)		Firm step (3-7years)	Organic growth (7-15 years)	Steady growth (15 years-)
	Establishment	Death valley			
Business characteristics		-Trial stage -Uncertainty -Lack of collateral	- Initial stage: production and sales proved successful - Management system is still weak -Insufficient collateral	- Develop new products for the initial market or new markets for the initial products - Management system is still weak for their growth - Collateral is increasing	-Stable performance - Management system is improving - Sufficient collateral
Financial needs	-Funds for start-up	- Working capital for 1-2years operation	- Working capital for expanding production volume	- Working capital and funds for new investment	- Working capital and funds for new investment and new business
Characteristics of funds	-Risk money	-Risk money	-Temporary funds before collection of sales proceed	-Funds for business development -Vulnerable to economic cycle	-Funds for business development -Invulnerable to economic cycle
Source of funds	- Own capital - Borrowing from informal sector	- Own capital - Borrowing from informal sector	-Own capital - Borrowing from financial institution	-Own capital - Borrowing from financial institution -Public offering in special stock market - Public offering in capital markets	-Own capital - Borrowing from financial institution -Issuing corporate bonds - Public offering in capital markets

2.2.2 Main Difficulties Facing SMEs in Meeting Financial Needs

(1) Limited supply of risk money

In China, most of risk money needed in the start-up stage is supplied by the informal sector such as the business originator's relatives and friends. The supply channel through venture capital is narrow. Even though Japan is still in a similar situation as far as the supply volume is concerned, venture capital channels have been well established as an institutional framework. It is necessary to widen the channel of venture capital in China.

Venture businesses are required to yield profits high enough to match their investment risks. Such a condition can only be met when the successful venture business is listed in the capital market and the investors can enjoy so-called capital gains by selling their listed shares at a high price. It is necessary to develop such a framework under which venture businesses can list their shares on a stock exchange as early as possible, at the latest, within two to three years after their conception.

In developing countries, it is rather difficult to develop venture capital under the market mechanism. For acceleration of its development, it is indispensable for the public sector to be involved by extending financial assistance such as capital injections to venture funds.

The contribution by the banking system to the development of venture capital seems to be not so large for the following two reasons. First, venture capital is basically risk money and the banking sector, as an intermediary of financial assets, tends to take a negative stance against such risky business. Second, operation of venture capital necessitates specific knowledge and substantial experience in the venture's business model and technology, which commercial banks are not always properly equipped with.

(2) Insufficient supply of funds for business expansion

Not only the supply source of risk money but also the supply sources of funds for business expansion seem to be lacking depth in China. Not withstanding the importance of the role of SMEs getting large in the midst of rapid economic development in China, the financial system has not been made sophisticated enough to support the development of SMEs and their various financial needs. The Chinese financial market is often called the "plain-vanilla" market.

1) Underdeveloped capital market.

As for corporate financing channels, there are two markets as is shown in Table 2.2.2. One is the financial market, or loan market, and the other is the capital market. In China, the financial market is still the main channel and the capital market is underdeveloped. Since the capital market is lacking room to absorb the needs for funds, every corporation rushes to the financial market for its financing.

Table 2.2.2. Channels for Fund Raising by SMEs

Development stage	Firm step	Organic growth	Steady growth
Capital market	Private placement of bonds	Private placement of bonds Public placement of bonds Public offering of shares	Public placement of bonds Public offering of shares
Financial market	Borrowing under collateral	Borrowing under collateral	Borrowing without collateral

With respect to the development of the capital market in China, as is shown in Table 2.2.3, a substantial amount of bonds and shares are issued. However the main financial products of bonds are government bonds and public financial institutions' debentures. The private sector is clearly crowded out by the public sector. Although the stock market shows vigorous expansion, as a channel for raising funds it is still narrow for SMEs

The corporate bond market is almost negligible as far as its size is concerned. Three reasons can be cited. First, the central government controls the size of bonds to be issued. Second, issuing procedures are complicated. Third, the requirements to be cleared in order to issue bonds are too strict. These factors lead to the high issuing cost. Taking into consideration a worldwide trend that the capital market becomes a major source of corporate financing, it is expected that the Chinese government will make every effort to accelerate the development and improvement of the market.

It is noted that, even in Japan, the capital market is not a major source of financing for SMEs as is indicated in the figure that shows that SMEs' fund raising from the capital market is only 0.1% of the total financing for SMEs. Even in the U.S. where the capital market has been well developed, only 8 to 9%of SMEs' total corporate finance was secured through the capital market in 1998. These facts, however, do not imply that the importance of the development of the capital market is only marginal for financing of SMEs. The principal beneficiary of capital market development is large sized corporations rather than SMEs. However, when large sized corporations can easily access the capital market for their fund raising, it becomes easier than ever for SMEs to raise necessary funds through the financial market, since the importance of the financial market for large sized corporations lessens (See Box 2.2.1). This could happen in China when large sized corporations turn to the capital market from the financial market for their fund raising, the financial market can absorb the needs of SMEs more easily than before. Development of the capital market also facilitates SMEs to raise necessary funds through private placement of their bonds as well as through securitization, which will be referred to in more details later.

Needless to say, even if the capital market is well developed, it will not contribute to the SMEs' corporate finance as long as major securities holders are banks. Because it means that the banking sector will shift their allocation of funds, which are collected by taking deposits and savings, from loan assets to bond assets. In this sense, it is necessary to promote the participation of individual and institutional investors in capital market.

Reflecting the immaturity of the capital market mentioned above, SMEs receive 58% of their financing needs from internal sources, 32% from intermediary financing through banks and 9% from informal sources, while only 1% comes from the capital market in China.

Table 2.2.3. Issue of Bonds and Shares in China (Unit:100 million RMB)

Year	1997	1998	1999	2000	2001	2002
Government bonds	2,411	3,808	4,015	4,657	4,884	5,934
Debentures by Government banks	1,431	1,950	1,800	1,645	2,590	3,075
Debentures by banking sector	32					
Corporate bonds	255	147	158	83	147	325
Share (A)	105	82	83	117	77	117

Source: Almanac of China's Finance and Banking

Box2.2.1 Development of SMEs finance in Japan

Small and medium sized enterprises (SMEs) have played a vital role in the development of the Japanese economy and industry for many years. Even though multi-national companies such as Toyota, Honda and National are widely known around the world, they are not the only Japanese corporations. SMEs have supported these famous companies. With all their importance, SMEs have been placed in an unfavorable position as far as access to the financial market is concerned for the following two reasons. First, the Japanese economy achieved high growth for a long time and continuously produced a condition of a shortage of funds. Under such a situation, even large companies sometimes faced difficulties in getting funds for expansion of their business. An immature capital market accelerated the situation. SMEs were crowded out by large companies especially during the period of tight-money policy. The situation was intensified by " overloaning " by city banks. " Overloaning " is defined as a lasting phenomenon in which city banks extend loans far beyond their capability of collecting deposits and money, resulting in continuously borrowing money from the Bank of Japan. Under such a situation, city banks could hardly afford to extend loans to SMEs. SMEs complain about city banks' behavior that they push for you to borrow an umbrella (money) when the sky is clear and SMEs do not need to do so, while they push for you to return the umbrella when the rain falls and SMEs are in need. Second, SMEs' credit risks were higher than those for large corporations. The following factors are cited as factors of SMEs' high credit risks.

- Lack of management capability
- Weakness of financial position
- Immature management organization
- Incomplete disclosure
- Lack of a long-term business plan

To avert the SMEs high credit risks, commercial banks charged higher interest rates and required stringent conditions on collateral and guarantees. High interest rates, relatively short maturity and too heavy requirements for collateral and guarantees are always a point of dissatisfaction for SMEs when they borrow money from commercial banks. In addition, intricate loan procedures and time-consuming credit analysis frustrated SMEs. Some part of the complaints on collateral were solved by widening the items of collateral and revising the calculation method of the collateral value. However, it never satisfied SMEs.

In order to improve the SMEs' unfavorable position for financing mentioned above, financial institutions specialized in financing for SMEs were established. Private institutions, Credit Associations and Credit Cooperatives were established, while government institutions such as National Life Finance Corporation (NLFC), Japan Finance Corporation for Small Business (JFS) and The Shoko Chukin Bank (SCB) were also established. They have made a great contribution to the improvement of the SMEs' position by extending loans necessary for the development of SMEs. Especially, their financing to SMEs revived many SMEs during the period of tight-money policy and supported the development of the SMEs.

As the economy developed and became mature, demand for funds by large companies became modest. In addition, with the development of the capital market, they began to raise the necessary funds in the capital market rather than in the loan market. Further, globalization of the financial market facilitated SMEs to procure necessary funds in foreign markets easily. As a result, commercial banks lost business opportunities with large companies and began to pay more attention to SME loan market.

Around the mid-1980s, the percentage share of SME loans of the total loans by commercial banks began to pick up. The trend is still persisting today. Taking into consideration the change in commercial banks' behavior, it can be said that the position of SMEs was largely improved in at least the quantitative aspect of SME financing is concerned. This is because SMEs can raise the necessary funds so long as they pay risk premiums in accordance with their credit risks.

2) Lack of diversification in financial market channels

In the financial market, four state-owned banks hold more than a ninety percent share of total loan assets among the fourteen major banks as shown in Table 2.2.4. In this sense, financial channels are not diversified. In other words, room for the selection of financing source is very limited for SMEs. Once these four banks simultaneously adopt stringent lending policies, SMEs face difficulties in getting necessary funds from the financial market. Even though commercial banks exist in each city and rural area, and extend loans to local enterprises, their lending capacity is too small to meet the huge financial needs of SMEs.

Table 2.2.4. Main Banks in China

Bank	Loans outstanding (100 million RMB)	Capital accounts (100 million RMB)	No. of offices	No. of employees
Industrial and Commercial Bank of China	29,578	1,778	25,960	405,558
Agricultural Bank of China	19,129	1,292	39,286	480,931
Bank of China	13,989	1,421	12,090	174,919
China Construction Bank	17,663	851	21,616	406,441
China Communication Bank	1. 820	159	2,675	56,160
CITIC Industrial Bank	727	68	372	9,228
Everbright Bank of China	570	82	31	7,817
Hua -Xia Bank	219	25	211	5,852
China Minsheng Banking Corporation	321	25	146	4,254
Guangdong Development Bank	660	35	567	11.596
Shenzhen Development Bank	166	19	198	5,834
China Merchants Bank	367	57	332	15,261
Fujian Industrial Bank	249	30	233	5,615
Shanghai Pudong Development Bank	337	36	284	6,698

Source: Almanac of China's Finance and Banking

Since the number of offices of the four state-owned banks is so large, it seems that their financing to SMEs is spread all over China. However, taking into account that there are many state-owned enterprises as their customers, which are competitors of SMEs, the large number does not always mean that SMEs are in a favorable situation in getting necessary funds.

In addition, the four large state-owned banks are ridden with so many non-performing loans. Under such a situation, they tend to become reluctant to extend loans to SMEs, whose credibility is relatively low compared with those of state-owned enterprises. Rather they have to reduce their loan assets in order to maintain their capital adequacy level at international standards. To expand their loans to SMEs, they have to strengthen their capital accounts by receiving capital from the central government or issuing new shares. However, under the unfavorable financial position, it is difficult for them to take this latter measure.

3) Insufficient efforts to develop new financial products and services for SMEs

State-owned banks are sometimes criticized for a lack of effort to develop new financial products and services. This is another source of narrowness to finance avenues through the four state-owned banks. Among others, it is claimed that their policy for requirements on collateral is so rigid and there is only a few types of collateral that are accepted.

SMEs are always requested to extend collateral when they approach banks for funding. The type of collateral is limited to real estate assets such as buildings and rights to use land. Even though rights on doing business under government permission are sometimes accepted as collateral, it is still an exceptional case. SMEs want banks to enlarge the type of collateral to inventory and movable assets but there is no rule to facilitate such an idea because the legal and institutional framework is not yet developed. Another problem on collateral, which SMEs complain about, is the relatively low assessment of value on the collateral.

The most serious complaint of SMEs is in regards “non-collateral” loan. It is quite natural for banks to require collateral against their loans to SMEs. This is because banks are intermediary institutions, which collect deposits and savings from depositors and lend them to borrowers and they are not allowed to directly transfer lending risks to depositors. A recent survey by the Federal Reserve Board in the U.S. reveals that even in the U.S., where the financial system has been well developed, while about 30% of loans to large corporations are loans with collateral, around 80% of loans to SMEs still involve collateral (FRB ”Terms and Condition of Lending Business”). If SMEs request banks for non-collateral loans, such loans could be only extended by financial institutions, which can transfer directly such risks to depositors. They are risk lover type non-banks who collect lending money from specific risk lover type investors or by issuing their bonds to institutional investors instead of collecting general deposits.

There are some banks, which do not request any collateral in extending their loans to SMEs. These banks are equipped with rich experience in SME lending. However, even in such a case, specific requirements are asked to be met. They are the following. First, that the lenders can judge the exact credit ratings of SMEs based on their long time transactions. Second, SMEs disclose information on their financial data based on which banks can analyze the SMEs’ credibility properly. Putting these conditions in another way, in the case that SMEs are ready to disclose such information as their net assets, debt-equity ratio, profit to total assets and interest coverage ratio to lenders, lenders may be ready to extend their non-collateral loans to SMEs under the condition that SMEs will maintain these credit indicators at some level. It is difficult for SMEs to get non-collateral loans while they refuse full disclosure of their financial data.

As one type of non-collateral finance, so-called project finance is available. The scheme is that lenders are only concerned about borrowers’ cash flow and control a part of the cash flow under their escrow accounts. However, providers of such loans are not commercial banks but investment bankers who have much knowledge in the scheme.

A credit guarantee is a tool to supplement non-collateral loans. However, the tool is not well utilized because the guarantee itself seems to be unreliable. As a result, the performance of credit guarantee institutions stays at a low level. In China, the ratio of guarantee to capital accounts is at the highest only 5 times, while in Japan the rate is 50 times. This means that the default rate is 20% of the outstanding guarantee. Credit guarantee institutions run by the government extend 10 times guarantees of capital accounts only because lenders believe that they will not be bankrupt since the government supports them. Even though some governmental assistance is necessary for sound development of the credit guarantee scheme, the scheme should be designed so as to avoid a so-called moral hazard.

A frequent complaint by SMEs is that the value of collateral is evaluated so low. If it is so, it may come from the following reason. That is, the asset price is not low but taking into consideration the complicated procedures and time required for disposition of the asset, banks have to evaluate the assets lower. In other words, banks account for the uncertainty for disposition of the collateralized asset. In order to reduce such transaction costs, it is necessary to establish a rule for disposing the asset with the minimum time and cost. To speed up the transaction, it is necessary to set up institutions that are specialized in and have experience in the disposition procedure.

4) Crowding out by large state-owned corporations

State-owned banks are major sources of finance for SMEs. On the other hand, these banks' major clients are state-owned companies. These two factors result in a mismatch of SME financing. State-owned banks tend to extend their loans to state-owned corporations partly because they feel it is their role to do so but partly because they believe their loans to these corporations are immune to bankruptcy while loans to SMEs are vulnerable to bankruptcy. Recently, some state-owned corporations became bankrupt but people still believe that loans to these state-owned corporations are safer than those to SMEs. This is equivalent to saying that the government sector extends "guarantees" to loans of state-owned corporations. Such a situation brings about the crowding out of funding for SMEs by funding for state-owned corporations.

In order to sort out these problems, two institutional schemes are proposed. One is that the government urges state-owned banks to assess their loans to state-owned corporations in accordance with the same international standards as private companies. The other is that the government designs a special financing channel, which SMEs can exclusively use. It is a kind of institutional financing to SMEs. Some typical examples are finances for export promotion, finances for upgrading of productivity and finances for new technology development. In designing the scheme, the following three conditions should be met. First, the scheme should be designed with a definite term. Second, the amount of loans should be determined at the start. Third, financial institutions, which extend such loans, should be designated at the start.

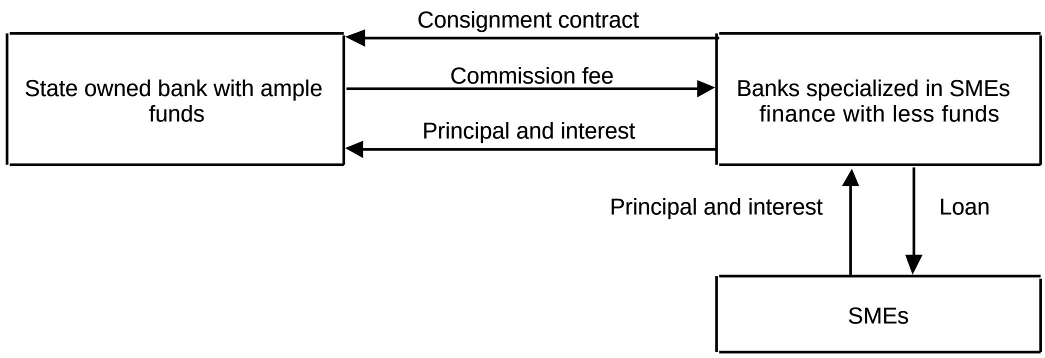
5) Lack of specialty

There is much room to be improved in the strategy of state-owned banks for financing of SMEs. State-owned banks have begun to focus on financing for SMEs. Some of them organized new sections for financing SMEs. However, unlike Beijing City Commercial Bank, their efforts do not seem to bear fruit in establishing "financing for SMEs" as new branded products at the moment. Their capability in developing new financial products and services is not enough either. The reason lies in that SME finance does not yield any advantage compared large state-owned corporate financing because of the relatively high risks of SME financing. There is clearly a handicap in SME financing compared to state-owned corporation financing. One of measures to overcome the handicap is to charge higher interest rates on SME financing. The interest rate is limited to up to 1.7 times the standard rate. However, charging a higher interest rate is not enough to balance the risk when considering the financially weak position of SMEs whose collateral is few and weak. In order to offset such weakness, it is necessary to expand the ceiling on interest rates up to 3 to 4 times the standard rate. However, this is unrealistic.

It is unrealistic for the government to compel state-owned banks to follow a strategy of putting SME financing as their top business priority, but it may be possible for The People's Bank of China to induce state-owned banks to focus their business more and more on SMEs financing, when it becomes necessary to do so. An example is to set up an organization specialized in SMEs finance. Since The People's Bank of China does not have any plans for establishing newly financial institutions specialized in SMEs at the moment, another idea should be proposed. It is proposed to set up a holding company and establish an organization specialized in SMEs under the umbrella of the holding company. The importance is to separate the organization from the existing banks. By doing so, the organization is to be specialized in SMEs financing and tends to concentrate their activities on SME financing ranging from development of new financial products and services to training expertise. They can become a professional institution for SME financing.

One issue to be solved is how the newly established organization gets funds for SME financing. One idea may be to conclude a consignment agreement between the new organization and the mother state-owned bank as is shown in Figure 2.2.1.

Figure2.2.1 Consignment Agreement



6) Weak recognition of importance of disclosure

There are two types of transactions in financial systems. One is "transactions with no third party" and the other is "market transactions." In the former transaction, a financial institution, one party, extends funds to an SME, the other party. In this deal, the SME is requested to disclose its financial information by the financial institution. So long as the institution is satisfied with the disclosure, the deal is on. In market transactions, an SME has to please all parties participating in the deal by disclosing its financial data and information. Even though it takes substantial effort to do so, it has an advantage of being able to secure substantial amounts of funds in one shot. In this sense, transition from "transactions with no third party" to "market transactions" is a barometer of matured financial systems as shown in Table 2.2.5.

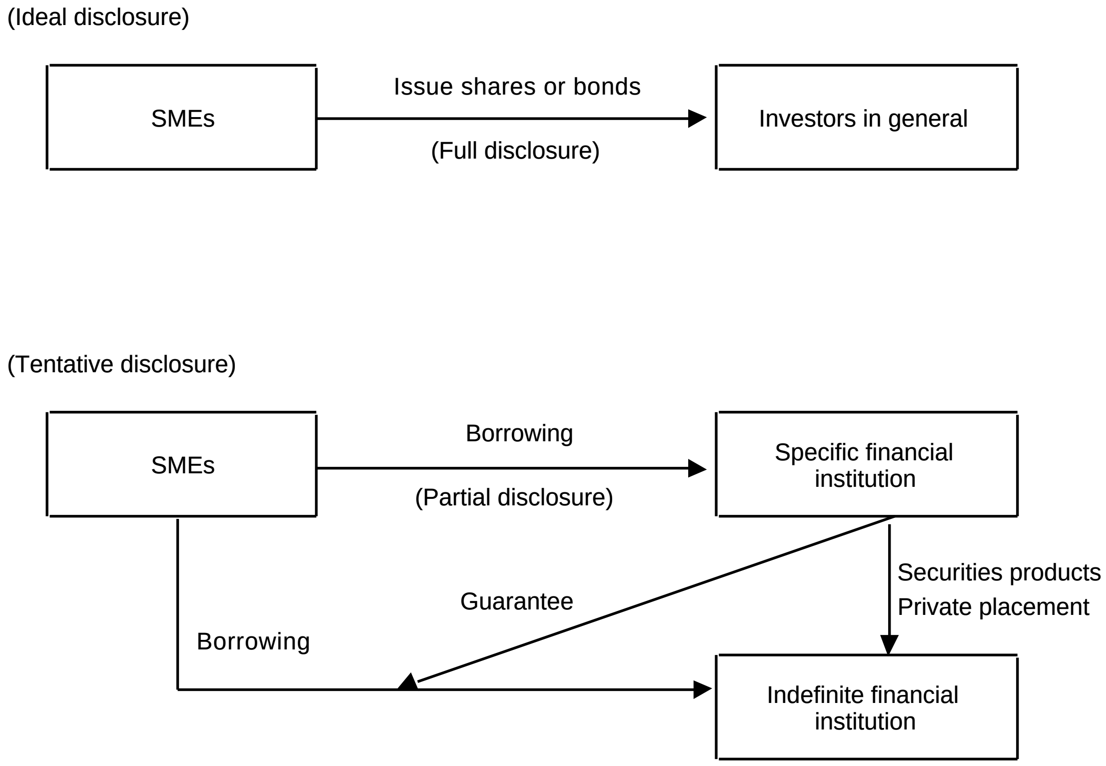
In China, as far as SME financing is concerned, the main stream is "transactions with no third party." It is shown to be a fact that SMEs depend largely on the informal sector for their funding. With respect to the background, two factors can be cited. First, Chinese financial institutions are lacking in the sense that "market transactions" are important for sophisticated and matured financial business development. Second, the institutional framework and infrastructure for “market transactions” is not well developed. Development of the capital market falls under such an infrastructure and the key for development is disclosure of information on the financial status of SMEs.

Table2.2.5. Current Corporate Finance

Developed economy	Start-up	Firm step	Organic growth	Stable growth
Large company	Own funds Borrowing from relatives Venture capital - Domestic	Borrowing - Domestic	Share issuing Borrowing Bond issuing - Domestic	Share issuing Borrowing Bond issuing -Domestic -Foreign
SMEs	Own funds Borrowing from relatives Venture capita -Domestic	Borrowing - Domestic	Share issuing (Equity investment institution) Share issuing in special market Borrowing - Domestic	Share issuing Borrowing Bond issuing -Domestic
China	Start-up	Firm step	Organic growth	Stable growth
Large company	Own funds Borrowing from relatives -Domestic	Borrowing - Domestic	Borrowing - Domestic	Borrowing Share issuing - Domestic - Foreign
SMEs	Own funds Borrowing from relatives -Domestic	Borrowing - Domestic	Borrowing Share issuing in special market - Domestic	Borrowing Share issuing in special market -Domestic

Incompleteness of information disclosure is seen in developed countries, as well. Japan is not an exception. The importance is its degree. When disclosure is advanced, the channel for financing expands. This is common to not only SMEs but also large corporations. In China where information disclosure is behind, a main stream for finance is not “market transactions” but “transactions with no third party.” Even though it is recommended to accelerate information disclosure in China, it is neither easy nor realistic to disclose financial data to indefinite customers. One idea is to promote medium class disclosure in the beginning. SMEs disclose their financial data only to some limited financial institutions, which may be called “core” banks. The core banks guarantee the SMEs based on disclosed data and information for the indefinite customers. By doing so, it becomes possible for SMEs to enlarge financial channels.

Figure 2. 2.2 Information Disclosure and Finance



The above concept implies that there is a third type of finance, which will fall between direct financing through the capital market and indirect financing through the financial market. This type is called “market involved in indirect financing.” The typical example is securitization of loan assets. Details of the scheme will be introduced in the next part. The scheme has the following three advantages. First, it is not always necessary for the loan to be supported by collateral on fixed assets. Second, banks can spread loan risks to many parties concerned. Third, it is possible to develop many sophisticated products such as securities products having various risk structures. Various risk structures are accompanied with various return structures ranging from high-risk high-return to low-risk –low-return.

2.2.3 New Challenges in Japan's SMEs Finance

How to strengthen SME financing is a hot issue in Japan, too. Many challenges have recently been undertaken in Japan. We will introduce four challenges here. So long as "transactions with no third party between a lender and a borrower" are normalized as stated later, it is not difficult for China to follow in undertaking these challenges. These challenges could add fresh dimensions to China's "plain vanilla " financial markets.

(1) Non-collateral loans

1) Approach to "non-collateral loans"

A complaint is quite often heard from SMEs that commercial banks always request collateral on loans. The request of commercial banks is quite natural because they have to hedge their risks to SME loans for their creditors, namely, general depositors. If SMEs are fully cooperative to disclosure of their financial data, commercial banks will become comfortable with non-collateral loans since they can evaluate fairly the risks involved in their loans to SMEs. SMEs have two options in getting loans from commercial banks; to give collateral or to disclose financial data.

In this regard, it should be noted that in Japan, until very recently, a company had been requested to present collateral even when it issues a bond, whose purchasers are risk lovers as is shown in Table 2.2.7. It is only recently in Japan that bond issuers became free from providing collateral in their bond issuing. In Japan, it was a principle that bond issuers extend collateral in bond issuing since the purchasers of these bonds were mainly commercial banks, which take deposits from general individuals. However, with the increase in purchases by institutional investors who are basically risk lovers, issuers began to request the removing of collateral from the issuing conditions. The investors and underwriters of bonds agreed to lift collateral under the condition that issuers disclose fully their financial data and maintain their financial position at a level that investors are comfortable with (see Box 2.2.2)

Table2.2. 6 Loan and Bonds

	Loan	Bonds
Source of funds	Savings Deposits	Investment money
Risk	Should be small as much as possible	Theoretically large, but smaller than that of share
Collateral	Necessary	Theoretically unnecessary

In order to respond affirmatively to the request from SMEs on non-collateral loans, it is recommended to develop guidelines to be met and financial restrictions to be posed on SMEs, which are entitled to enjoy the advantage of getting non-collateral loans. It is necessary to develop common financial indicators, which make it possible to go with non-collateral financing. Using the indicators, banks will determine whether they extend loans to their clients on a collateral basis or non-collateral basis. Banks may ease the conditions of the indicators depending on the credibility or credit rating of their clients.

2) A new type of non-collateral loans

A new type of non–collateral loans has recently been developed in Japan. The loan is called covenant finance. The concept is not new and has been utilized for a long time mainly in sovereign loans to developing countries. Also, in issuance of bonds without collateral, bond issuers are requested to follow the scheme in Japan.

Under the scheme the banks do not request any collateral from SMEs but impose some conditions on their financial position. Even though conditions differ case by case, they generally cover leverage ratio (outstanding interest bearing debt / operating profit before depreciation and tax), interest coverage ratio (free cash flow / interest to be paid), debt-service ratio (free cash flow / principals and interests on debt), net assets, outstanding f interest bearing debt, sales and ordinary profits. When they meet and keep these conditions through a loan period, SMEs are entitled to borrow necessary funds without collateral.

3) Possibility of introducing non-collateral loans into China

So long as SMEs agree to disclose their financial data and conclude covenants to commercial banks, commercial banks will be comfortable to extend non-collateral loans to SMEs. A key is disclosure of financial data by SMEs. Contents of covenants may differ by a lender and a borrower, but they will become standardized in the long run as was seen in the case for issuance of bonds in Japan.

Box2.2.2 History of introduction of non-collateral corporate bonds in Japan

1973	Issue convertible bonds with no-collateral but special reserve of designated collateral by Mitsubishi Corp., Marubeni Corp., Hitachi and Kawasaki Heavy Industry Set a guideline on conditions of eligible issuer of non-collateral bonds and restrictions on financial status (hereinafter referred to “the conditions and restrictions”)
1977	Ease the conditions and restrictions
1979	Issue non-collateral straight bonds by Sears, a US retailer in Tokyo market Issue non-collateral convertible bonds by Matsushita Electric Corp. Ease the conditions and restrictions
1984	Ease the conditions and restrictions
1985	Issue non-collateral straight bonds by TDK: the first issue of non-collateral straight bonds by a Japanese corporation Ease the conditions and restrictions
1986	Ease the conditions and restrictions
1987	Ease the conditions and restrictions
1988	Ease the conditions and restrictions Introduce credit rating system
1989	Ease the conditions and restrictions
1990	Ease the conditions and restrictions
1991	Ease the conditions and restrictions
1992	Ease the conditions and restrictions
1993	Ease the conditions and restrictions Revise fundamental law governing issue of corporate bonds
1994	Ease the conditions and restrictions
1995	Abolish the conditions and restrictions, while new guidelines on corporate disclosure was Introduced------Issue of non-collateral corporate bonds was completely liberalized Issue non-collateral convertible bonds by a medium sized super store named Fuji which has not acquired a credit rating higher than BBB

(2) Securitization of loan assets: Financial engineering in financing for SMEs

1) Background

In China, financial channels for SMEs are too narrow when China's economic scale, economic power, number of SMEs and their importance are considered. Even though loans to SMEs by city commercial banks and regional commercial banks are rapidly expanding and its growth rate exceeds those by state-owned banks, main lenders are still state-owned banks. On the other hand, it is not easy for SMEs to raise necessary funds through the capital market in China. The situation is the same even in advanced economies. However, various schemes using the capital market have recently been developed for overcoming such restraints in developed countries. One of them is a structured finance called securitization. This scheme could be applied in China.

2) Concept of securitization

Securitization is to convert such financial assets as bank loans to securities products and sell them to investors. Since the securities are issued with the financial assets as collaterals, these securities are called as asset backed securities and securitization is called as structured finance by its unique function. Financial assets include not only bank loans but also trade receivables, high yield bonds, vehicle loans and lease receivables, commercial real estate loans, credit card receivables, computer and equipment lease receivables and loans to restaurant franchisees. Since new securities are produced with collaterals of purchased financial assets, they are called asset backed securities. Major asset backed securities are collateralized loan obligations (CLOs), collateralized bond obligations (CBOs), and collateralized mortgage obligations (CMOs). The economic activity of the scheme has the following characteristics.

- Convert transaction with no third party between a lender and a borrower to market the transaction among a securities issuer and investors
- Transform a simple financial transaction into sophisticated transaction in which many participants are involved
- Convert simple loan products to more sophisticated products having various risk-return structures (for example, produce "A","B", "C" and "D" rated products from "B" rated loan products)
- Various institution's involvement in market transactions instead of regionally limited financial institution's involvement in loans
- Risk dispersion through a kind of credit derivatives
- An important step of SMEs' access to the capital market
- Disclosure of SMEs' financial data to the market, even though it is indirect and partial
- A new tool of expanding the money supply by the central bank when the bank designates these securities products as suitable securities for collateral for the central bank's loan to financial institutions
- Local people's contribution to the development of SMEs through investment to securities products

3) Scheme of securitization and major participants

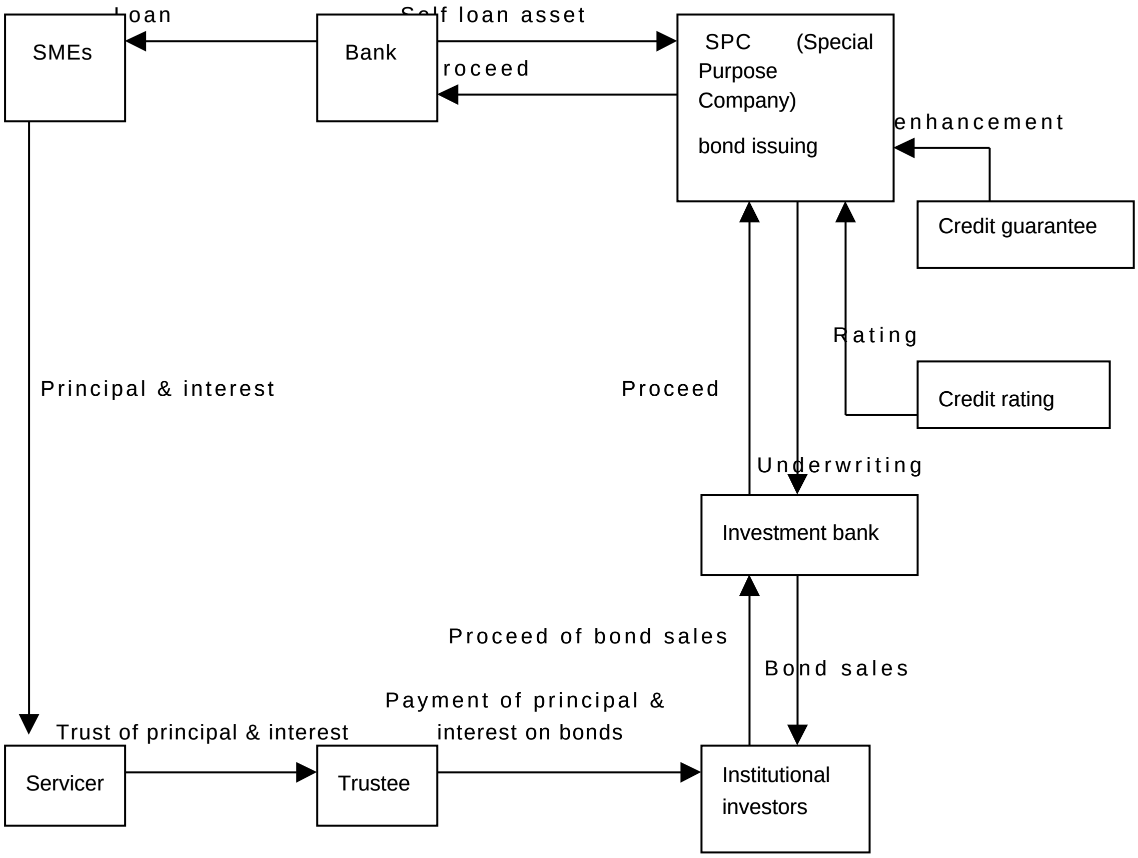
Basic scheme for securitization is shown in Figure 2.2.3. Major participants in this scheme are as follows.

- SMEs (borrowers from banks)
- Loan originators (banks)
- Special Purpose Company (SPC: Issuer of securities with loan assets transferred from loan originators)
- Underwriter of securities products (investment bankers)
- Investors to securities products (banks, institutional investors and individual investors)
- Servicer recovering principal and interest of loans from SMEs
- Trustee distributing principal and interest recovered from SMEs to investors（banks and trust companies）
- Credit enhancer of securities products (credit guarantee institutions, etc)
- Rating agency for securities products
- Lawyer

There could be varieties in the above scheme. For example, banks, themselves, continue to recover principal and interest instead of letting servicers do the operation. It could happen that the credit enhancer extends guarantees directly to loan originators instead of guaranteeing securities products.

The produced securities are called Collateralized Loan Obligations (CLOs) since loan assets with collateral are converted to securities. As a similar product、 there are Collateralized Bond Obligations (CBOs). SMEs issue private placement bonds and banks underwrite them. The SPCs buy them from the banks, transform them into new securities with these bonds and sell them to investors through investment bankers.

Figure 2.2. 3. Securitization



4) Tokyo Metropolitan Government's initiative

The reluctant attitude of commercial banks towards SME loans urged the Tokyo Metropolitan Government to launch the initiative for SMEs who are one of the major economic sectors in Tokyo. SMEs located in the Tokyo Metropolitan area suffered from fund shortages in 2000 because commercial banks were forced to maintain their capital adequacy level at BIS standards and refrain from expansion of loan assets, and, as a result, they begun to make stringent loan policies with regards to SMEs, whose risk was relatively high compared to large enterprises (see Box 2.2.3.). Facing SMEs' difficulties in getting sufficient funds to carry out their daily activities, the Government decided to save these SMEs through securitization.

Box 2.2.3 Loan asset reduction by Japanese banks

In the course of the bubbled economy, Japanese banks competed to expand their loan assets since it brought about profits. As a result, their equity ratio plunged sharply. Faced with the stringent BIS regulation, they begun to reduce their loan assets after the burst of the bubbled economy. For example, under situation that a bank maintains 8% capital adequacy level, if the bank has a bad loan of X, in order to maintain the level, the bank has to reduce loan outstanding amounting 11.5 times. The first victims for Japanese banks' loan assets reduction were SMEs because most of large companies were too big to be bankrupt and were dealt as core customers of large Japanese banks. This means that large banks' sound financial condition is so important for expansion of SMEs finance.

In March 2000, under the Government initiative, the first securitized products, CLOs, were developed and sold in the market. Since then, CLOs and CBOs amounting to 380 billion yen were issued for SMEs in five installments with the collaboration of representative financial institutions. The details are shown in Table 2.2.7.

Table 2.2.7. Securitized SME loans or bonds

	First issue	Second issue	Third issue	
Issuing year	Mar.2000	Mar.2001	Mar.2002	
Type			A	B
Amount (billion Yen)	69.42	32.48	83.08	5.01
No. of SMEs participating	1,715	952	2.313	176
Financial institutions involved	Citybanks, Shinkin bank Securities house	City banks, Shinkin bank	City banks, Shinkin bank Shoko Chukin	City banks, Security houses
Interest rate on loan per annum (%)	3.14	2.67	2.47	2.92
Type of issue	CLO (PP)	CLO (PO)	CLO (PP)	CLO (PP)
Max. of loan to each SME (million yen)	50	50	80	50
Term	3 years	3 years	6 years	1,2 or 3 years
Remarks			Collateral for BOJ's open market operation	Without fiscal burden on the Tokyo Metropolitan government

	Fourth issue			Fifth issue		
Issuing yea	Mar.2003			Mar.2004		
Type	A	B	C	A	B	C
Amount (billion yen)	46.06	52.04	15.06	41.54	34.31	4.4
No. of SMEs participating	688	1,426	189	344	1,093	111
Financial institutions involved	Banks	City banks, Sinkin bank Shoko-Chukin	Banks	Banks	City banks, Shinkin bank	Regional banks, Security houses
Interest rate on loan per annum (%)	2.93	2.807	2.57	Multiple depending on term	2.5	2.6
Type of issue	CLO (PP)	CLO (PO)	CBO (PO)	CLO (PP)	CLO (PP, PO)	CBO (PP)
Max. loan to each SME (million yen)	100	80	100	1,000	80	100
Term	3 years	5 years	2 years	6 months, 1 year, 2 years	5 years	2 years
Remarks	Without fiscal burden on the Tokyo Metropolitan government	Collateral of BOJ's open market operation	Collateral of BOJ's open market operation		Sell to citizens in Tokyo	CBO led by regional banks

Source: Finance Div. , Industry and Labor Dept., Tokyo Metropolitan Government

Note: PP: Private placement,

PO: Public offering

The following table compares the characteristics of SMEs participating in the above securitization scheme.

Table 2.2.8. SME characteristics

	CLO	CBO
Sales (million yen)	Less than1,000	Less than 5,000
No. of employees	11-30	More than 100
Operation years	20 years	20 years
Age of president	50-60 years	50-60 years
Capital (million yen)	Less than 30	Less than 100
Rating by Teikoku Data Bank (Score)	53	60

Among the above CLO and CBO, ones to be specifically noted are the third issue (A), the fourth issue (B) and (C) because bond holders of these CLOs are entitled to borrow money from the Bank of Japan by rendering them as collateral in case the holders are financial institutions. They are selected as suitable collateral for open market operations and, therefore, their liquidity is very high. It means that the Bank of Japan indirectly supports the development of SMEs. The Bank of Japan took a similar policy previously, after the end of the World War II, even though selected bonds were those issued by large corporations (see Box 2.2.4).

Box.2.2.4 Bank of Japan's loan and open market operation under collateral of bonds

In 1946, the Bank of Japan adopted a policy for fostering the bond market that was destroyed by World War II. BOJ's policy was composed of the following two aspects. One was to extend loans to commercial banks as collateral bonds that the BOJ designated under the same terms and conditions when government bonds were provided. The other was to designate these bonds as collateral for open market operations.

c) Recent developments

Being stimulated by the Tokyo Metropolitan Government's initiatives and its success, other local governments followed by launching similar programs. Fukuoka prefecture securitized a total amount of 14 billion yen in loans to 600 SMEs in July 2002, while Osaka prefecture securitized a total amount of 91 billion yen to 1400 SMEs in May 2003. Osaka city also arranged securities products of a total amount of 28.5 billion yen loans to SMEs in July 2003. Chiba prefecture and Chiba city cooperated in arranging securities products jointly.

d) Issues to be solved for further development

i) Diversification of investors

It is necessary to diversify investors for securities products in addition to current investors such as banks and institutional investors. For this reason, it is necessary to produce securities with low risks as much as possible, which will be easily underwritten by risk averter type investors, mainly individual investors.

ii) Development of products with the least fiscal burden

In the above initiative of Tokyo Metropolitan Government, the Government partly guaranteed the securitized products. However, securitization supported by fiscal burden is not normal. It is necessary to design products, which are not accompanied with fiscal burden or credit guarantees.

iii) Design security without collateral

At this moment, securities are produced by collecting loans or bonds with collateral. It is expected that new securities products will be developed, which are produced by collecting covenant finance loans in addition to traditional collateral loans.

iv) Protection of bond holders

In the case that loans to SMEs are defaulted, the loan originator recovers the loan asset by itself. However, in the case of securitization, who will recover the defaulted bond? If investors for securities products are professional, there will not be serious problems because they know how to behave and recover the asset. On the other hand, if investors are amateurs and are not accustomed with how to recover, an institution, which represents those investors' interests and makes efforts to recover their assets, should be assigned. A new framework for protection of bond holders may be necessary.

In case the bond falls into default, senior investors will receive the dividends first and later inferior investors will be entitled to receive the dividend next. In the case that there is no structure of senior and inferior investors, dividends will be distributed among all investors pro-rata. The problem is who should recover the dividends? It is a financial institution that brought in the defaulted loan asset. In this sense, it is very important that the financial institution bringing in their loan assets should be sensitive to the quality of their loan assets.

Taking examples from the Tokyo Metropolitan Government's securitization, the default rate was high at 6.9% in terms of number of SMEs and 6.3% in terms of loans outstanding in the first CLO issuing. However, the rate improved to 1% in terms of number of SMEs and 0.5% in terms of loans outstanding in the second and third issue. It is attributable to the financial institution's prudence in bringing in high quality loans to SMEs for securitization.

5) Possibility of introducing securities products in China

So long as the following two conditions are to be met in addition to disclosure of financial data on SMEs, borrowers, it is possible to introduce the product to China since its concept is not so complicated.

a) Secure as many investors as possible

In the start of its introduction, a major portion of investors may be banks that are knowledgeable about the products. However, in order for the products to be widely accepted, it is inevitable to cultivate a wide range of investors ranging from insurance companies to individual investors.

b) Good quality of loans originated

Credibility on the bond issued depends on the quality of loans originated by banks. In case the quality is not at a certain satisfactory level, the default rate will become high and confidence on credibility of the product and the scheme will be lost. Once the confidence is lost, it is not easy to regain it. In a usual transaction with no third party, the default will be dealt with between a bank and borrower concerned. However once a bond is issued and traded on the market, the default of the bond will bring about a mess to the market. The responsibility of both the loan originator and SMEs is large.

In the securitization scheme by the Tokyo Metropolitan Government, SMEs credit risk data compiled by Teikoku Data Bank has contributed to lessen the default risk on SMEs and to maintain the stability of the products. The data file includes the following information. The number of companies whose data is filed totals 1,230,000. Access costs to the data is 500 yen for each company. It should be noted that sustainable scuritization is only possible when such an infrastructure is developed.

Table2.2 9. SMEs Credit Risk Data Compiled in Teikoku Data Bank

Item	Content
1. Outline of company	Registration, location, established year, capital, main banks and credit rating
2.Registration, management, shareholders	No. of investors, top management and main shareholders
3.Employee, investment in building and machinery	No. of employees, recruitment plans. sales offices, outline of facilities and insurance
4. Top management	Age. residence and carrier
5. Business group	Affiliate. Subsidiary or group company
6. Recent performance	Production, sales, profit, income and dividend
7. Clients	Buyer, seller, outsourcing, payment schedule and recovery schedule
8. Banks	Principal banks and collaterals extended
9. Cash flow	Non-performing assets, profitability, recovery and terms and conditions of payment
10. Future prospects	Business concept, performance and future prospects for sales and profits
11. Financial statement	Balance sheet, profit and loss account, content of assets and liabilities
12. Registered real estate	Real estate registered

Source: Teikoku Data Bank Homepage

(3) Small and Medium Business Investment Consultation Corporation (hereinafter referred to as SMBICC)

1) Background

SMEs need new capital injection at the expansion stage of their business. However, they face difficulties in getting such capital unless they are listed companies. At the start-up stage, they raise such capital through their relatives and friends. Since necessary capital injection becomes large at their expansion stage, it is difficult for them to rely on their relatives and friends for a substantial portion of the capital, even though they may be able to cover a portion. For the purpose of supplying necessary capital to SMEs at the growth stage, three institutions were established at the initiative of the Ministry of International Trade and Industry (now, Ministry of Economy and Industry, MEI) in the 1960s. They are small and medium business investment consultation corporations in Tokyo, Osaka and Nagoya. This kind of facility will become necessary in the course of SMEs' development in China, too. Here, the activity of Tokyo Small and Medium Business Investment Consultation Corporation (hereinafter referred to as TSMBICC), one of three institutions, is introduced and necessity and possibility of establishing a similar institution in China is discussed.

2) Outline of TSMBICC

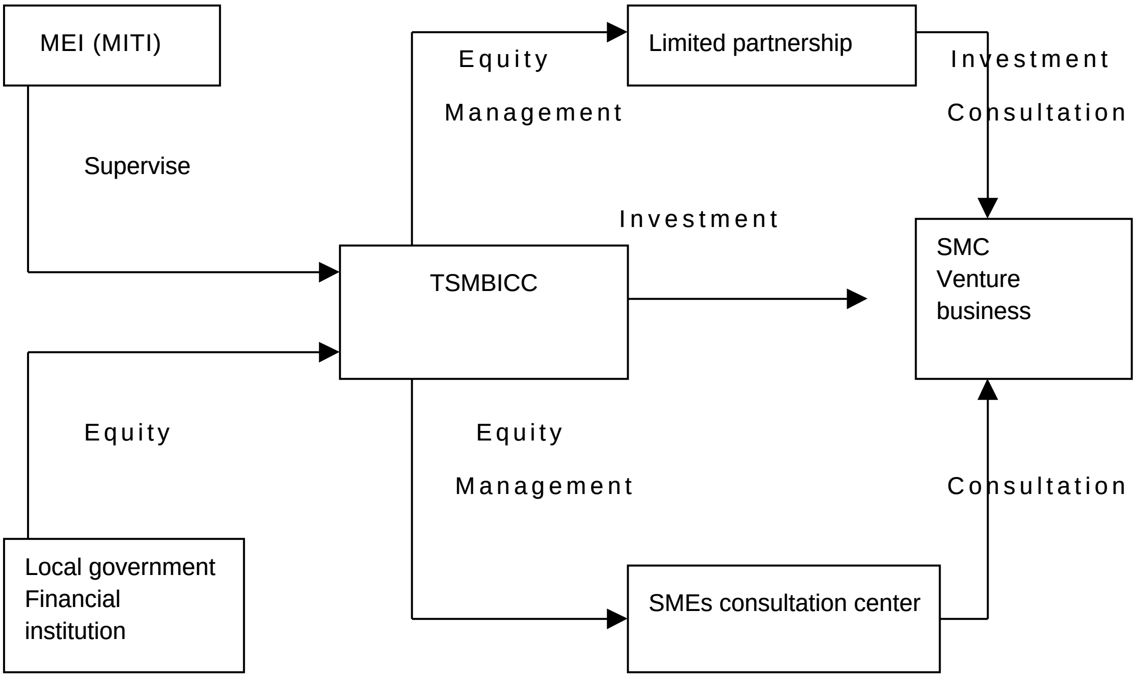
a) History

TSMBICC was established with MITI's initiative and support in November 1963 with a view to promote sound development of SMEs by strengthening SMEs' capital account. Since its establishment, TSMBICC has invested about 70 billion yen in 1,300 SMEs. TSMBICC's history is summarized below. Among its historical development, a change in 1986 should be noted. In that year, the institution was transformed from a semi-governmental institution contributing redeemable stock as equity to a private corporation, even though MEI still maintains the power to control and manage the institution because the corporation was established under a special law, which still prevails today. The president is still dispatched from MEI.

Current business line of TSMBICC is shown in Figure 2.2.4

1963	Established with a capital of 2,500 million yen based on SMBICC law
1965	Added underwriting business of convertible bonds as a new business line
1982	Increased capital to 6,673 million yen
1984	Added investment business in venture business as a new business line
1986	Added underwriting warrant business an a new business line Converted to private corporation
1989	Added underwriting business of shares for newly established company as a new business line
1995	Accumulated number of invested corporations exceeds 1,000
1999	Established the first limited partnership with other SMBICC
2000	Established Tokyo SMEs' limited partnership with the Tokyo Metropolitan
2000	Government
2003	Injected investments into universities who initiate venture businesses

Figure 2.2.4 Outline of TSMBICC



b) Corporate philosophy

Since TSMBICC was established with the government's capital injection, national policy towards SME development is strongly reflected in their corporate philosophy. Despite government intervention fading out after transformation to a private corporation, the institution's philosophy of reinforcing smooth and sound development of SMEs did not change. As an equity investment corporation, it aims to maximize capital gains as well as income gains from dividends. However, it does not necessarily stick to listing of SMEs invested. Further, even after SMEs list in the stock exchange market, TSMBICC does not always dispose its stocks in order to earn capital gains. On the contrary, they continue to hold the shares if invested companies expect TSMBICC to do so. This is their policy. It is quite natural in Japan for SMEs to expect TSMBICC to stay as one of their stable shareholders. Among SMEs where TSMBICC invested, fifty companies had their shares listed in stock markets as of February 2002.

c) Shareholders

Local governments	21.7%
City banks	37.1
Regional banks	14.2
Trust banks	1.6
Shinkin bank	1.5
Corporations	11.8

d) Business area

18 prefectures, including the Tokyo Metropolitan area, located east from Shizuoka, Nagano and Niigata

e) Type of business

Underwriting new shares and warrants issued by SMEs
Consulting services to SMEs on their management

f) Number of employees

95

g) Performance

Table 2.2.10. Performance of TSMBICC

Fiscal year (Apr.-Mar.)	Outstanding investment (million yen)	No of SMEs invested	Ordinary profit before tax (million yen)
1964	462	13	N/A
1970	4,603	157	N/A
1975	8,476	224	N/A
1980	10,545	257	N/A
1985	15,109	349	N/A
1990	22,362	478	N/A
1995	30,612	657	1,595
2000	34,574	789	820
2002	34,006	825	1,047

Source: Home page of TSMBICC

3) Possibility of establishing SMBICC in China

There are equity investment companies for SMEs in China. However, most of them are established to earn capital gains when SMEs become listed companies. Needs for Japanese-style SMBICCs seem to be large. In developing such institutions, it is necessary for central and local governments to extend assistance or support to them. The most important in its operation is the ability of evaluating the future potential of SMEs. This condition will be met in collaboration with companies supplying professional services such as Beijing SME service organizations. A possible concept for SMBICC established in China is as follows.

- Established under a government law
- Equity injector: central government, local governments and financial institutions (central or local governments inject their equity by underwriting redeemable stock)
- Features:
  a) Mission is SMEs' development rather than profit taking (the institution does not dispose their shares in principle even after SMEs become listed)
  b) Gradually move the stress from SME financing to financing for venture business

(4) Special stock market for SMEs: Mothers in Tokyo Stock Exchange

1) Background

Even in Japan, financing sources of the stock market have been limited for SMEs. Percentage share of finances through the stock market in total finances is less than 10% even if SMEs' retained profit is included in the figure. This is because it takes many years for SMEs to list their shares under the current strict conditions. To overcome the situation, a new stock market named Mothers was established in the Tokyo Stock Exchange in 1999. Since the establishment, the number of listed company counts 110. Even though the number is still small compared with those in Section 1 and Section 2 (1582 and 557 respectively; mainly large corporations), it is expected to increase, reflecting the rapid birth of venture businesses.

2) Characteristics

The characteristics of Mothers lies in that SMEs are entitled to list their shares regardless of how many years it has been since inception so long as they satisfy several conditions, whereas only corporations having at least three years worth of operation records are entitled to list in Tokyo Stock Exchange Section 1 and 2. In addition the requirements to be met for listing are relaxed compared with listing in Tokyo Stock Exchange Section 1and 2 as is shown in Table 2.2.10. First, the number of issued shares should be more than 1000. Second, the number of shareholders should be more than 300 for securing liquidity of the shares. Third, their market capitalization should be more than 1 billion yen. Further, the evaluation analysis for listing in Mothers is to be completed within one and half months, while the term is within three months in the case of Section 1 and 2. However, SMEs are requested to disclose their financial records and to hold investor relations meetings every quarter to secure accountability.

Table 2.2.11 Major Requirements for Listing in Tokyo Stock Exchange

	Section 1(Direct listing)	Section 2	Mothers
Number of shares to be listed	100,000 units or more	4,000 units or more	1,000 units or more
Number of shareholders	More than 2,200-4,000 depending on number of shares to be listed	More than 800-1,200	More than 300
Operation years	More than 3 years	More than 3 years	-
Market capitalization	50 billion yen or more	2 billion yen or more	1 billion yen or more

(Source) Tokyo Stock Exchange

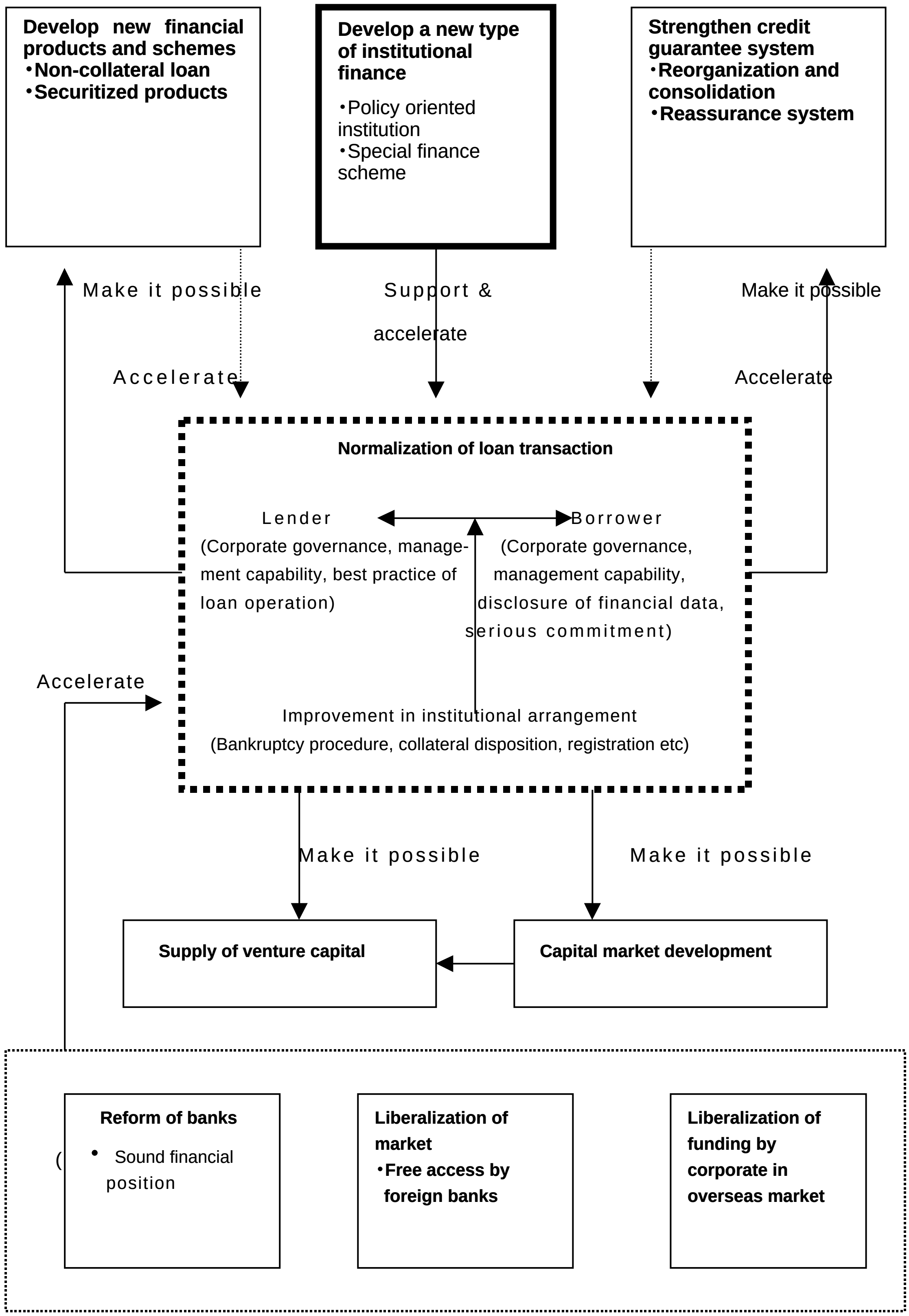
3) Implication to development of similar market in China

Full disclosure of financial data is the key to development of a similar market in China. Since the period between business origination and its listing becomes short, financing through the capital market expands. To develop and improve the market, the Chinese government is advised to accelerate the improvement of the disclosure system.

2.2.4 Strategies for Solving Problems

The problems to be solved for SME development in China cover a wide range of areas from the financial market to capital market. In the financial market, not only daily operation issues but also institutional issues should be tackled. Since each problem requires much time and many resources for its solution, it is necessary to design well-thought strategies in tackling these problems by making the structural relations among these problems clear and by setting priorities for solution. Structure of the strategies to be followed is shown in Figure.2.2.5

Figure 2.2.5. Proposed Strategies



(1) Normalize “transaction with no third party between lender and borrower”

1) Necessity of normalization

The real and fundamental problem for SME financing comes from the fact that a direct transaction between a lender and borrower is not normalized in a sense that the transaction is not always performed in line with international standards. Non-normalization truly becomes a source of an inefficient credit guarantee system and inactive development of new financial products and services. Top priority to smoothen financing for SMEs should be given to the normalization.

To realize the normalization, the borrower should maintain corporate governance, disclose their financial data and be seriously committed. Among others, full disclosure of financial data is by far the most important. Without this, it is difficult to develop a capital market where transaction is performed on the principle of one’s own risk of investors as is stated later. On the other hand, the lender should also maintain their corporate governance and follow the best practice of loan operation. Further the measures mentioned in 2.3&2.4 should be followed. The Government should support the efforts for the normalization on both sides by arranging and improving related infrastructure such as the disclosure system of corporate information, disposition system of collateralized assets in the event of default, and bankruptcy law. Among various infrastructures to be developed or improved, top priority should be given to protection of lenders’ right in their loan to SMEs.

In accelerating the normalization, it is advised for Chinese banks to improve their financial operation under international banks’ assistance. Finance operations for SMEs are different from those for the financing of large corporations in each area of credit evaluation, supervision of loan proceeds and recovery of loans. Specific know-how is needed to handle these matters smoothly. It is recommended to invite experts in financing for SMEs from foreign countries and let them transfer their know-how. The most important is to follow current best practice in operation ranging from research, credit evaluation, loan proceeding, recovery and disposition of collateral.

There are many financial institutions that are specialized in financing for SMEs and record good performance in foreign countries. It is advised for the Chinese government to give them free access to the Chinese SMEs finance market. The advantages are the following two. One is that they will stimulate domestic financial institutions through competition with them and the other is that they will bring in know-how in financing for SMEs, development of new products and services and new business model for SME financing.

Only with the above normalization can new products and schemes be developed or improved in financing for SMEs. To present some examples, the credit guarantee ratio will be increased and syndicate loans will be easily introduced. In addition, new products such as securitized products and loans based on fiduciary transfer of movable assets are developed. In the capital market, new financial products such as private placement bonds with warrant or loans with warrant could be introduced (see Box 2.2.5 & 2.2.6). At the same time, it is expected financial institutions do every effort to develop new financial products and services even on condition that the least disclosure of financial data is available from borrowers.

Box 2.2.5 Examples of new products recently developed in Japan

- Loan with warrant: low interest rate and non-collateral
- Private placement bonds with warrant: low bond yield
- Covenants finance: non-collateral
- Securitization: partial collateral
- Scoring typed loan: portfolio management of loans
- Syndicated loan: risk dispersion

Box 2.2.6 Fiduciary transfer of inventory

SME extends its inventory to a financial institution as collateral for loans. The inventory is kept in the SME's warehouse in order to save cost for transferring them to the warehouses of third parties, and managed by an asset management company, which is designated by the financial institution. The financial institution pays a fee to the asset management company for their task and transfers it to the borrower, the SME. In this sense, the collateral is fiducially transferred. Fiduciary transfer cases are seen in base metal of copper, tobacco leaf and Japanese sake

2) Reduce transaction cost in disposition of collateral

It is indispensable to reduce the transaction cost pertaining to the disposition of collateral. For the purpose, it is necessary to analyze why the cost is high by paying attention to the duration required for each operation and their unit cost.

(2) Strengthen state-owned banks' management capability

1) Upgrade and maintain state-owned banks' financial strength

For expansion of loans for SMEs, state-owned banks have to strengthen their financial position by injecting new capital and maintain their capital adequacy level at international standards. If necessary, the central government will have to inject fresh money to them in addition to capital injection by foreign banks. Similar measures were taken in Japan in 1998 (see Box 2.2.7).

Box 2.2.7 Capital injection to major city banks by central government in Japan

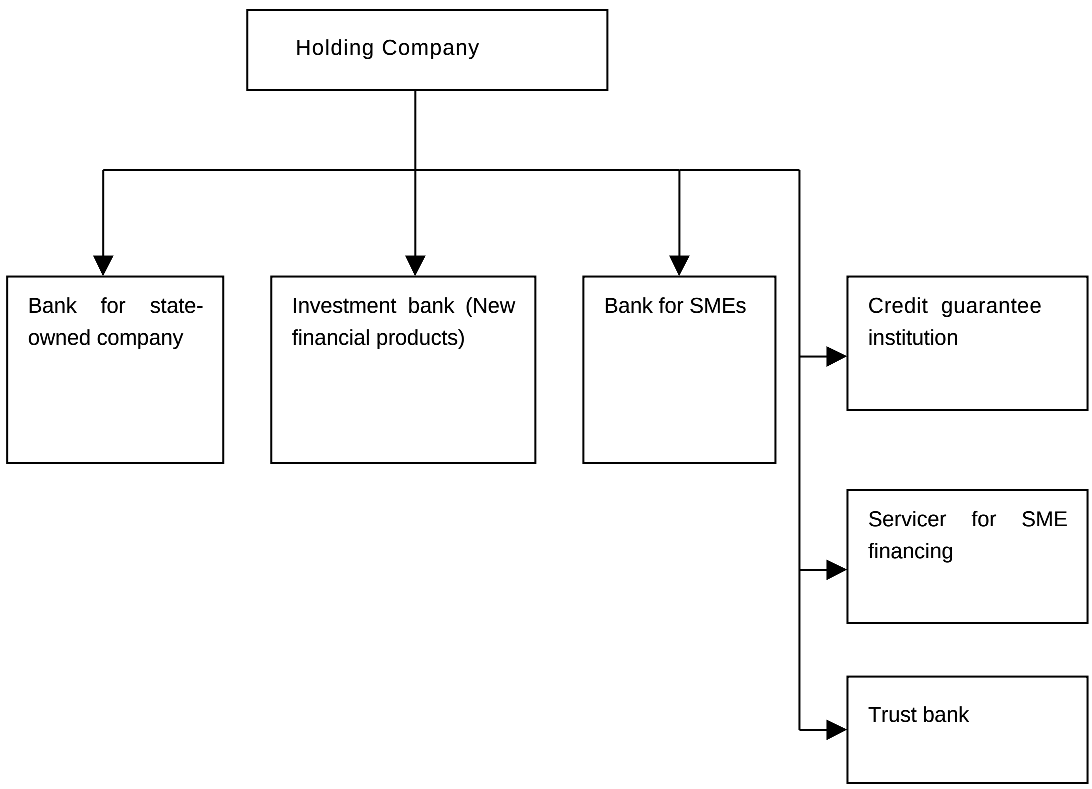
The central government injected around 7,500 billion yen in total to 15 banks in Japan in 1998.
The government urged these banks to accept the capital in fears of these banks becoming extremely reluctant to expand their loan under the burst of the bubble economy and that these banks' action will limit corporate financing, not only for large companies but also SMEs. Initially, these banks were reluctant to receive government funds because the Ministry of Finance controls them once they receive the funds. The Industrial Bank of Japan decided to accept the capital in due consideration of the possibility of the banks' reluctant attitude leading to it becoming an obstacle to the speedy recovery of the economy. Other major banks followed IBJ's decision and a financial crisis was avoided.

2) Business development under a holding company

This involves the establishment of a new holding company and a new financial institution specialized in financing for SMEs under the company as one of its affiliates (see Figure. 2.2. 6). The aims are two fold. One is to specialize in financing for SMEs by separating SME financing from state-owned corporation financing. The action will facilitate the state-owned bank to have two hats, one for large state-owned corporations and the other for SMEs. By doing so, the bank still acts as a core and institutional bank for state-owned corporations. The other aim is to retain profits gained from financing for SMEs as much possible within the company. Such a strategy is necessary because financing for SMEs will not yield such high profits considering their financial risk. By establishing such related institutions as venture capital and credit guarantee companies under the holding company, the holding company secures every kind of profits ranging from capital gains to various fees.

As for the credit guarantee function, it could be considered to be one form of investment banking business. There are assumed to be two types of credit guarantees. One is provided by an institution specialized in the business based on the principle of probability. The other is provided by investment banks based on a specific relation between the client and the bank. In the latter case, the client discloses the financial data and information only to its main bank. In China where borrowers are reluctant to disclose their information to the general public, this scheme seems to be useful. Actually, some credit guarantee companies extend their guarantee services to their clients with prudent credit analysis of the clients, even though their business is done based on the principle of probability.

Figure 2.2.6 Function of a Holding Company



(3) Create institutional finance

1) Set up financial institutions specialized in financing for SMEs

Normalization of “transaction with no third party between a lender and a borrower” is extremely important but that is not all. It is impossible to solve every kind of problem pertaining to financing for SMEs with “normalization”. It is because there exists a bias between credibility of large corporations and that of SMEs, which is not dissolved by market mechanism. Banks tend to evaluate that loans to large corporations is less risky than those to SMEs. Therefore under the economic situation where the economy expands and every company rushes to financial markets to get funds for expanded business due to underdevelopment of capital market, SMEs are easily crowded out by large corporations in financing. To mitigate the situation, a special institutional finance scheme should be designed for SMEs.

Even though market mechanism is in the main stream, under the condition that vast disparity in economic condition prevails among the East and Central region and the Western region, it may be necessary to set up a special channel for SME financing in these handicapped areas. From the regional viewpoint too, it will be needed to set up a special institution, which provides funds to SMEs in the western region.

As one measure to strengthen financing for SMEs, it is suggested to set up financial institutions specialized in SME financing. However, since institutional finance requires a considerable amount of money and taking into consideration that fiscal burden should be minimized, the institutions will be set up mainly with private funds. The government injects some money as a catalyst of such an institutional finance through extending a part of equity, dividend guarantee, a part of loaned money and subsidy on interest paid by SMEs.

Under these conditions, a new model of institutional finance named “China model” should be developed. Key concepts are region-oriented and private sector initiative. As for the type of such an institution, the following concept may be considered.

- Established under a special law having a termination clause
- Main business: “Market typed ”intermediary function
  ---Raise necessary funds through bond issuing in capital market and extend the funds to SMEs
  ---Securitize the loan assets and sell them to investors in capital market
- Type of the institution: relationship banking
- Expertise: both financial market and capital market

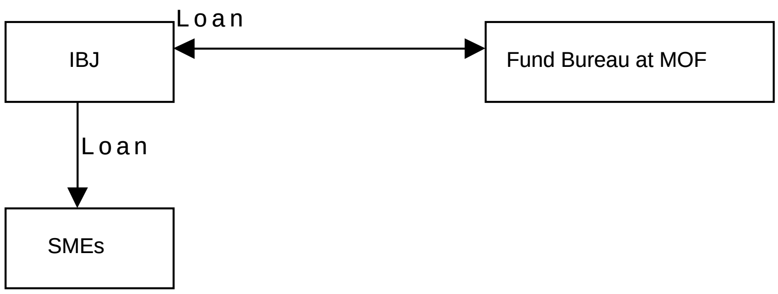
2) Create a new institutional finance scheme

Depending on necessity and specifying purpose, amount and term, the state-owned banks extend loans to SMEs. The funds will be specifically supplied by the Ministry of Treasury. The finance should be only temporary because it is extended for some specific emergency purpose (see Box 2.2.8).

Box 2.2.8 Institutional finance in Japan

After World War II, three government financial institutions were established for SME financing and they have supplied institutional finance to SMEs depending on its necessity. Before then, the Industrial Bank of Japan (IBJ) played a key role in institutional finance to SMEs. The scheme was not complicated. IBJ issued special bonds for SME financing and the Fund Bureau at the Ministry of Finance underwrote the bonds. Using these funds, IBJ extended loans to SMEs. In this scheme, two facts should be noted. First, the scheme was used only temporarily depending on such necessities as anti-depression, reconstruction after the great earthquake in the Kanto region and transformation of SMEs to wartime business in World War II. Second, both coupon rates on the bond and lending rate to SMEs were set lower than the market rates. Lower rates became possible because the original funds are government funds, which were collected from nationals as savings.

. Bond issuing and underwriting



(4) Accelerate infrastructure development for capital market

1) Improvement of disclosure system

One of the infrastructures to be developed is a disclosure system. In capital market transactions, investors participate in the transaction looking for detailed information on related financial data of the issuing company. If the information is inaccurate, investors will not gather the market and capital market transaction will decay. It is no exaggeration to say that development of the capital market depends on maturity and completeness of the information disclosure system.

2) Bond market

Priority should be given to the improvement of the bond market. Since the government bond and debenture market already exists, it is not so difficult to improve the market. Keys are to improve the disclosure of corporate financial data, reduce issuing cost and develop a secondary market where issued bonds are sold and bought. It is also necessary to foster institutional investors who hold bonds since financial institutions are main investors but are not in a position to absorb all the issued bonds. Development and improvement of the bond market will facilitate the diversification of financial products such as securitization of loan assets and receivables.

3) Special stock market for SMEs to become listed

It is necessary to develop and improve the stock exchange market for SMEs. SMEs need a special market where they can list their shares at earlier stages after their establishment. It is recommended to design and create such a market. Referring to Japan's Mothers market, the market should be designed considering the following three points. One is to ease listing criterion as much as possible. Second, on the other hand, disclosure of financial records should be as strict as possible. Third, time required for listing examination should be shortened as much as possible.

4) Strengthen equity investment institution

This kind of institution is needed by SMEs who are at an organic growth stage but are not financially strong enough to list their shares in the stock market. It is said that local governments have established such funds in China. It is necessary to strengthen their function. In addition to the traditional type of equity investment institutions, which aim to maximize their profit with capital gains, such a new type of TSMBICC referred before should be designed.

(5) Free access to international market by large Chinese companies

Free access to international markets by large corporations facilitates easier access to the domestic market for SMEs. This is because large corporations are able to raise necessary funds from not only the domestic market but also international markets. If there are any restrictions on access, it should be gradually lifted. It is clear from Japan's experience of the financial deregulation in the later half of 1980's how this kind of deregulation served to mitigate "crowding out" phenomenon in SMEs finance (see Box.2.2.1).

(6) Reform of current credit guarantee system

For strengthening the existing credit guarantee system and for its better use, it is to be reorganized and consolidated. In addition, a reassurance system should be created. Section **2.5 Reform of Credit Guarantee System** shall be referred to for details.

2.3 Management and Financing Issues of SMEs and Public Support

2.3.1 Main financial problems in the development of SMEs

Financial and management problems of small and medium enterprises (SMEs) in China will be observed and summarized as follows. These analyses are views and opinions of the publication "China's Small and Medium-sized Enterprises' Development and Prediction during 2002-2003" planned and compiled by the researchers of the Small and Medium-Sized Enterprise Department of the State Economy and Trade Commission and others.

(1) Definition and the status of SMEs in China

The Chinese government revised the definition of SMEs in 2003. The new definition covers a wide range of businesses, including manufacturing, construction, transportation / communication / distribution, postal service, wholesale and hotel / restaurant.

The new definition classifies SMEs based on the number of employees, sales amount and capital size. In manufacturing, small businesses are defined as businesses employing no more than 300 or sell no more than 30 million yuan or capitalized no more than 40 million yuan.

Medium businesses are defined as businesses employing no more than 2,000 or sell no more than 300 million yuan or capitalized no more than 400 million yuan. Large businesses are defined as businesses employing more than 2000 and sell more than 300 million yuan and capitalized more than 400 million yuan.

According to the researchers of the Small and Medium-Sized Enterprise Department of the State Economy and Trade Commission, small businesses have 89.04%, medium businesses have 10.1% and large businesses have 0.86% share in all line of businesses.

(2) Management problems of SMEs

1) External problems

a) Social and policy discrimination

The current policy is unfair for SMEs. For example, preferential policies on taxation, financing and land usage are given to large-scale companies. Those SMEs that perform well cannot achieve listing on the stock market. China's capital market is dominated by large enterprises with governmental backgrounds.

b) Credit and financial discrimination

SMEs receive prejudice from financial institutions for their smaller size and inferior trustworthiness. It is estimated that nearly 80% of the loans from State-owned banks since 1978 are provided to State-owned enterprises. For SMEs, financing is very difficult. For example, banks require joint guarantee when granting loans to SMEs, but small companies often cannot meet this requirement. As a result, a shortage of funds has become a main headache for the development of SMEs.

c) State-owned enterprises' difficulty in re-organization according to the modern corporate system

Public-owned SMEs are in a disadvantageous position in terms of competition. They neither enjoy advanced equipment and preferential policies like State-owned large enterprises, nor are they flexible like private businesses. Public SMEs meet a lot of problems in re-organization in accordance with the modern corporate system, in attracting foreign investment, arranging laid-off workers and dealing with loans.

d) Irregular competition

Over and vicious competition exists in China's current market economy. A method of offering abnormally low prices is used by some enterprises to enhance market share. Some even conduct vicious dumping on overseas markets to win over domestic competitors. Large enterprises often delay in paying their small and medium suppliers.

e) Irrational management system

Operation systems of State-owned SMEs are out of date, with characteristics of the planned economy. There is also no organization responsible for supervising SMEs for long. As a result, there has been no policy to promote the development of SME.

f) Lagging social service system

The current intermediary organizations cannot meet the requirements of enterprises. Meanwhile, SMEs cannot afford the high fees of intermediary institutions.

2) Internal problems

a) Improper management organ

Taking joint-stock companies as an example, SMEs suffer from various contradictions, such as between shareholders within and outside of enterprises, as well as among employers having different amounts of shares.

SMEs lack efficient systems of incentives and disincentives for unclear ownership and mixing government functions and enterprise management. Backward systems result in out-of-date management methods. At some private businesses, modern management methods exist with traditional household management.

b) Low management level

According to an investigation by a State-owned commercial bank of its clients, nearly 52% are in the red. Non-performing loans of SMEs accounted for 41.7% of the total figure of loans issued to SMEs and 73.1% of the bank's total non-performing loans. SMEs owe two thirds of the total interests not received. Furthermore, some public-owned SMEs use various methods to avoid banking debts.

c) Lack of research and development (R&D) capability

Most SMEs use equipment produced in the 1970's and 1980's. The reason why SMEs do not pursue technological innovation includes inadequate investment, lack of skills, out-of-date equipment and technology, weak competitiveness and slow reaction to the information era. Meanwhile, many SMEs are ignorant of international items, such as patent protection and electrical commerce.

d) Lagging in modern management systems and human resource development

There is not enough policy measures on the development of SMEs in China so far, reflecting the fact that the country does not attach great importance to their development. This is in spite of the facts both at home and abroad that prove the national economy is supported by SMEs, instead of large companies under the protection of the government.

Economic policy to guarantee development of SMEs will create more working posts and enhance the economic development. China's SMEs, especially private ones, are short of necessary skills. Most of the owners have little idea of how to run their businesses in the market economy for lack of relevant professional knowledge, especially in marketing, public relations and exploring the international market. Furthermore, China's SMEs are short of engineering staff and professional managers.

(3) Problems in fund raising and financial management of SMEs in China

Problems in fundraising and financial management of SMEs in China will be summarized as follows.

1) Many SMEs have no experience of fund raising from financial institutions. Many SMEs are not aware of the banks' requirements on granting loans in need of funds. Professional guidelines are needed for SMEs for various financing methods.
2) Almost all small businesses and newly established businesses are procuring funds for business from their private sources not from financial institutions. Due to a lack of financial sources, SMEs tend to rely on their own funds or support from their friends and relatives.
3) In cases where SMEs have transactions with financial institutions, it is limited to short-term loans. It is not easy to raise long-term funds for equipment investment and operating.
4) The financing gap between SMEs and financial institutions will be explained by the Chinese corporate ownership system and land ownership system. SMEs have little property for mortgage. Furthermore it is difficult for SMEs to find proper guarantors.
5) SMEs are at the first stage of establishing a modern corporate system and internationalization.
6) SMEs’ lack of credibility from financial institutions and lack of a credit information system.
7) Lack of intermediary organizations and consulting organizations between clients and financial institutions.

(4) Solutions for the financial gap of SMEs

Key factors to solve current financial problems of SMEs are as follows:

- Sound accumulation of capital and shareholders' equity funds
- Financial management based on cash flow statements
- Disclosure of corporate management and strengthen relationship with financial institutions
- Public support system for SMEs on financial management

1) Fund raising and fund operation of SMEs

<Fund operation>

Equipment investment, securities investment, working capital, extraordinary loss

<Fund source>

Retained earnings, securities, long-term loans, short-term loans, notes and accounts payable, sale of equipment, sale of current assets

The major items to be studied and to analyze the actual state of financial management are as shown below.

a) Sound accumulation of equity capital (capital and shareholders' equity funds)

Equity ratio = equity capital / total assets, Debt ratio = debt capital / total assets
Leverage ratio = debt capital / equity capital

b) Operating funds

Net working capital = Current assets for operation – Current liabilities for operation
= [Trade receivables (bills receivable / accounts receivable) + Inventories] – Trade payable / accounts payable)

Causes of and reasons for producing demand for net working capital are as follows:

c) Increase in net working capital

Increase in sales
Decrease in sales
Longer turnover conditions
Longer turnover period of inventories
Shortening of payment conditions

d) Equipment funds

Investment purpose and effect, Calculation of actual redemption capacity
Fixed assets ratio = fixed assets / equity capital
Ratio of fixed assets long-term capital = fixed capital / (fixed liabilities + equity capital)

e) Assessment of investment plan

Calculation of ‘Economic effects of investment’ and ‘Increased amount of fixed costs’
Marginal profit, Interest payment, Estimated depreciation cost for the equipment of this time, Increased amount of fixed costs

Study of long-term capital and annual redemption resources:
Long-term capital (annual) = long-term borrowings + deferred bills + accounts payable facilities, bills payable / annual redemption resources

Calculation of annual redemption resources = (ordinary profit before depreciation – normal depreciation expenses)*50%(tax) + normal depreciation expenses

Calculation of actual redemption capacity and period:
Actual redemption period = current (long-term borrowings + deferred bills for equipment + accounts payable for equipment) + borrowings this time / actual redemption resources

2) Financial management and analysis

Major items to study on financial management are as follows.

a) Cash flow management analysis

Turnover period (Bills receivable, Accounts receivable, Inventories, Bills payable, Accounts payable)

b) Profit and loss management analysis

Profit and loss management based on sales and cost analysis; Financial management based on revenue and expenditure analysis

c) Cash flow statement

Operating activities + Investing activities + Financial activities
Cash flow statement
(Structure of cash flow statement)
Operating activities + Investing activities + Financial activities

d) Operating activities

Cash received from customers, rentals received, interest and dividends received, merchandise purchased and paid, operating expenses paid, interest paid, cash paid for taxes on income

e) Investment activities

Proceeds from sale of trading equity securities, proceeds from sale of investment securities, cash paid for purchase of trading securities, cash paid for purchase of trading securities, cash paid for equipment

f) Financial activities

Proceeds from sale of additional stock, repayment of short-term notes payable, repayment of long-term loans payable, cash dividends paid

g) Important factors for cash flow management:

Retained earnings
Turnover period of working capital
Balance of ordinary account and extraordinary account

h) Improvement of cash flow management

Turnover period (Bills receivable, Accounts receivable, Inventories, Bills payable, Accounts payable)
Sale of assets (inventories, accounts receivable, equipment)
Advances from customers
Net income margin

(5) Disclosure to encourage better relationships with financial institutions

SMEs are required to disclose a wide range of information about their business operations and financial position in order to win broad understanding and support of financial institutions. Also, it is recommended to popularize financial knowledge. Many SMEs in need of funds are not aware of banks' requirements on granting loans. Professional guidelines are needed for SMEs for various financing methods.

Important points for corporate disclosure will be as follows:

1) Leadership of management, grasping the actual status and credibility
2) Business line and business trends
3) Results of operation, financial statement
4) Income statement, cash flow statement
5) Current business transactions
6) Profit and loss, actual state of business
7) Collateral, fund raising capacity

(6) Government and private support system for SMEs

Establish intermediary organizations for SME financing. They should perform better in negotiations between banks and SMEs in case of recommending loan clients to banks and conduct pre-loan appraisals with banks. Other types of intermediary organizations such as consulting firms and accountant firms are also needed.

Comprehensive guidance and support systems for SMEs should be developed, focusing on the following aspects:

1) Supply of long-term loans for equipment investments
2) Financial management, cash flow management

3) Information service on business management and business strategy

4) Credit analysis and loan system specifically for SMEs

5) Corporate analysis, creditworthiness and disclosure

6) Information network

7) Guidelines for SME management and financial statements

8) Arranging meetings and organizing SMEs

2.3.2 Financial Issues of SMEs and the Roles of Financial Institutions for SMEs

(1) Financial issues of SMEs in China

1) Almost all private SMEs are newly established businesses in and after the 1990s
2) Turnover periods of receivables are about 20 days longer than those of payables
3) Positive in business and investment thinking without financial support
4) 29% of SMEs are operating without cash flow statements
5) 60% of SMEs are provided follow up advisory services after raising funds from financial institutions
6) Credit guarantee institutions are not favorable for SMEs in credit analysis procedure nor financing costs

SMEs depend heavily upon short-term financing. This tells, on the other hand, the difficulty for them to raise long-term funds, which we will see also from the viewpoint of financial institutions. The long-term financing of SMEs is the field in which private financial institutions are most unwilling to be engaged.

The difficulty in raising long-term funds suggests that the lending in the field needs to be fostered from a point of view that involves the development of the national economy.

These facts imply the importance of the establishment of government financial institutions specialized in SME financing as a supplement to private banks.

Many countries have set up special policy financial organizations for SMEs and granted preferential loans and other policy loans to SMEs.

(2) Government Financial Institutions and their Role in the Japanese Economy

The following is an analysis of the role and function of the government financial institutions specifically organized for SMEs in Japan.

a) Outline of Japan Finance Corporation for Small and Medium Enterprise (JASME)

Japan Finance Corporation for Small and Medium Enterprise (JASME) is a wholly-owned government financial institution whose task is to supplement the role played by private financial institutions by providing SMEs with long-term, fixed-interest funds in accordance with Japan's Small and Medium Enterprise Policy.

(This chapter is based on information and data from JASME home page and annual report.)

JASME provides financing for SMEs via two routes. First, it extends direct loans and accepts corporate bonds through its head office and branches. Second, it extends agency loans through the head and branch offices of virtually all private financial institutions nationwide.

Since its establishment, JFS has drawn the funds it requires for financing SMEs from the Fiscal Investment and Loan Program (FILP) and other sources.

In addition to government-guaranteed bonds JFS started to raise funding through fiscal funding from fiscal 2001 in line with the reform of the FILP system. From fiscal 2002, it will also adopt a more proactive response to the spirit of the reforms by raising funds through issues of FILP agency bonds, which are not guaranteed by the government.

b) Characteristics

i) Long-term financing

After providing successful applicants with funding according to their medium and long-term needs, JASME follows up by playing a fair and impartial role in actively supporting the growth and development of its clients' businesses, offering information and advice on dealing with management problems.

In addition to providing long-term funding, JASME adopts a broad and flexible approach toward easing existing loan repayment conditions as a means of alleviating clients' short-term cash management problems.

ii) Information providing

JASME provides SMEs in an individual, customized manner, with effective and useful information that is based on analytical know-how accumulated over the years and on a customer database of 50,000 companies nationwide.

Adopting a fair, impartial and long-term viewpoint JASME offers funds and information on how to make optimal use of the funds, in order to support the growth and development of SMEs.

It also assists with efforts to revitalize regional economies and industries through close cooperation with local governments and organizations

c) Special character of JASME in financing

i) Specialized in long-term financing

Compared with larger businesses, the fund-raising options available to SMEs are limited because of difficulties in procuring funds from the capital markets and other problems. For this reason, access to long-term and fixed-rate funding is essential for the stable growth and development of SMEs.

ii) Stable supply of long-term and fixed-rate funds

While private financial institutions are often not in a position to provide SMEs with the long-term loans they need to continue playing a key role in Japan's economy, JASME is well positioned to provide them with a stable supply of such funds irrespective of their financial situation.

iii) Providing various types of finance to meet the needs of the times

In accordance with the government's Small and Medium Enterprise Policy, JASME offers a variety of special loan facilities to meet the growing and increasingly diversified needs of SMEs.

The globalization of economic activity and progress in deregulation are fueling dramatic structural changes in the Japanese economy. JASME actively supports SMEs that take a positive approach to dealing with these changes and strives to develop new businesses and revitalize their existing businesses using unique technologies and know-how.

JASME also serves as a safety net for SMEs that find it difficult to cope with rapid changes in the financial environment. In addition to providing higher levels of support and offering various kinds of special emergency loans in line with the economic stimulus packages introduced by the government, it has established various special consultation desks.

iv) Evaluating Business Potential and Providing Backup for New Enterprise and Management Innovation

Since SMEs tend to demonstrate a strong entrepreneurial spirit and a sense of creativity in setting up new enterprises and management innovation, they play a vitally important role in revitalizing the Japanese economy as it strives to cope with the massive changes that now confront it.

Generally speaking, however, most of these SMEs find it very difficult to obtain loans from private financial institutions. Few of them have been in business long enough to compile impressive track records, and in addition to lacking adequate collateral, they pose serious problems when it comes to assessing their business potential.

With its sure eye for SMEs, JASME is skilled in assessing the viability of new initiatives. Even new ventures that are unable to provide adequate collateral are usually covered. After taking their business potential into consideration, JASME is often able to employ Loans that Foster New Business with High Growth Potential, as outlined below, and provide funds with collateral exceptions.

Nor does the support end after the loan has been made. The JASME head office works very closely with its branches to back up the development of new businesses by offering the advice and information they need to solve the various management problems that invariably arise.

v) Safety net for SMEs

JASME also serves as a safety net for SMEs that find it difficult to cope with rapid changes in the financial environment. In addition to providing higher levels of support and offering various kinds of special emergency loans in line with the economic stimulus packages introduced by the government, it has established various special consultation desks.

vi) Over 500 clients listed on stock exchange

As a government financial institution specializing in long-term finance, JFS is involved in long-term transactional relationships with clients that sometimes extend over 20 or even 30 years.

Over these periods, it helps to foster its clients by ensuring that they have access to the timely, stable funding they need at each stage of their growth, while continually providing them with useful information and management advice on how to resolve their management problems, a result of these efforts in the area of fostering SMEs, the number of companies that have successfully listed on stock exchanges or over-the-counter markets with the aid of transactional relationship with JFS amounts to over 500.

vii) Cooperation with Regional Financial Institutions to Enhance Relationship Banking Functions

The Financial Services Agency released its Action Program Concerning Enhancement of Relationship Banking Functions in March 2003, to revitalize SMEs and local economies. Regional financial institutions are to create a Plan for Enhancing Relationship Banking Functions by the end of August 2003, and are requested to concentrate on enhancing such functions by fiscal 2004.

JASME will utilize its wealth of credit appraisal expertise and an extensive database covering about 50,000 companies nationwide accumulated over many years to enable smoother funding for SMEs by helping to enhance regional financial institutions' relationship banking functions.

JASME will cooperate with regional financial institutions in such fields as supporting establishment of new companies and businesses, prompt business revitalization, management consultation and proposals for improvement, and cooperating in human resource development.

d) Special character of JASME in providing information

i) Providing effective and useful information

In the process of arranging loans and other financial support, JASME uses the data and analytical know-how it has accumulated over years of service as a financial institution specializing in SME loans to carry out management studies and provide its clients with as much feedback as possible.

JASME maintains close dialog with applicant companies and provides them with appropriate advice on dealing with management problems. After loans and other financial support have been arranged, JASME remains closely involved in ensuring that the funds are used with maximum effectiveness. In particular, it offers clients the crucial information necessary to ensure their continuing development, taking care to tailor it to each company's individual management requirements.

In order to provide SMEs with the systematic support they need to solve the various management problems they face during the long-term growth process, JASME has established the RIP System. This unique business support system draws on a database containing information on approximately 50,000 SME clients.

ii) Characteristics of business information service

Provides effective and useful information through "RIP" operations support system, based on a nationwide database covering approximately 50,000 clients

Helps find and nurture business opportunities through a client network

Provides appropriate advice with "a sure eye for business" as an expert in SME finance.

RIP: RIP illustrates JASME's stance of striving to assist client companies to grow and develop by building mutual trust with customers through dialogue (**R**elationship), maximizing the use of both parties' know-how (**I**ntelligence), and actively making suggestions (**P**roposal).

iii) Business information service

JASME provides information and advisory services that make effective use of management know-how and examples accumulated over the years and a nationwide network, in order to help clients solve their management problems.

Clients may choose, according to their needs, any combination among the following types of services.

<Management analysis>

Utilizing the financial analysis know-how developed over many years, JASME offers a financial analysis service that carefully analyzes the financial statements of the client, and a "Management Simulation" service to assist in understanding management problems and making business planning. These are components of an "Easy to Understand Business Analysis." It is very comprehensive and can be used for grasping management problems and steering business management.

<Matching>

JASME can introduce clients to buyers, subcontractors, suppliers, and other potential partners, and assist clients in finding industrial parks, shops, and office space.

Making effective use of a nationwide network of client companies and JASME branch offices, JASME helps clients find business opportunities.

<Offering successful examples>

JASME advises clients on the management problems and provides them with useful examples and the information on SME management JASME has accumulated.

According to the client's request, JASME can arrange a meeting with companies that have been successful in solving their management problems.

<Overseas information>

Through JASME's domestic and overseas network of affiliated organizations and databases, it provides SMEs with timely information on the local investment environment, such as local market trends, and preferential investment policies, which is indispensable for SMEs investing overseas.

iv) Think tank specialized in SMEs

Conducting a variety of surveys that are indispensable for SME management and government policy-making in the midst of profound structural changes in the economy and industry.

Varied questionnaire surveys and industry surveys are used in assessing business trends and judging medium and long-term economic/industry trends and are highly respected for their quality and insights.

Research results are circulated through the mass media and fed back to SMEs.

<Economic surveys>

Quarterly Survey on SME Trends

Business conditions for SMEs are examined on a national basis each quarter. This is one of the most important surveys regarding SMEs and is used by Japan's Cabinet office as one of the leading indicators.

Monthly survey on trends of SMEs

To understand the SME climate promptly, this survey is conducted monthly.

Survey on plant and equipment investment by SMEs in the manufacturing sector

Conducted nationwide twice a year, this survey looks at the plant and equipment investment plans of small and medium manufacturers. This survey is the largest in Japan in terms of the number of companies surveyed, and is widely regarded as indispensable for understanding plant and equipment investment trends.

Survey on plant and equipment investment by SMEs in commerce and service sectors

This survey is commissioned by the Small and Medium Enterprise Agency and is conducted nationwide twice a year. This survey examines the plant and equipment investment plans of small and medium commercial and service businesses.

<Industrial surveys>

As the economic environment surrounding SMEs is changing considerably due to globalization, changes in industrial structure, deregulation and technological enhancements, we conduct timely surveys on the problems confronting SMEs and their solutions.

The following are examples of recent surveys:

The exodus of major motor vehicle manufacturers to China

Changes in regional industry, and the response of regional SMEs

Changes in divisions of labor among Asian economies in the electrical and electronic equipment industries

(3) Implications for the establishment of government financial institutions specialized in SME financing

1) The financial structure of SMEs in Japan

The financial structure of Japanese firms depends heavily upon liabilities to outside sources, especially upon current liabilities. In addition, this tendency is much more evident in Japanese SMEs than in large ones.

This is a reflection of the fact that SMEs are practically unable to issue stocks and debentures in the public securities market and have little capacity to acquire stable long-term funds through private financial institutions.

Japanese SMEs suffer from managerial weakness, being placed at the bottom of the economic "dual structure" with large differences in capital size, technology, productivity and wage levels compared to large corporations.

Besides, in the course of the postwar reconstruction and high-pitched growth, financial institutions have formed themselves into a very closed system.

While the demand for funds has tended to exceed their supply in the business sector including both large enterprises and SMEs, banks have allotted funds with first priority to large corporations and generally regarded SMEs as marginal borrowers, especially when the money market is tight.

The Japanese economy has been possessed by such a financial structure that the connection between the large bank and its related group of large corporations has been strengthened.

In addition to the need of modernizing equipment and catching up with the progress of developed countries, the demand for funds is so large on the part of SMEs in adapting themselves to the new socio-economic situation that the financing of SMEs would continue to be important.

a) The importance of SMEs in Japan

After World War II, the various entrepreneurships of SMEs were the driving force behind Japan's fast-growing economy. SMEs are an indispensable part of the nation's industrial structure and have developed and diversified in response to environmental changes in the domestic and international economies.

The Japanese government was quick to recognize the economic importance of SMEs and adopted a number of key policies to support their development.

Private financial institutions serving SMEs include city banks, regional banks, second regional banks, credit associations and credit cooperatives. Since they operate on a commercial basis, they are not always able to provide SMEs with appropriate amounts of loans on favorable repayment conditions, particularly in the case of business start-ups.

To solve some of the problems involved, the government established several government financial institutions, including National Life Finance Corporations, the Shoko Chukin Bank and the Japan Finance Corporation for Small and Medium Enterprise (JASME).

Lending to SMEs by these institutions accounts for about 10% of all lending. Such lending tends to increase during recessions, when it is difficult for SMEs to obtain loans from private financial institutions. Government financing thus plays an essential supporting role in the SME business sector, especially during economic downturns.

JASME was originally established to mainly provide SMEs with long-term facility and operating funds.

In order to implement its management philosophy of providing both funding and information on how to use it, JASME endeavors to grow SMEs by continuing to supply information and advice on solving management problems from a fair and impartial point of view, not only when supplying funds but afterwards as well.

SMEs must have access to stable, long-term funding if they are to develop and grow smoothly because of the need to make timely and appropriate plant and equipment investments and strengthen their financial health on a continuing basis.

Compared with large businesses, the fund-raising options open to SMEs are limited because of difficulties in procuring funds from the capital markets and other problems.

Moreover, lending by private financial institutions tends to focus on short-term funding for one year or less, so there is not enough long-term funding available for SMEs. Against this background, it is necessary to establish government financial institutions specialized in the long-term funding that the private financial institutions find difficult to provide.

2) Role and function of government financial institutions specialized in SME financing

a) Supplementing private financial institutions and stably supplying long-term and fixed-rate funds. Serves as a buffer and safety net for SMEs.

b) Providing various types of finance in accordance with the government's SME policy. Serves as a pump-primer for private financing.

c) Appropriate and efficient financing for SMEs as an expert in SME financing.

d) Providing information and advisory services to enhance relationship banking functions and to realize the development of SME.

e) Nationwide network with equal loan conditions for SME financing serves as a supplement to private financing especially in local areas.

f) Direct financing systems provide new financial opportunity for SMEs in addition to existing private financing, credit guarantees and venture business investing.

3) Key factors for establishing government financial institutions specialized in SME financing

a) Supplementing and cooperation with private financial institutions not to distort private initiatives and a market oriented economy. Limited share and loan conditions in the SME financial market.

b) Study of administration costs, government budgets as a fund source. Study new fund sources such as bonds, private funds and overseas funds.

c) Introduce financial schemes in accordance with government SME policy. Provide loans to meet the needs of the times such as loans for new businesses, management innovation, environment protection and local economic stimulus.

d) Provide information and advisory services to SMEs with neutral and long-term approaches.

e) Cooperate with private financial institutions, local government and industrial cooperatives to enhance relationship banking and to establish an SME support network.

2.3.3 Human Resource Development Policy for Strengthening SME Management Capacity

(1) Major problems identified and necessary perspectives on human resource development

As mentioned above, among the major problems facing SMEs, those arising internally are identified in "China's Small and Medium-Sized Enterprises' Development and Prediction during 2002-2003" compiled by the Small and Medium-Sized Enterprise Department of the State Economy and Trade Commission and the Small and Medium-Sized Enterprise Research Center of the Chinese Academy of Social Sciences, as follows:

- Improper management structure;
- Low management level;
- Lack of research and development (R&D) capability;
- Weak market competitiveness; and
- Slow response to changes including globalization and informatization

Since a lack of human resources is a common obstacle lying behind the above problems, human resource development both for management and staff is indispensable. Public institutions should consider developing and implementing policies for human resource development for SMEs from the following two perspectives:

- To design and implement systematic and uniform support including human resource development for SME business management, in order to form a solid foundation of human resources playing an important role in the development of the SME sector in the medium- and long-term; and
- To make up for the lack of resources for management faced by individual SMEs, in the short- and medium-term.

The above-mentioned publication, "China's Small and Medium-Sized Enterprises' Development and Prediction during 2002-2003," proposes that a comprehensive guidance system to SMEs should be developed focusing on the aspects of a human resource training system, technology development, information inquiry and financial affairs guidance. In addition, among the SMEs interviewed by the study team in this study, some good performing companies are making efforts to establish their own human resource development system with a clear understanding that medium- and long-term sustainable growth of enterprises lies in steady accumulation of management capacity including financial management, marketing skills and technical capabilities. For most SMEs with weak management bases, however, there are insufficient finances and human resources allocated for skills development of their management and staff due to their higher priority placed on activities directly contributing to securing a short-term profit. Naturally, it would be difficult for such enterprises to prepare consistent plans for investing in human resource development on their own. Therefore, policies on human resource development for SMEs must be considered from a long-term perspective for the development of the entire sector, as well as from a short-term perspective for filling the resources gap that individual SMEs are struggling with.

(2) Human Resource Development Policies and Systems for SMEs in Japan

This section looks at major examples of human resource development measures for SMEs by public institutions in Japan, in order to examine how the aforementioned two perspectives on human resource development have been reflected in the SME promotion policies in Japan.

1) Support programs for SME management and human resource development

Taking into consideration weak management bases of SMEs in comparison with large-scale enterprises, the Japanese SME policy attaches importance to supporting SMEs to secure "soft" resources such as management know-how, technology, and other information. Based on this policy, support measures are organized systematically and consistently nationwide. The following two sets of measures are particularly important components of the policy:

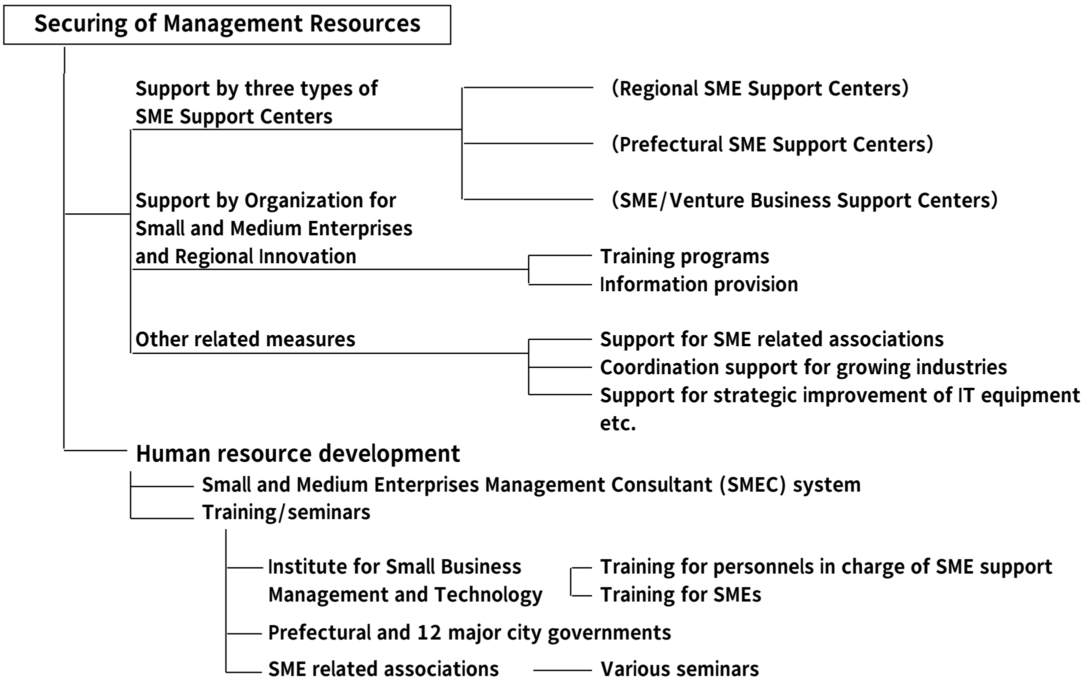
- Business support centers are established at various levels of government, i.e. national, prefectural, and local levels, so that SMEs can choose the appropriate center to consult with or receive support from, based on the nature of their business and their own problems.
- Human resource development for SME promotion including training for persons responsible for SME support, is advanced on a national basis by the Institute for Small Business Management and Technology and by the Small and Medium Enterprises Management Consultant (SMEC) system. The nationwide schemes enable SMEs in any region in the country to receive uniform and high-quality support services.

In the next section, the Japanese support system for SMEs to secure their management resources will be outlined. After that, as an example of measures for human resource development for SMEs, training programs offered at the Tokyo Institute for Small Business Management and Technology are presented.

2) Support system for securing management resource bases for SMEs

Figure 1 shows the overview of the support system for SMEs to secure management bases. Business support centers are established throughout the country as important organs to provide various types of support to SMEs based on the Small and Medium Enterprise Support Law on the national, prefectural and local level. Support activities conducted at each level of center are as follows:

Figure 2.3.1 Overview of Support System for Securing Management Resource Bases for SMEs



Source: Small and Medium Enterprise Agency, "SME Measures Overview 2003" (Excerpt)

a) Regional SME Support Centers (260 centers nationwide)

These centers are located in each broader municipal area of the country to provide consultation services at a counter and various types of information. The center is meant to function as a support center that is easy to access for those who plan to start-up a business and small enterprises that have business problems.

b) Prefectural SME Support Centers (59 centers nationwide)

These centers are established as the core of the system of prefectural governments for supporting SMEs under the Small and Medium Enterprise Support Law. In order to help SMEs secure business resources, they undertake various programs such as advisory services, dispatch of experts, and provision of training and seminars.

c) SME/Venture Business Support Centers (8 centers nationwide)

These centers are established in order to support business ventures considering going public by providing financial and technical assistance and high-level consulting services. The Center also supports the Regional SME Support Center and the Prefectural SME Support Center as the central organ of the SME support in the region.

d) Outline of the Institute for Small Business Management and Technology

We will look at the activities by the Institute for Small Business Management and Technology, which is one of the main pillars of the human resource development policies for securing SME management resource bases. The Institute was established by the Organization for Small and Medium Enterprises and Regional Innovation to provide practical training in advanced business management and specific subjects for SMEs, as well as training for persons responsible for SME support. Currently, there are nine institutes established across the country. The Institute has offered training programs for more than 40 years, and the number of people who have taken the programs has amounted to 300,000. The Institute is highly regarded as an organization that renders comprehensive support to SMEs, based on the national policy on human resource development for SMEs.

Each of the nine institutes is providing training programs with its own focus on subjects and issues, according to the characteristic of the location of the industries and the situation of the economy in the area.

e) Training programs provided at Tokyo Institute for Small Business Management and Technology

The Tokyo Institute for Small Business Management and Technology is playing a central role in the activities of the Institute, offering training to about 130,000 people to date. Among the variety of programs it offers, training courses for government personnel at the prefectural level in charge of SME support and training for fostering Small and Medium Enterprises Management Consultants, are some unique offerings of the Tokyo Institute. As an actual example of activities conducted by the Tokyo Institute, below we will look at the training programs for SME managers and staff and the training course for fostering Small and Medium Enterprises Management Consultants.

i) Training programs for SME managers and staff

A wide range of programs has been prepared for training SME personnel at different levels and in different sections. The programs are organized under the following themes: (i) training of management successors, (ii) training of management personnel, (iii) strengthening of personal capacity, (iv) special knowledge on corporate strategy and planning, (v) special knowledge on financial management (vi) special knowledge on personnel and training policy, (vii) special knowledge on sales and marketing, (viii) special knowledge on manufacturing, (ix) support for venture businesses. In fiscal 2004, a total of 35 training courses are planned whose training periods range from 2 days to 10 months. Several programs are prepared and designed on each theme, so that persons at all levels of the company such as the executive, middle-management and staff level can find appropriate programs. Thus, for individual enterprises that cannot afford to fully provide their own training in response to various needs of the employees, the programs of the Institute will help them increase their knowledge and skill level as a whole.

The lecturers of the Institute come from a variety of backgrounds, such as business managers, university professors, Small and Medium Enterprise Management Consultants and tax accountants. Program fees are maintained at affordable prices, reflecting the nature of the Institute established as part of the national policy.

ii) Training to foster Small and Medium Enterprise Management Consultants

The Tokyo Institute is providing a training course to foster Small and Medium Enterprise Management Consultants so that the candidate students can acquire knowledge and methods for business diagnosis of SME management and to be able to propose appropriate measures for improvements in business activities. This training is a fulltime program. After completing the one-year program while passing the examination in all the necessary subjects, the students are registered as a Small and Medium Enterprise Management Consultant. As of March 2004, 6,100 people have already completed this program since it started in 1962.

A Small and Medium Enterprise Management Consultant is a government qualified management consultant, authorized by the minister of MITI, in accordance with the Small and Medium Enterprise Guidance Law, designated for SME consulting projects. Apart from the completion of the training course provided by the Tokyo Institute, Small and Medium Enterprise Management Consultants can gain qualification by passing the examination and practice test held by the Japan Small and Medium Enterprise Management Consultant Association. Since Small and Medium Enterprise Management Consultants are expected to have intensive and extensive knowledge on a wide range of SME's management issues as experts to provide consulting services to SMEs, the program of the Tokyo Institute covers a variety of subjects that the students are required to take.

f) Effect of measures for securing management resources of SMEs

As shown above, in Japan, a network of organizations established nationwide for directly and indirectly supporting SMEs through human resource development based on national policy, have played an important role in securing management bases of SMEs. In addition, the uniform Small and Medium Enterprise Management Consultant system has contributed to SMEs receiving the benefit of high-quality consulting services all over the country.

In order to examine the extent these measures have actually benefited SMEs, some of the results of the policy evaluation for measures for securing SME management bases, conducted by the Small and Medium Enterprise Agency, are shown below.

i) Support by SME Support Centers

In fiscal 2002, the following were the number of services provided by Regional SME Support Centers, Prefectural SME Support Centers, and SME/Venture Business Support Centers, by service type (Table 1). Table 2 shows the percentages of users who responded that they were "satisfied" or "satisfied to a certain degree" with the services provided by the centers. Presented in Table 3 are the percentages of users who responded that their problems were "solved" or "solved to a certain degree" by the services provided by the centers. These results indicate that a substantial proportion of users recognized that they received high quality, satisfactory services on the whole, with some exceptions.

Table 2.3.1 Number of services provided by SME Support Centers (FY 2002)

	Advisory services at the counter (Number)	Business support courses (Number)	Dispatch of experts (Number)
Regional SME Support Center	61,258	1,603 (43,998 participants)	4,643
Prefectural SME Support Center	118,408	2,000 (67,986 participants)	20,094
SME/Venture Business Support Center	10,143	112 (6,182 participants)	3,403

Table 2.3.2 Users' satisfaction level: percentage of users "satisfied" or "satisfied to a certain degree" (FY 2002)

	Advisory services at the counter (%)	Dispatch of experts (%)
Regional SME Support Center	54	52
Prefectural SME Support Center	60	67
SME/Venture Business Support Center	35	66

Table 2.3.3 Resolution level of users' problems: percentage of users "solved" or "solved to a certain degree" (FY2002)

	Advisory services at the counter (%)	Dispatch of experts (%)
Regional SME Support Center	57	60
Prefectural SME Support Center	53	49
SME/Venture Business Support Center	45	52

Source (Tables 2.3.1-2.3.3): SME Agency, "2003 Policy Evaluation Report: Measures for Securing SME Management Resource Bases"

ii) Training programs provided by the Institute for Small Business Management and Technology

Up until fiscal 2002, the Institute for Small Business Management and Technology has provided training programs to 205,000 people from SMEs and 82,000 people in charge of SME support in the government or government-related organizations. To date, 6,000 people have taken the training course to foster Small and Medium Enterprise Management Consultants provided in the Tokyo Institute.

The survey of user satisfaction with the Institute's programs to SMEs and government personnel responsible for SME support shows that more than 90% of the participants in the training courses highly evaluated the programs. About 80% of the lecturers in the Institute have been highly appraised by course participants, in terms of their level of understandability and usefulness. The Institute is maintaining a database of 9,500 lecturers including information on evaluations made by the course participants in the past, which has been made good use of in order to improve the entire quality of lectures.

(3) Future orientation of SME management support and human resource development

Based on the role the Japanese SME policy for securing management resource bases have played, the following issues would be of particular importance when considering the future orientation of SME support in management and human resource development in China.

1) Establishment of systematic and uniform support for SME management and human resource development

It is essential to develop and improve the human resource base in SMEs, for instance, by fostering people with high management capacity or technical skills, in order for SMEs to achieve further growth by acquiring competitiveness and to gain major recognition commensurate with the increasing size and role of the SME sector in the national economy. Establishment of a systematic and uniform support system would greatly contribute to the enhancement of the general level of human resources at SMEs. For individual SMEs, the establishment of such a system will provide them with common knowledge and skill bases, increased business opportunities with other partners and the possibility of geographical business expansion. However, detailed structure and program design of the support system including the degree of uniformity and the division of roles between different administrative levels should be carefully considered in the context of the actual situation in China.

While sufficient time would be needed for establishing the most appropriate system for China, the following are the important items which can be promoted immediately: the diversification of the service menu for SMEs and the training of persons engaged in SME support. Enhancement of these immediate measures would be advanced in existing public support institutions such as SME Service Centers as a core, which have been established in major cities such as Beijing and Shanghai in recent years. In that case, it is crucial to strengthen these institutions by reinforcing the financial and human resources, so that they can provide a full-fledged service menu.

2) Response to technological innovation and globalization

The trend of technological innovation and globalization has rapidly been changing the business settings of enterprises, including business models, the competitive environment, and geographical coverage. How SMEs with relatively scarce management resources can cope with these changes is a common challenge in many countries. In particular, it would be important to strengthen support for human resource development in SMEs in the following areas.

a) Support for IT-based systematization in SMEs

It is important that small-business owners themselves understand fully the effects and problems of IT-based systematization when they consider introducing it. Human resource development in IT should therefore be targeted at managers as well as the staff in SMEs by providing IT seminars or training programs and such. In this case, it is crucial to consider the characteristics of the enterprise in question, such as its line of business and the current progress of systematization. In Japan, prefectural SME support centers organize seminars for SME entrepreneurs and provide practical IT training in order to enable participation in e-commerce by using experts such as IT coordinators and SME consultants. In addition, the Organization for

Small and Medium Enterprises and Regional Innovation, Japan (SMRJ), dispatches experts to advise on the introduction of IT at the request of SMEs.

b) Support for promoting utilization and acquisition of patents

Measures for developing human resources engaged in patent work should be steadily promoted in order to encourage patent acquisition by the SMEs that have developed original technology, and utilization of patent information so that SMEs can efficiently facilitate technology development. In Japan, for instance, advisory service on the procedure of electric application for patent is provided for SMEs, and patent distribution fairs are held for interaction among SMEs, universities, and research institutions.

c) Measures for globalization of SME business

While globalization encourages more and more SMEs to pursue business abroad, providing support to these enterprises would be needed more than ever by providing necessary information and strengthening human resources engaged in foreign business. In Japan, various kinds of information provision and support for human resource development are conducted by government or government-related organizations, for SMEs that are planning to start foreign business, and SMEs that have already started foreign operations. For example, the Institute for Small Business Management and Technology provides a training course on management with progress in globalization, and governmental organizations such as the Organization for Small and Medium Enterprises and Regional Innovation, Japan (SMRJ) provide training for managers and employees of overseas branches of Japanese SMEs by dispatching experts.

2.4. Loan Procedures for SMEs of commercial banks in China

2.4.1. Beginning of analysis

In Japan, the main lender for private SMEs is private financial institutions. And the role of policy support is compensation for an area where private financial institutions cannot support. (Please refer to Chapter 2.1) And both lending by governmental financial organization and lending based on guarantee by credit guarantee corporations are executed through private financial institutions. Considering these facts, in Japan, it is quite important for us to understand the procedures of lending to a corporation, including SMEs, within commercial banks of China. In this part, understanding procedures for lending to SMEs in commercial banks of China, as of the end of the 2nd term (April 2003 – March 2004) of this project, marks the beginning of this analysis.

(1) Comparison of problems on finance by SMEs between Japan and China

1) Position of lending to SMEs within the bank-lending business

"The closer a relationship between a bank and a borrower is, the bank will have to consider more "special" factors or client background during appraisal. For this reason, appraisal procedures of lending to SMEs are fundamental to the appraisal of a loan ("Summary of systems for lending to SMEs in Japan" Material delivered at hearing research held at Dec. 2003). The reasons and backgrounds for which lending to large companies should be "more exceptional" than to SMEs are as follows:

- Annual Reports or other various kinds of related materials are quite popular. But, from time to time, even banks are unable to see all the facts behind or, for that matter, essential technologies.
- As everybody evaluates a company based on the same materials disclosed, no differences are found in the results of an analysis on the company.
- In the decision-making process of lending, capital or personnel relationships between bank and borrower should be of more importance than any result of creditability analysis.
- If the borrower has large shares in the market, the decision-making process will be biased by political power. (For example: Financial assistance is strongly requested by a regional government to a large company in the region, whereby financial results of which have been significantly deteriorated.)

It is true that such factors as capital relationship, personnel relationship, or assistance of policy are essential factors to be considered for creditability analysis. But these factors are not factors to bias decision making – rather, they are objects of analysis. If decision making were to be biased by any such factors, one could be punished. Such a situation would constitute crimes of favoritism lending or a cartel.

The fundamentals of lending in a bank are "to understand facts of a company". In other words, it is to let actual facts of a company be disclosed based on any phenomena and information that could arise from mainly three points of view: personnel, products, and funds. Lending procedures for a large company could be “exceptional”, as any parts of understanding actual facts of a company might have been missed, or when the conclusion of consideration has been predetermined.

Any process in lending to SMEs to understand any activity and phenomena of them based on daily and frequent relationship with them cannot be missed. That is why procedures for lending to SMEs are the cornerstone of any company’s lending procedures.

2) Explanation of “hardness of finance” by SMEs in China (In comparison to Japan)

Bank lending to SMEs in China is reported to be in the situation of “hardness of finance”, “hardness to lend,” and ”hardness to obtain collateral”. In other words, “for SMEs not to be able to obtain finance as expected”, “for banks not to be easy to lend to SMEs” and “for the inability of satisfactory collateral to be obtained by a bank as expected,” respectively. On the other hand, it has also been reported in Japan that bank lending is not sufficient enough to satisfy SMEs.

Are these problems in China and Japan the same? If there is a difference, where does it lie? An understanding of the situation in China, which is discussed after the hearing research held in the 2nd term of this research project, is as follows.

a) What is “hardness to lend” in China? (From the point of view of a bank)

While “hardness of finance” refers to “a company that is not able to provide finance in the full amount required,” ”hardness to lend” means that “terms and conditions required by bank can not be fulfilled by the company.” More practically speaking, “hardness of finance” is such a situation where a bank has declined an application for new borrowing, or one in which that bank did not agree with the full amount of the application. And ”hardness to lend” is a situation in which a proposal of new lending (by a person in charge of a company) is declined by a person in charge of verification because of not satisfying all the terms and conditions required by the bank. We will begin by discussing a situation of “hardness to lend” in China.

i) ”Hard to lend”

To talk about hardness of lending to SMEs from the point of view of a financial institution, three points must always be pointed out (local bankers who attended our hearing research will agree). They are as follows:

- Actual financial data of SMEs is not clear and disclosed.
    - The owner of a SME enjoys a rich life in spite of the fact the financial results of his company show a deficit.
    - Family members of the owner use assets not listed on B/S of the company.
    - Contents of SMEs financial reports differ by recipient (tax authority, bank, or accountant, etc.)
    - Contents of financial report submitted to bank differ from actual situation.
    - Such financial reports are not submitted to the bank as satisfactory enough for the bank to conduct a financial analysis.

- SMEs do not have real assets; hence, secure borrowing becomes an issue for concern. Nor are details of asset very clear.
  - SMEs do not have any real assets (i.e. land, building, machinery, and other equipment). This is especially true when the company has been newly founded.
  - Even if potential of development is recognized, SMEs do not have satisfactory real assets to be securely borrowing funds required for development.

- Boundaries between person and company are not clear.
  - SMEs refuse to submit asset that is used for business due to ownership of the asset belonging to a family member.
  - Assets for the business of private enterprise cannot be distinguished from assets for daily life.
  - Whole assets for the business owned by a single individual.

Note, however, that these are not characteristics specific to China (nor only in countries shifting to a market economy) but characteristics common of lending to SMEs around the world. The fundamental procedures of lending mentioned before crystallized practical technology for banks to analyze the creditability of SMEs, which is essentially required for consideration of lending to SMEs. In this regard, banks in China lacked the practical technology required to lend confidently to SMEs until now.

But this does not mean all commercial banks in China should suffer from such problem.

Taizhou Commercial Bank (台州市商業銀行), for example, which we visited on Dec. 2003, was established by a merger between eight city credit cooperatives (城市信用合作社) in Taizhou City, and enjoys a non-performing asset ratio of 3%. The chairman, Mr. Chen Xiao Jun (陳小軍) expressed, "whether it is collateral of real asset or guarantee by a person, security is just a comfort," and "as far as a bank knows any details of a company, security shortage will not occur." He confidently explained that rational decision-making based on recognized real facts of a company will lead to services that satisfy customers, as well as sound banking. His explanation gives proof that essential fundamentals of lending, especially to SMEs, are common both in China and developed countries.

SMEs that attended to our research pointed to similar problems. Said SMEs are comparatively excellent companies that have relationships with mainly four large state-owned commercial banks or joint -equity commercial banks, which have a nationwide network. Most SMEs said that the frequency of visits by a banker in charge were one to two times a month.

And another comment by Mr. Chen is also important and thus worth mentioning: "rational management decisions in a bank should be biased by political intention, whether it is the national government or regional government, so long as shareholding ratio of the government is big." This means that "exceptional cases of lending procedure for a large company" is spread over state-owned commercial banks and other commercial banks.

"Hardness to lend" to SME s that is, for a bank to be difficult to lend to SMEs, means that for SMEs, which are weak to banks and find it hard to enjoy institutional assistance, are the ones most significantly deteriorated by common problems of commercial banks in China.

- As practical technologies for lending are not spread enough in commercial banks, banks cannot understand real facts of companies and underestimate creditability of companies.

- Desirable processes of rational evaluation based on practical technologies that are biased by factors of capital relationships, personnel relationships, and political factors.

ii) ”Hardness to obtain collateral”

“Hardness to obtain collateral” refers to a situation where a bank cannot obtain satisfactory security from a company that applied to borrow. In other words, “hardness to obtain collateral” does not occur simply because a bank is too lazy to understand the real facts surrounding a company.

From the point of view of a bank, in the sense of both business promotion and understanding facts about a company, the first step to building a relationship with a company is to support working capital. The appropriate amount of working capital required can be computed using three accounts, which are accounts receivable, inventory, and accounts payable. The bank’s rationale in estimating the actual amount of working capital is by considering monthly sales, payment condition, and procurement condition. But we must note that in China it is impossible to compute required working capital due to the prevalence of unsatisfactory credit practices in China.

The most fatal problem in Chinese credit practices is that promissory notes are not used as common payment methods. Usually in developed countries, the first step of bank lending is the discount of a promissory note. Meanwhile, the first step of working capital loans is the discount of a promissory note. Banks are able to understand business relationship of the company, creditability of the company in the market, and business cycles of the company judging from the details of a promissory note (which the customer requested to have discounted). Banks can understand the rationale of working capital on the B/S by watching customer facts and by having conversations with the customer based on this information. It is true discounts on a bank’s promissory note are admitted by governmental authorities. But as far as promissory notes, it is not a common method of payment and since outstanding transactions of promissory note discounts are quite few, it is quite difficult for a bank in China to estimate rationales of working capital. Please note that a promissory note underwritten by a bank substantially represents a bank check or, in other words, cash or check.

Another fatal problem is the “matter of collection of receivables,” which means a company cannot collect its receivables despite all efforts. Mr. Zhou, who is the Chairman of Zhicheng Champion Group Co., Ltd. in Dongguan (広東志成冠軍集団有限公司) says, “one-third of all receivables is over due,” and “without further supply such a company would not be able to pay our receivable that is payable to us and is likely overdue.” Under this kind of situation, it is difficult to manage a company. And any efforts to estimate required working capital are purely in vein.

- Apparent conditions of payment are meaningless and are breached anytime without any rational reason.
- Ongoing existence of large “cost of promotion to collect receivables” makes it difficult for banks to analyze details of receivables and P/L.

Local financial institutions that attended our hearing research said, “generally speaking in China domestic trade, retail, and international trade are difficult concepts for a bank to grasp.

These sectors are estimated as sectors with high risk." In other words, seeing the actual situation of law, materials, half-completed products, and products, it is barely possible for Chinese banks to understand flows of money with manufacturing companies because manufacturing has a substantial flow of goods and process of production. But as far as the payment conditions are meaningless a bank cannot understand the facts of a trading company in which products move among other places than the company itself. And, furthermore, the facts of retail or wholesale in which inventories could be in a warehouse far from company are difficult to understand whether products are old or not. These explanations are specific examples.

In developed countries, trade company sectors such as mercantile, distribution, and trade are relatively easy for banks to understand, as is the same with manufacturing. But because promissory notes are a common form of payment, once committed, it is common knowledge to anyone to obey the terms of and conditions of payment.

Current trade practice among companies in China does make it difficult for a bank to understand the facts of some companies. This problem is quite grave, though, because even a minor change of laws and systems by governmental authorities will not resolve the issue, for it is more a problem of public opinion on credit practices and norms.

iii) What kind of finance is required by SMEs in China (Where is "hardness of finance"?)

Needs of finance by companies are mainly categorized as follows.

- "Funds for foundation"
- "Working Capital": compensation of funds shortage occurred because of time difference between payment and collection.
- "Long Term Equipment Fund": fund for procurement of new manufacturing machinery, construction of factory and set-up of new outlet.

It is "working capital" that SMEs in China requires. In other words, it is "working capital" that "hardness of finance" exists for. Based on results of our hearing research, almost all funds for foundation should be financed by funds from outside banks (including capital injection by the founder himself). And currently banks are eager to support a long-term fund, which occurs after development of a company, for the purpose of which is clear and which a bank can easily obtain real assets as collateral. Not only SMEs, but also such companies as are rated high by a bank argued that support to working capital by banks should not be satisfactory. This proves that financial problems by SMEs could be common when finance support to private companies is by commercial banks.

Conflicts between requirement from companies to banks and understanding on companies by banks are as follows.

- Requirement from companies to banks: Companies expect banks to understand any detailed facts including "problems on collection of receivables," and to admit as large amount working capital as possible, considering such facts
- Understanding on companies by banks: It is quite difficult for banks to support even short-term working capital without reliable collateral (real asset, etc.), considering the situation that whole receivables of a company could, at anytime, be changed to non-performing assets.

At our hearing research, it was reported by even developed companies to usually finance working capital by accumulated profit. They cannot finance working capital by borrowing, because receivable could at anytime be changed to non-performing.

iv) Internal operation procedures of commercial bank/regulations by monetary authority.

Local bankers who attended our hearing research disclosed such a situation whereby a bank cannot fully support funds needs because of an operation procedure or authorization accord with a bank or regulation of monetary authorities. For example, we most frequently hear of severe requirements for approving lending without collateral. This problem could be regulated directly by law, as shown below.

PRC Commercial Bank Act The 4th Section Article36 (**中華人民共和国商業銀行法第四章第** 36 **条**)

“The borrower has to submit collateral to bank at lending by commercial bank.”(**商业银行贷款，借款人应当提供担保**。)

“Danbao (**担保**)” in Chinese has three meaning in Japanese: “security”, “guarantee,” and “real asset collateral”. ” Danbao (**担保**),” used in the article above, would be understood as meaning “Hozen (**保全**)” in Japanese banking terminology for practical banking procedure. But as the same with Article 10 of Lending Cord (**貸出通則**) as introduced in 2.1.3(2), “Danbao (**担保**)” is understood as “real asset collateral” in China. This is called “collateralism”.

3) Difference from problems of finance by SMEs in Japan

Apparently “hardness of finance” by SMEs is no different than in between Japan and China, considering the situation of working capital shortages and strict regulation on credit risk control of monetary authorities. But significant differences do exist.

		Japan	China
Bank	Private capital in commercial bank	Completely private	Few regional commercial banks are private.
	Technology of estimating creditability	Spread among all the private commercial banks	Not spread enough.
Intercompany practice of credit and trade	Promissory note	Quite common method of payment in society.	Not used.
	Obedience of payment condition	Common understanding on obedience.	Disobedience as possible.
Laws	Laws on ownership, collateral and liquidation of collateral	Completed	Not completed
Authorities	Governmental Regulations on financial institutions	Has long history. Recently getting stricter.	Just begun.

As for Japan, related regulations or institutional systems were once fixed during high-growth era. But during restructuring of industrial structure and deterioration of profitability in the1990’s, profitability of banks was also deteriorated as governmental regulation has become stricter than before. Japanese banks cannot adopt aggressive business policies under such a situation. And as for China, it is currently in the process of constructing a fundamental institutional system and popularizing new technologies and practices.

(2) Credit Information System

1) The priority of constructing new credit information system is much lower than fixing the description of procedures of a private commercial bank.

When a member of the study team introduced in Xian that a Japanese banker in charge of customer relations, especially SMEs, usually takes care of around 50-100 customers, all the local bankers attended were very surprised. The local branch of The Bank of China disclosed that it could possibly be no more than 5-6 customers that it serves. He complained that he was often interrupted by unexpected instructions from his seniors or higher branches or headquarters and that he could not pay frequent visits to all the customers nor cultivates new ones.

Against such transaction problems, volume should not increase the efficiency of the process. In addition, bank management instructs their subordinates to introduce new IT systems without any detailed analysis on facts surrounding developed countries. As for procedure of credit control, many bank managers believe that credit information control system could easily solve all the problems.

Could bankers in Xian take care of 50-100 customers if such expanded IT system were introduced? It would be incorrect to assume so. Even bankers in Japanese city banks during the 1960's, when IT system had not developed as much as now, could only take care no more than 5-6 customers. Even nowadays Shinkin Banks or Credit Cooperatives, whose bankers typically service 50-100 customers, have yet to introduce IT systems with the same specifications of city banks.

Construction of internal operation procedures and an authorization cord, which is practical technology for a private financial institution, is the most important point. Introduction of IT systems has to be considered in order to solve requirements of mass processing a specific process, but only after description of the operational procedure has been fixed and become completely standardized. Financial institutions that attended our research hearing argued for reconstruction of authorization hierarchy, requirement to approve lending, and governmental regulation on lending. But they did not argue to solve the burden of mass processing. This proves that commercial banks in China currently are at a stage of constructing practical technology. In other words, Chinese commercial banks are constructing a set of descriptive procedures.

It is true that introducing of whole operational procedure that has already been adopted in major commercial banks in a developed country, including both description of procedure and IT system, could be an alternative. But it should be, of course, too rude and out of question.

2) Desirable credit information system in China

"Credit information" does not mean a simple database of financial data of companies. Even if record of non-payment, overdue, and bankruptcy is added, such a database could not be considered as "credit information". Essential credit information is recorded and used as a consideration to lend. That is why standards of procedure for lending are required for construction of database of credit information.

Information compiled by the Credit Guarantee Corporation of Japan is a good example of "credit information". Credit Guarantee Corporation accepts applications from all commercial banks that lend to SMEs and such commercial banks are required to provide all the "credit information" related to borrower for appraisal by the credit guarantee corporation. Then all the "credit information" related to borrowers that are guaranteed by the credit guarantee corporation are accumulated in a database. Even Shinkin Banks and Credit cooperatives, which operate in restricted regions, can enjoy credit consideration based on credit information, including that of other banks in other regions or that of past transactions through appraisal by a credit guarantee corporation. And large city banks, which operates all over Japan and accumulates huge amounts of "credit information," enjoys similar benefits as for new customers. Credit guarantee corporations can inform us only of the results of an appraisal, which do not include any process of appraisal to financial institution that applied for credit guarantee. This means that contents of "credit information" of a bank should not be delivered to other banks.

As for now, the situation in China has not reached a stage for constructing a new credit information database. This is because descriptions of lending procedures (containing "credit information" and procedural processes) have yet to be fixed. And a legal description of a credit guarantee corporation is not yet clear. Nor has a nationwide organization, or even provincial organization of a credit guarantee corporation, been established. Under such a situation, the processing system or database with only credit information cannot be constructed without fixing practical procedure.

On the other hand, The People's Bank of China has already prepared a "System of Inquiring Bank Lending Registration " (**银行信贷登记咨询系统**)that all the commercial banks in the business of lending, Which includes foreign banks, are required to register to. For now, though, this is nothing more than a database of credit information. Any new other system or database should not be established. But it is quite important in China to maintain and develop a "System of Inquiring Bank Lending Registration " (**银行信贷登记咨询系统**).

On February 10, 2004, at The People's Bank of China Financial Work Meeting(**中国人民銀行金融工作会議**), the governor of The People's Bank of China (**周小川行長**) announced the completion of a nation-wide network of "System of Inquiring Bank Lending Registration " (**银行信贷登记咨询系统**) as one of the great successes in 2003. And on November 2003 at "Awarding Ceremony of construction of System of Inquiring Bank Lending Registration"(**全国銀行信貸登記諮詢系統建設総括表彰会**), vice governor (**呉暁霊副行長**) said that this system should be fundamental of credit information formula in China and should be constantly improved to minimize risks in monetary system. This understanding is considered as quite correct and reasonable.

(3) Procedure of lending and authorization hierarchy to approve lending in commercial bank in China

1) Xindai(信貸) and bank lending

"Xindai (**信貸**)"in Chinese is usually translated to bank lending. Strictly speaking "exposure on creditability of borrower" could be appropriate. In other words "Xindai (**信貸**)" means all the ways a banks bears creditability of the borrower, including direct lending, which is most typical way, but it also refers to guarantees, import L/C, and foreign exchange.

＜To be Noted＞

"Xindai (**信貸**)" in Chinese is not abbreviation of 「**信用貸款**」(clean lending).

In procedure of lending of commercial bank in developed countries, details of operation or workflow as below are defined or explained.

- Method and criteria to evaluate creditability of company
- Criteria to undertake creditability of company
- Procedure and work flow to admit new lending
- Method and procedure to control outstanding transaction during undertaking creditability of company

And the most important part in the procedure of lending is for an authorization hierarchy to approve lending. This defines criteria of title to approve what kind of risk on undertaking of borrower's creditability.

2) Authorization hierarchy of commercial bank in China explained in hearing research

In hearing research, various kinds of examples on procedure to control lending and on-going transactions in China have been introduced. But these are just pieces. It is too early to consider recommendation to improve the system of China. In order to conduct rational evaluation, verification of these facts is required referring to procedure of lending.

Two important phenomena were recognized by the study team. One is that regional private commercial banks, for example Taizhou Commercial Bank , have already begun operations based on excellent practical technology, which are at the same level as developed countries. And such commercial banks have succeeded in SMEs market. Another is that state owned commercial banks are, in this sense, behind. Workers in such banks complain about reluctant attitude of their management to adopt idea for improvement by them.

Typical phenomena are shown as below:

<Phenomenon 1> the Bank of China (Xian)

Bankers in charge of customer relations could take care of no more than five to six customers. They cannot make enough time to visit customer, as are frequently interrupted by instructions or inquiries by seniors or headquarters.

⇒＜**Comment**＞

Division of operation in office is not clarified. "The person in charge of a customer" could be forced to take all the responsibility of any operation in the office, and any results of business promotion related to the customer including deposit, loan, and any other. Such bankers cannot be "person(s) in charge of a customer" as they take care of no more than five or six customers.

And it was felt quite strange to see that a "person in charge of a customer" is forced to take responsibility to improve such phenomena. It should be the responsibility of top management in the office to improve operations.

<Phenomenon 2> The Agricultural Bank of China (Taizhou)

Only Beijing headquarters is authorized to change rules or procedures. Both internal and governmental auditors conduct an audit according to procedures set in Beijing. Even if branch management decide they want to improve operations, regulations fixed by headquarter may be too severe to realize such ideas even with the use of excellent local workers. Headquarters can only instruct a business target, for example, outstanding amount of lending to SMEs, without having to any take improvement of rules and procedures into consideration.

But in regional commercial banks, authority is moved to a lower level. Speed of improvement is fast and they make full use of workers.

⇒<Comment>

It is not considered to be a serious matter that procedure is common all over the nation. Problems in procedure could be that procedures are not made based on actual operations. Someone may argue that procedure should be different by region, as China is much larger than Japan. But they must recognize procedures of lending in Taizhou Commercial Bank are at the same level as that of developed countries.

<Phenomenon 3> The Industrial and Commercial Bank of China (Taizhou)

We adopted system of evaluation on worker in charge of lending named “3 undertakings, 1 gearing”（三包一掛）. According to this system, he is responsible to make borrower to repay, is responsible to realize new lending and is responsible to watch on-going transaction. The amount of salary shall be fixed considering results of these assignments.

If he failed to collect, he himself is responsible to repay. We have tried this system for couple of years. And workers in charge of lending are reluctantly promoted.

⇒<Comment>

It was quite strange to hear this explanation because the Industrial and Commercial Bank of China do not seem to have any common procedure or rule to fix procedure. The bank seems to force individual workers to be responsible for everything. And further it was felt quite strange that this system was explained to have been developed in Taizhou. It was difficult to understand a reason why one regional organization of a bank was authorized to fix an essential part of a fundamental procedure.

On the other hand, Taizhou Commercial Bank has such a rational system to seek responsibility of problem after objective analysis. This is at a reasonable level as compared to developed countries.

Having heard explanations by state-owned commercial banks, the study team cannot understand the irresponsibility of management or general manager of branch office. They seem not to have any responsibility of decision of lending or recommendation to higher branch. If a person is in charge and responsible for a non-performing loan, worker morale shall be significantly deteriorated and any credit information or any methods of lending control shall not be accumulated in such bank.

3) Importance of procedure of lending and authorization criteria to approve lending

In order to solve questions derived from phenomena above, in other words, in order to investigate causes of “hardness of lending” in bank, it is required to check specific lending procedure currently effective in commercial banks.

Based on 「中国農業銀行客戸経理制実施弁法（暫行）」 (2001.9.18.農銀発[2001]156 号), a manager of a customer relations division in a branch office seems to be just a personnel manager. He or she could not be responsible of lending, including application for a new loan, or non-performing loans. Based on 中国農業銀行可循環使用信用管理暫行弁法 (2001.7.30.農銀発[2001]119 号), clean lending is admitted only for customers rated AA (internal rating) or more and with approval by 1st level branch or more. And based on 中国建設銀行流動資金貸款弁法（試行）(1995.10.6.建総発字[1995]132 号), clean lending is admitted for customer rated AAA (internal rating) or more.

(4)"Security" in finance system of China

As mentioned in (1), "Danbao (担保)" in Chinese has three meanings: "Security", "Guarantee" and "Collateral of real asset". These three banking terms have common characteristics. "Guarantee," "Collateral of real Asset," and methods of "Security."

"Security" is recourse of collection when a serious matter has occurred to a borrower. "Clean lending" could be "lending without collateral" in the sense of not obtaining real asset as collateral. But "clean lending" also has "security". "Security" of "clean lending" is creditability of a customer. In this sense, there shall not be any lending without "security". Lending based only on disposal value of collateral real asset without any consideration of creditability is pawnbroker finance or finance to property developer.

As mentioned in (1), practical technology of understanding facts of customer as financial institution is required to evaluate creditability. Even real asset collateral is just a compensation of creditability. When "guarantee" is "security" of lending, creditability of guarantor is "security". Consideration of creditability is always required in a lending operation.

During the 2nd year of this research, the study team faced strange practices of "security" in commercial banks from the point of view of a banker in a developed country. Two typical examples are shown below.

1) Security of "inter company guarantee"

One common method of "security" in most other countries is a "guarantee submitted by a third party. But quite strange practices of "inter company guarantee" were found as shown below.

<When a bank rejected to approve lending because of insufficient creditability and security>

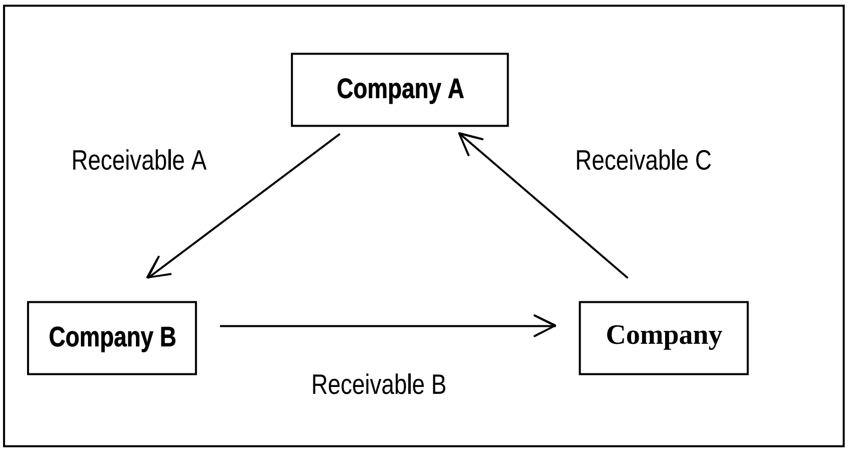
- The bank asked borrower that lending might be approved if borrower accepts security of guarantee by a company recommended by bank.
- The bank forced borrower to guarantee lending to other company, which the bank recommended as guarantor of borrowing.
- Company which bank recommended as guarantor of borrowing is such company with quite low creditability that cannot be undertaken.
- Bank rejected to disclose detail of company which bank recommended as guarantor.

Bank receives interest of lending or guarantee fee as business revenue in return for undertaking creditability risk. Bank must at any time understand current value of creditability risk by borrower. Usually risk of normal lending shall fall on borrower and risk of guaranteed lending shall fall on guarantor.

"Inter company guarantee" above is just a temporizing method. Most important problem of this method should make risk of lending unclear.

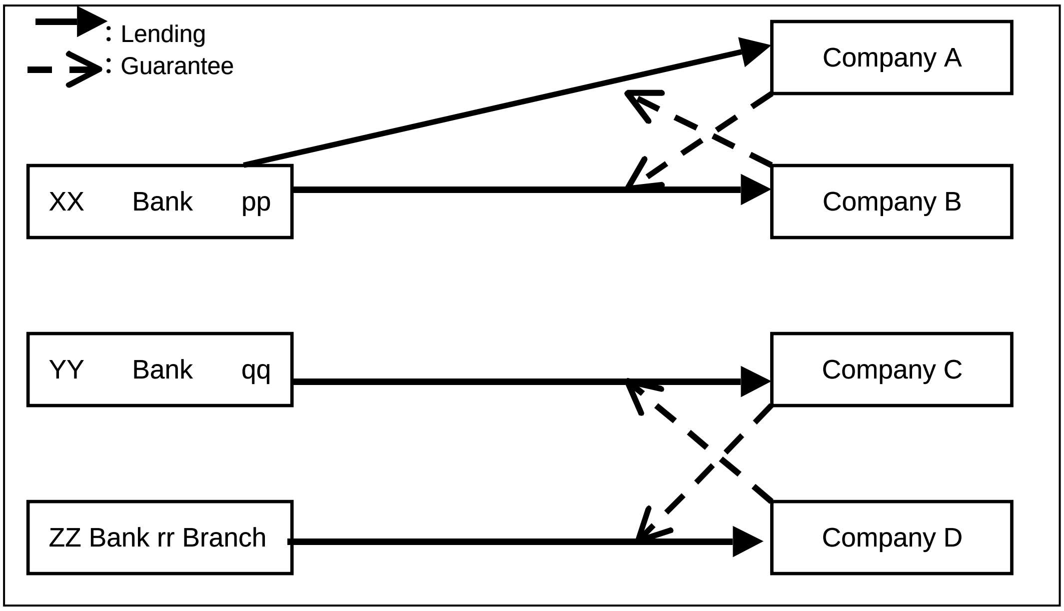
Furthermore, the branch office might know what is temporizing and what is not temporizing. As far as a bank is small and more than one office, problems should not arise. But creditability risk has to be accumulated in a bank and is reported to monetary authorities. If this method was adopted in all the branches in all the nation-wide banks, accumulated value of creditability risk in nation could be meaningless.

Phenomenon of "inter company guarantee" is something like "Triangle Debt".



"Triangle Debt" is shown above. Company B says the cause of non-payment of receivable A falls on non-payment of receivable B. Company C says the cause of non-payment of receivable B falls on non-payment of receivable C. And Company A says the cause of non-payment of receivable C falls on non-payment of receivable A. It is unclear who is ultimately responsible of non-payment and who is ultimate undertaker of inter company credit.

Taken to an extreme, the situation shall become as shown below.



Suppose that the amount of lending by "XX bank pp branch" to company A and B is the same: RMB 1M. The above chart shows lending-borrowing-lending of RMB 1M to A and B realized on the condition of the guarantee each other, although one bank rejected lending without a guarantee.

On this chart, XX bank does not undertake creditability risk of A regarding lending to A. In other words, risk on creditability of A did not increase with lending to A. XX bank undertook creditability risk of B regarding lending to A. But XX bank cannot undertake the creditability risk of B.

"Inter company guarantee" is nothing but temporizing. XX bank undertook creditability risk of both A and B. If A and B are not companies that will admittedly increase the creditability of risk by RMB 1M (referring to internal procedure or governmental regulation), these lendings are a breach of compliance.

And if YY bank reports no creditability of C, and ZZ bank reports any creditability risk of D to monetary authorities, aggregated creditability risk by governmental authorities does not include risk of C and D.

From the point of view of monetary control, correct contents of creditability risk by bank cannot be understood. From the point of view of bank management, correct contents of creditability risk by branch or by customer cannot be understood. In order to maintain control, a detailed history related to each transaction is required to be recorded. Such an arrangement is too troublesome to manage.

But it is acceptable by a bank for the borrower to voluntarily seek guarantor then quit. This kind of arrangement provides quite useful information for a bank to consider, especially when creditability of a borrower can be determined through trade relationships or an associate's relationship. Sometimes banks ask borrowers to let its parent company (with high creditability) or a subsidiary with firm cash flow to be the guarantor. It is a natural course of conducting banking business. But it is serious problem for a bank to introduce a stranger as guarantor to a borrower. And it is out of question to introduce a company that even a borrower recognizes as having quite low creditability, or not to admit investigation of creditability.

On the other hand, complaint by a bank that detail of debt or contingent liability should not be disclosed by borrower is also heard in hearing research. This is a contradiction. Promoting lending by “inter company guarantee” makes a company’s financial structure (i.e., use of debt) highly non-transparent.

Sometimes increase of lending cannot be admitted because of a ceiling of creditability risk for one company, in spite of satisfactory security. In this case, banks in China should recommend multi bankers to customers. Multi banker are of benefit, not only to the borrower, but also to the bank. Financial institutions have a role to support development of companies. If a bank does not increase lending and does not introduce others bank, it is abandoning its public role. But for the development of a company, the banking business cannot develop.

- Scale of creditability risk per one bank is minimized and spread.
- Borrower can obtain various opinions from various banks. Then a borrower can rely on banks.
- Sound competition shall make sound development of banking business.

Basics of risk control are correct measurements of risk. Creditability risk cannot be correctly estimated as far as the “inter company guarantee” remains. Without correct measurements of risk, appropriate decisions on risk control cannot be realized. And they complicate operations because the “inter company guarantee” acts to increase operational risk.

If lending to A and B by XX bank does pose any serious problem, internal or governmental regulations should be reconsidered to admit clean lending to A and B. And criteria to decide the ultimate debtor must be clarified.

Please note that monetary authorities of China have recognized this problem of “inter company guarantee,” and are preparing to prohibit it.

2)”Security” in Chinese banks

Understanding of the risk of lending by Chairman Chen Xiao Jun of Taizhou Commercial Bank (台州市商業銀行陳小軍董事長) introduced in (1) is standard and reasonable, considering the standard of developed countries.

- “Security” is just a comfort whether it is real asset or guarantor.
- “Insufficient security” shall not occur as far as a bank understands the details of borrower.
- Rational decision based on facts of borrower shall realize supply of service satisfied by a customer and sound banking.

But judging from explanations in hearing research, these principles are not understood by most of banks in China (as shown by the phenomena below).

- Clean lending: shall be admitted to quite few companies. Substantially prohibited.
- Real asset: shall only be effective security accepted by a bank.

- Guarantor: includes “inter company guarantee”.
- Credit guarantee: Officially, creditability risk should be shared with a bank. But, substantially, a credit guarantee corporation is forced to take the entire risk.

It is true that consideration of creditability based on facts of a company are fundamentals of the lending business of a bank. But as far as clean lending is substantially prohibited, any incentive to make an effort to understand facts of a company are deteriorated. Although lending based on disposal value of real asset as collateral (without any consideration to creditability) is an “evil way,” banks cannot help but adopt pawnbroker finance since considering creditability is meaningless. In other words, the normal functions of a bank are interrupted by work in China.

But we pose yet another question. Why are guarantees by credit guarantee corporations effective, under conditions that clean lending is substantially prohibited? How can a credit guarantee corporation execute clean lending?

It must be true that credit guarantee corporations make every effort to obtain ”反担保” (Collateral against Guarantee). But the legal description of a credit guarantee corporation is not concrete, while its legal position still remains inferior to that of banks. In spite of such a weak position, the reason why credit guarantee corporations remain could be that credit guarantee corporation take on a role of recourse known as “insufficient security”. Note that credit guarantee corporations are not regulated as financial institutions.

If credit guarantee is security in lending, then this lending is cannot be categorized as clean lending. If credit guarantee is obtained ”反担保” (Collateral against Guarantee), a bank does not need to conduct troublesome collateral control. And a bank should be subrogated if the lending was to go into the category of non-performing. Considering these merits of a bank, banks in China could shift creditability risk and operational risk to credit guarantee corporations.

Most credit guarantee corporations are struggling everyday to maintain a minimum scale of business in order to survive without a fixed position in the market without a system of reguarantee, like Japan. In spite of such an environment, business procedure and methods of operational control of「深圳中小企業信用担保中心」under Shenzhen City Government are as reasonable as procedures of a bank in a developed country with the same as Taizhou Commercial Bank . It is not a matter of whether banks or credit guarantee corporations take the initiative to improve practical technology. But whether banks in Shenzhen, and other regions, act like a cash dispenser based on the security of credit guarantees.

Credit guarantee corporations in China have adopted a system of partial guarantee, the purpose of which could be to let banks maintain responsibility to undertake creditability risk, and to prohibit banks to shift responsibility to credit guarantee corporations. But a bank substantially rejects to take on the burden of realized cost of non-performing loan and, instead, watch the customer. The biggest complaint heard about a credit guarantee corporation during our hearing research was the avoidance of responsibility by banks. In Japan, a credit guarantee corporation guarantees 100% of lending. But a bank undertakes responsibility of management of credit guarantee corporation, since it is one of the shareholders of a credit guarantee corporation. Banks cannot recommend any project without consideration of creditability while maintaining responsibility by mere observation. The environment of security for bank lending is still primitive and is a negative factor to create an incentive for banks to maintain sound management. This will lead banks to adopt conservative fiscal lending policies.

3) Cooperation with credit guarantee corporations

Out of five requirements for credit guarantee system, pointed out in Section 2.5 of this report, two requirements of human resources are also requirements for bank to adhere to, as their assignment is to undertake creditability risk.

Similarly, three essential business divisions of a credit guarantee corporation, pointed out in Section 2.5, are also essential to a bank. It is common for both credit guarantee corporations and banks to undertake creditability risk only after having considered a borrower's creditability, and to be responsible for risk control after execution.

We recognize the policy of the People's Bank of China to be that legal definition of credit guarantee corporation. It should be fixed as early as possible. Moreover, a credit guarantee corporation should be treated as a financial institution after it exchanges opinions with them.

(5) Lending by Bank

In various kinds of policies and laws, the words, "encouragement of SMEs" are quite frequently used. But objects of encouragement could be split into the following categories:

- Foundation
- Development of a large company
- Maintaining fundamental work on a large company
- Maintaining the regional economy

From this point of view of industrial policy, no objects should be missed. But specific types of financial institutions cannot support all of these objects.

Regarding the foundation, priority to support the foundation by a commercial bank and a credit guarantee corporation is quite low. The most effective method to support the aforementioned three objects is to provide working capital. Complaint of shortage of funds for a foundation was not heard in hearing research.

As introduced in (1), the function of providing working capital is the most important public assignment in both Japan and China.

2.4.2. Comment on the report by "Special Assignment Team" of The People's Bank of China Research Division

In this section, the study team's comments are presented on analysis in report by special assignment team regarding authorization criteria to approve lending in commercial banks and inter-company finance.

(1) Authorization criteria to approve lending in commercial bank

1) Importance of authorization criteria and personnel arrangement

In SECTION3 III 2., contents of the Interim Report as of the 2nd term (explained hereafter) were reasonably understood. They explained how commercial banks should understand correct facts of SMEs with words of "soft information" and "hard information." But it is not the final target for commercial bank to prepare workers with such skill. As far as authorization criteria and criteria of personnel arrangement are concerned, if not prepared, then the relationship between an authorizing body, personnel arrangement, and personnel evaluation will suffer. In such an event (where proper analysis is not conducted based on such criteria) commercial banks cannot make full use of workers with high skill and thus should spoil them.

To approve lending, workers with high authorization rights should not have to collect "soft information" by themselves. Nevertheless, they are responsible for the results of the lending they approve. Because the responsibility is great, one with such high authorization rights can enjoy, among other things, a high salary. Moreover, it is required for workers with high authorization right to distinguish false or "soft information" reported by their subordinates, whether the information is valid or not. If the required skill and responsibility of an authorization figure is clear, (meaning they are clearly mentioned in rules and procedures) such workers should soon be promoted to a higher position where the skill they have acquired will lead to more rich experiences, to be excellently performed.

In doing this project, the study team had the opportunity to hear facts from many workers of commercial banks in charge of customer relations throughout various regions in China. The conclusion we have reached is that most workers have already learned how to obtain and how to analyze "soft information" through their experiences. The problem, however, is that excellent skills maintained by excellent workers in charge of customer relations are taken for granted as part of bank procedures. And that good performance of developing excellent skills is not properly appreciated. As a worker in charge of customer relations at a commercial bank, no one can avoid a non-performing loan. As far as even excellent workers are concerned, they would be punished because of a single non-performing loan. Meanwhile, the worker who approved the lending would not be punished. Hence, workers in charge of customer relations should be granted a far greater degree of respect and compensation.

Workers in charge of customer relations, who have developed excellent skills, must be promoted to higher levels along with a higher right of authorization. Only then will other workers in the bank learn to adapt to her skills. At the same time, such excellent skills should be seen as authorization criteria and proper procedures. Only then, when a worker breaches the criteria and procedures, will he or she be punished. As far as criteria and procedure are continuously improved as mentioned, appraisal and decision of lending could be always properly conducted whether the worker with authorization rights is there to approve it.

2) Concentration of authorization to higher levels is not a problem at all

In SECTION3 III 3., concentration of authorization to approve lending to a higher level in bank was the main reason why lending to SMEs in ”xian (県)” level regions failed to increase satisfactorily. But it is not a problem at all for the place of appraisal or decision to be far from the project site. Nor is it a problem for the branch office nearest to the project site to be authorized to approve lending. The real reason why lending gets stalled is because of inappropriate appraisal procedures. If appraisal procedures were based merely on the skills of daily customer relations, then the worker who is authorized to approve lending could easily evaluate whether a worker or branch office have properly considered the facts. In other words, even if he cannot see the project by himself and even if he has never experienced the type of project, he can still properly understand and consider the proposed project.

Rules and procedures in banks are not simply binding mechanisms for superiors and their subordinates. The real purpose of them is to ensure the safety of daily operations. Furthermore, the purpose of rules and procedures is to avoid mistakes and risks in operation, and to improve efficiency in the process. Sometimes workers, or a branch office in charge of promotion, may become too enthusiastic and overlook risks. But if they recognize that rules and procedures are meant for the aforementioned use, soon they will learn to appreciate their utility and begin to adhere to them.

From the point of view of workers in charge of appraisals and decisions, the workplace should be far enough from the branch office, so as not to be easily reachable. Workers with the authorization to approve lending are not superior to workers in charge of customer relations. The two just happen to observe projects from different perspectives. Since the criteria to approve lending are not based on daily operations, any effort at a business promotion is clearly in vein. Outstanding lending does not increase and approved lending soon becomes non-performing.

SECTION3 III 3. Examples of the concentration of authorization rights, to a higher degree, are provided. Authorization to approve lending in a nation-wide large commercial bank is given to no less than the 2nd level branch in a city commercial bank, headquarters, an agricultural credit cooperative, or within a regional association (聯社). Compared with Japan, the situation seems quite reasonable. Even within city banks in Japan, the branch office does not have the authority to approve large amounts of lending. Basically, though, most of lending is approved at the divisional level. It is not rare for a regional bank, Shinkin, or a credit cooperative to limit a branch’s power of authorization so that they cannot approve any lending.

“Each bank has each policy”「一行一策」must be in sound order. The design of criteria to authorize lending must be different by bank. It is true that a governmental authority is required to establish a common rule for any financial institutions to obey. But, as far as financial institutions do not breach such rules, there should be no problem in “Each bank has each policy.”「一行一策」

3) Financial institutions correctly recognize risks

As SECTION 3 I shows, liquidation of collaterals based on current Chinese law is not easy. It is fundamental in the finance business for value of collateral (which is not easily liquidated) to not be evaluated. Low value of collateral means insufficient security. A lower branch cannot be authorized to approve lending without satisfactory security. It is explained to be the problem that comparatively higher levels in banks have the authority to approve mortgaged lending. But it is quite a reasonable arrangement, based on fundamental course of business finance.

As shown above, any phenomena introduced in "SECTION3 III 3" prove that financial institutions in China properly recognize risks and arrange countermeasures to avoid such risks. And these phenomena also prove that most of the workers in financial institutions properly recognize creditability risk and countermeasure to minimize risks, as mentioned before.

(2) Inter company finance

It could be appreciated that monetary authority of China changed its policy to admit existence of inter company finance. Inter company finance is one of the financial behaviors in a market economy and cannot be excluded from this discussion.

The phenomenon introduced in COLUMN1 proves that inter company finance obeys the mechanisms of a market economy. In Japan, short-term interest was higher than long-term interest in the past. And in Hong Kong, in the term of the currency crisis, short-term interest increased much higher than long-term interest within a short span of time. These phenomena, along with the phenomena in Wenzhou, (introduced in COLUMN1) are not in contradiction because interest was fixed according to market mechanisms. On the other hand, commercial banks in China are not considered as properly standardized. It is true that finance with high interest exists among inter company finance. But if interest is being decided on the basis creditability risk, it is agreed by the borrower, and then collected on schedule, it is functioning as an excellent financial institution. Nobody would consider this situation to be non-standardized.

(3) Importance of blood and/or regional relatives in a regional finance system

Blood and/or regional relative relationships in financial activity are quite important. Most "soft information" should be ascertained by observing these relationships. Finance by nepotism offers excessive respect to such relationships, posing a serious problem. This kind of finance is against standardization. But it is impossible for financial institutions to provide any service without there being close relationship within the local community based on a blood and/or regional relative. Shinkin and credit cooperatives in Japan, as well as regional commercial banks in China, respect this as an important factor to be considered in daily business. Financial services that hold close ties with the local community and its residents should not to be confused with nepotism.

2.4.3. Suggestions to Commercial Banks in China

(1) Reform of commercial banks is required

As mentioned in beginning, characteristics of lending to SMEs from the point of view of commercial banks are common in the world. And these are not characteristics specific just to China or other countries shifting to a market economy. Commercial banks in China must not take the characteristics of SMEs, which are their customers, into too much consideration as a reason for hardness of lending. On the other hand, commercial banks in developed countries can support finance of SMEs, because SMEs in developed countries do not have the same characteristics as those in China. Commercial banks in developed countries have prepared internal control procedures to allow workers to make every effort to obtain correct facts based on close relationships with customers, and to let such facts be reached to superiors with authorization rights, while allowing all workers (including the lowest worker, middle level manager, and authorized manager) to consider countermeasures. Having such a system enables financial institutions to support lending to SMEs. Commercial banks cannot obtain profit without putting forth their own amount of effort.

As mentioned in the beginning, the closer that a relationship between bank and borrower is, the more that a bank has to consider “special” factors (such as capital and personnel relationships) during appraisal, especially as the borrower becomes bigger. On the other hand, banks do not have to take such special factors into consideration for ordinary SMEs. That is the reason why appraisal procedures for lending to ordinary SMEs are the fundamental backbone of loan appraisals - craftsmanship of finance is required.

It is true that transactions with large companies are attractive for workers in charge of customer relations, mainly since good performance of a large transaction (in volumes and profit) is highly appreciated by the bank. Incidentally, larger companies tend to have a strong position with banks, and, over time through dealings with them, have acquired the rich skills of finance. Likewise, with a large company, banks are often forced to obey instructions by politicians or governmental officers, without much room to make independent decisions regarding lending policy. Though true of some, most SMEs do not have rich skills in finance. Banks usually support development of SMEs through careful consideration and, as often the case, wish to have desirable finance control.

(2) Craftsmanship of business finance

A bank’s public assignment is to improve the technology required as craftsmen of the finance business, and to provide appropriate suggestion on matters of finance. This “technology” refers to having a correct understanding of facts, which is something that should only be determined after frequent visits to a company. Bankers who sit in a building all day cannot possibly understand all the facts forever.

Japanese commercial banks utilize cash flow projections, which have been in use for many years by Western countries that introduced cash flow analysis, to ascertain facts of companies. Nor do Japanese SMEs prepare detailed financial reports. Any company can conduct a weekly or monthly settlement by paying frequent visits to a company in order to observe cash flow (e.g. going inside the head of management, watching where management goes, who management sees, what kind of car management rides, when and how he bought it, how many cars he has, the situation of procurement and sales, attitude of workers, etc). Bankers verify such information by viewing the contents of a promissory note or condition of receivables and payable, and make up weekly and monthly cash flow projections. Once sound financial and business performance has been recognized based on such efforts, banks can easily extend lending and enjoy thick spread, even as apparent financial performance may not be so good. And only after improving their technologies can banks can find out whether a customer is low risk or not. Then they will enjoy high profitability.

(3) Specific problems in China

There are two problems, though, which can only be resolved by additional means.

The first problem can only be solved by earnest efforts of financial institutions. In China, promissory notes are not a common method of payment. Condition of payment is not usually fulfilled as agreed prior. A promissory note represents flow of funds around the company and creditability in the market. Banks can understand supplier and condition of payment based on contents of a promissory note. And banks can understand their relationship with a buyer based on a promissory note issued by the customer. But even if banks understand the facts, such facts are of no use in China, as conditions of payment are not fulfilled and promissory notes are not used.

The second problem can only be solved if banks put forth their best effort. This is a problem of internal control. The Chinese would feel strange to hear that the financial technology of China is not well developed; especially since information on specific skills of the banking business and financial theories prevail in China. For instance, the People’s Bank of China recently issued materials of practice contents, which are the same level as textbooks used in Japanese commercial banks. Moreover, various textbooks on banking are practically the same level as those sold in an ordinary bookstore. For example, common knowledge says to prepare by accounting code, B/S, P/L, and cash flow are required. Yet many Chinese have not learned such skills. Nevertheless, sound banking cannot be realized even if a bank were to hire such knowledgeable personnel.

(4) Lending procedures in Japan

Here typical procedures of Japanese banks are introduced first for comparison before referring to the phenomena in China. Chinese bankers who attended the research hearing were all surprised to learn about the differences between Japan and China.

No matter what kind of bank, from a small regional bank to, what is commonly called, a four-mega bank in Japan, one worker in charge of an SME has the responsibility of overseeing 50-100 customers. A general manager will try to visit as many customers as possible, even if an urgent matter is not pending. On average, he may visit one customer in the morning and two in the afternoon. Evening entertainment activities are also important, for they pose opportunities to build customer relationships.

All the workers in a branch office, whether in charge of customer relations, loan operations, deposit operations, or general affairs, are required daily to report to the general manager: a plan, one’s progress, and the end result. The general manager not only reads it, but also instructs and sometimes takes action when necessary. As all the management on the line, including manager and joint general manager, also read these report daily, all parties can share the same information.

Sometimes a worker in charge of customer relations cannot help but keep incomplete and important materials with a customer’s signature. But if how to manage such cases is not standardized in procedure, and manage based only on the relationship between customer and the worker in charge, a serious problem will occur. This could even be the cause of a crime. Hence, workers in charge of customer relations may not feel at ease when they receive important documents. In Japanese banks, this procedure - for a manager of business promotion to verify all the important documents with reason of pending so that all the subordinates keep and to carry them in vault room – is standardized.

Many Chinese would also feel these practices to be natural. But it is not certain whether a state-owned commercial bank prepares common procedures and common forms or not, and whether detailed ways of verification are mentioned in the procedure or not. Nor whether compliance of procedure is audited or not.

(5) Lending procedures in Chinese commercial banks

The reason why the practices of Japanese banks were introduced first is that this phenomenon was heard in the research hearing. In Xian, a state-owned commercial bank, a worker in charge of customer relations told me he could take care of only five-to-six customers. The study team commented that the headquarter division in charge of procedures and planning and the branch office management were responsible to solve this kind of problem. We then introduced to him practices in Japan, which are as follows:

- Japanese banks prepare procedures that show detailed operations common to any branch office.
- Headquarter staff in charge of procedure begin by confirming facts in the branch office. Progress and drafts of procedures are disclosed to all branch offices. In order to improve, headquarter staff are always free to hear opinions on procedure.
- All the rules and procedures are common and so detailed that any worker can be transferred to any branch office. (Usually this process of transfer must be completed within a week.)

Headquarter staff in charge of the planning of procedure must understand the real purpose of rules and regulations, which is not to bind inferiors by superiors, but to avoid possible risk and to improve overall efficiency of an operation. Rules and procedures are not to be instructions that are of a vague concept, but specific instructions based on confirmation of daily operations.

A state owned bank in Taizhou disclosed that workers became too reluctant to business promotion after it let workers in charge of customers who are responsible for relationships, business performance, and non-performing loans. Such an arrangement is out of the question. It was felt quite strange that the regional office is authorized to decide such important matters related to the responsibility of lending and personnel evaluation. And there should be no reason for an assignment of general manager or manager if the worker in charge of customer relations is to be responsible for everything. A bank like this should consider relinquishing its rules of corporate governance.

The practice of an “inter company guarantee” is also a reason to give up corporate governance. Although governmental regulation has overlooked it, as far as corporate governance is effective in a bank, any seniors, president, general manager, or credit division should have rejected such an arrangement. Suppose if a general manager and lower worker were to take the “inter company guarantee” for granted in a branch office of a state-owned commercial bank. If this is the case, the credit division in headquarters should have argued. Because even if the credit division overlooked it, an internal auditor should have argued after execution. This phenomenon is considered as symbolic case of finance business in China.

(6) Corporate governance in Chinese bank

The ways of governance in commercial banks in China seems something like the ways of a capitalist without any skills of operation driving craftsmen. Unlike artwork, which we attribute value to subjectively, distinguishing management without any skills or knowledge on production from craftsmen who are evaluated by sales is an objective judgment. But even for manufacturing, such ways of management could only be applied to the small- home industry. If applied to mass production, a manufacturing operation would soon collapse.

In banks where workers do not know much about the daily operation of fundamental business, like deposits or loans (or not competent to make appropriate banking decisions) it is not worth assigning them to management. Management of a branch office must be such that personnel can give correct instructions to subordinates who cannot find appropriate countermeasure. And, if necessary, can perform in place of said personnel.

The answer to the proposition, “is it best for banks to hire worker with good skills so that they to improve?” is a resounding no. As far as appropriate procedures of personnel evaluation and operation, merely gathering skilled workers is not the sign of an efficient company. Local bankers that attended our research hearing complained that placing appraisals should be an activity left far from the project site because it raises the issue of criteria for appraisals, which are not common and detailed, nor based on daily operations. Hence, a worker in charge of them (appraisals) cannot avoid a basic human bias that says, ultimately, he will lend based on his own sense and experience. In other words, he cannot fully comprehend something (in this case, projects) he cannot see.

(7) Commercial banks in China must reconsider tradition

We would like to contribute to the development of banking in China by introducing the skills of Japan and the advanced Western countries. But we do not believe in applying these skills to China without some exception; the Chinese must first analyze the facts of their economy in order to implement improvements that are suitable to China.

As introduced, Japanese banks developed methods to analyze facts of a company based on detailed cash flow projections far before banks in the West made the concept of cash flow popular. It is an indispensable skill to have when lending to SMEs. In Hong Kong, for instance, the practice of ”Local L / C” was adopted for domestic transport. Bankers in charge of daily operations, who made an effort to employ risk minimization techniques based on local trade, practice to continually develop such skills.

People of Shanxi Province developed a system of promissory note (山西票庄). Some researchers believe B/S was used in the Yuan dynasty（元）. It is quite important not to ignore such a tradition and to make a conceited effort to apply such skills to the modern economy. Efforts were made by private financial institutions（商号・銭荘）to avoid risks and to improve operation control during the confused era from about the last stage of the Qing dynasty（清）to the establishment of the People's Republic of China. This history should be revered as a process or effort by Chinese to construct a well-working financial system and we should not discount it as simply a pre-revolution phenomenon. If commercial banks in China were to make an effort to improve their financial system, they would become a reliable trade partner of the Japanese and other western commercial banks. This effect is not only true in China but also of other countries attempting to forge their way into the international finance market.

2.5 Construction of the credit guarantee system in China

2.5.1 Credit guarantee systems in China

The following are requirements for development of the market economy:

- Fostering diverse SMEs that have production techniques and management skills, as a fundamental unit of economic society.
- Consolidating the financial system to allow necessary business funds to be smoothly supplied to SMEs as required.

To realize these two requisites, a credit guarantee system connecting SMEs with financial institutions must be established. This is because medium and small companies and financial institutions have conflicting demands:

- SMEs: As their size is small and operation is unstable, fund needs are not necessarily periodic. In addition, it is not easy to realize debt service as scheduled for long time.
- Financial institutions: They expect loan customers to be stable, that is, to make repayments according to installment schedule.

For a “credit guarantee system,” it is indispensable that the policy system has both sufficient social creditability and concrete assistance ability. As a result of establishment of the system, three parties, SMEs, financial institutions, and credit guarantee institutes will develop harmoniously and sound finance will be realized.

As sound finance is a base of development in a market economy, we consider this an urgent task for China, which aims to foster domestic private companies and fully join the international market, in order to have an effective credit guarantee system.

(1) History

Formulation of a credit guarantee system in China started in the 1990s.

In November 1993, under the direction of the State Economic and Trade Commission (now defunct; approximately corresponding to the Division of Industry, Ministry of Economy, Trade and Industry of Japan; hereinafter referred to as "SETC"), the Institute of Chinese Economic and Technical Investment Security (中国経済技術投資担保公司) (hereinafter referred to as the “Institute (公司)”) was founded experimentally in Beijing under the direction of the Division of Small and Medium sized Enterprise （中小企業司）. Taking this opportunity, SETC gave guidance to spread credit guarantee institutions called “trial institutions (試点)” throughout the nation after 1998. In response to this, many and various credit guarantee institutions were established in many regions in China.

During that period, under the slogan of “One Body with Two Wings,” SETC encouraged establishment of credit guarantee institutions by the use of private funds coming from private initiative, together with credit guarantee institutions in which financial funds were invested at the initiative of government organizations.

(2) Construction of a nationwide organization of credit guarantee institutions

To systematically organize credit guarantee institutions, whose numbers reached several hundreds as a result of policies to encourage establishment, SETC issued a order, "国経貿中小企 2001-198 号." Specifically, it was determined to, not later than March 31, 2001, appoint the following two kinds of credit guarantee institutions that met given requirements as institutions approved as "trial institutions for a nation-wide credit guarantee system for SMEs (全国中小企業信用保証体系試点)":

- Credit guarantee institutions engaged solely in credit guarantee operation for SMEs (**「中小企业信用担保机构」**)
- Institutions engaged in credit guarantee operation for SMEs (as an additional operation) (**「从事中小企业担保业务并符合试点条件的商业担保机构和互助担保机构」**)

Results of the approval have been disclosed three times so far and the number of "trial institutions for the system" is 483 in total.

Table 2.5.1

Number of institutions	First time	Second time	Third time	Total
Engaged solely in this business	66	98	25	189
Also having other operations	38	128	128	294
Total	104	226	153	483

First time: April 28, 2001; 「国経貿中小企 2001- 406」
Second time: September 18, 2001; 「国経貿中小企 2001-948」
Third time: February 14, 2003; 「国経貿中小企 2003-14」

We confirmed this information with the Division of Small and Medium sized Enterprise (中小企業司) of the National Development and Reform Commission (国家発展改革委員会). They answered that "trial institutions for the system" were under laundering review and the results would soon be made public as "the fourth" release of information.

Also according to the announcement of the above-mentioned Office, the number of trial institutions, as of June 2003, for the system was 966.

(3) SMEs Promotion Law

Acknowledging the importance of promotion of SMEs in the period of shifting to a market economy, China enacted the "SMEs Promotion Law （中小企業促進法） " as a fundamental law. (It was adopted at the National People's Congress, corresponding to the Diet of Japan, on June 29, 2002) The act was enforced on January 1, 2003. According to the Chinese government's explanation, based on this, the credit guarantee system changed from "the stage of trial institutions"(試点段階) to "the stage of promoting based on legal definition."（依法推進） .

A chapter regarding financial support by the government is set up as the second chapter of the said law, where it is stated that the government shall establish and expand "the national developmental fund for SMEs" using fiscal budget of national and regional government (Articles 10 to 12). The law states that the government is to "support in the establishment of the credibility guarantee system for SMEs" as one use of this fund (Article 13 (2)), and that the People's Bank of China, the central bank, "should enhance its support to the small and medium financial institutions, encourage the commercial banks to adjust their credit structure and enhance their credit support to the SMEs." (Article 14)

Articles 18 to 21 provide that the state shall promote construction of a credit guarantee system and that "the regulations for SME credit guarantee management"(**中小企业信用坦保管理办法**) will be stipulated separately by the State Council." "Various forms of mutual aid financial guarantee" (**多种形式的互助性融资坦保**) in Article 21 mean a kind of mutual guarantee credit cooperatives established by SMEs themselves.

"Mutual aid financial guarantee" institutions are around 5% of all credit guarantee corporations now, and the main ones are formed autonomously by local Federation of Industry and Commerce （**工商聯**） (* organizations of those engaged in industry and commerce of the Chinese Communist Party) and associations of enterprises. The source of guarantee funds (capital) is mainly injected by member companies and local governments give certain grants-in-aid.

The credit guarantee system in China has acquired its legal basis from the SMEs Promotion Law. However, the above-mentioned "regulations for SME credit guarantee management"(**中小企业信用坦保管理办法**) based on the said Act have not been enacted yet, which is one of the causes of on-site discontent and confusion.

(4) Actual situation of credit guarantee institutions in China

According to 「**中小企業簡報第 7 期**(2004.2.10)」issued by the Division of Small and Medium sized Enterprise, the situation as of the end of June 2003 was as follows:

Table 2.5.2 Overviews of credit guarantee institutions (Figures are the number of institutions.)

Provincial level	43	100% owned by the Government	305	Artificial persons	701
Local city level	436	Partly owned by the Government	321	A unit of artificial person or government	181
Others	487	Wholly owned by the private sector	340	Incorporations	84
Number of credit guarantee institutions in China 966		Number of credit guarantee institutions in China 966		Number of credit guarantee institutions in China 966	

Table 2.5.3　Actual achievements of credit guarantees

Accumulated number of companies enjoyed guarantee by credit guarantee institutions	48,318	(50 per institution on average)
Accumulated number of loan transactions guaranteed by credit guarantee institutions	100,035	(103 per institution on average)
Accumulated amount of loans guaranteed by credit guarantee institutions	RMB 117.9B	(RMB 120M per institution on average; RMB 1.17 M per company on average)

Table 2.5.4　Guarantee funds

Injected by the Government	RMB 12.18B	(42% in amount; RMB 29M per institution on average)
Total amount of guarantee funds of 966 institutions	RMB 28.65B	(RMB 194M per institution on average)

(Accumulated amount of loans guaranteed by credit guarantee institutions ÷ Total amount of guarantee funds　= approx. 4*)

Table 2.5.5　Income of operation

Income of credit guarantee fees	RMB 2.09B	(74% of total income, RMB 21M per institution on average)
Income of investment	RMB 510M	(18% of total income, RMB 5M per institution on average)
Others	RMB 220M	(8% of total income, RMB 2M per institution on average)
Total	RMB 2.82B	(RMB 2.9M per institution)

(5) Problems of credit guarantee institutions in China

Credit guarantee institutions in China are small and most institutions can guarantee small loans only.

SETC had expressed guiding opinions(指導意見) regarding standards of establishment of credit guarantee institutions several times prior to enactment of the SMEs Promotion Law.　It is surmised that, with a mind to future enactment of the Act, the SETC set those guidelines to support the establishment of institutions with the credit guarantee function for loans in relatively small sums as a trial and to facilitate the establishment of cooperative relationship for credit guarantee business between government organizations and the private sector. It is, however, considered that enabling simplified establishment of credit guarantee institutions might have been the main reason for establishing several hundred institutions.

Development is expected under the system based on the SMEs Promotion Law.　But there are also problems to be settled.　Three problems are listed below.

1) The object of the system is discursive.

Since the expansion of “trial institutions” was started in 1998, the number of credit guarantee institutions in China has increased at a year-on-year rate as high as 25%. Characteristics of established credit guarantee institutions, sources of guarantee funds and those given credit guarantee have been diversified and the number of institutions which deflect from the primary object of the credit guarantee system has been increasing.

Characteristics of credit guarantee institutions can be divided into policy related, commercial, and a mixture of these two. Corporate structure is also extremely diverse, such as departments in governmental organizations, wholly state owned corporations, private limited companies, corporations managed by various investment funds and those established by industry associations.

As a result, there are many institutions that are widely different from the primary object and the primary operating policy of the credit guarantee system.

2) Tight guarantee funds

One important condition to maintain the credit guarantee system is to secure a large amount of funds in the form of guarantee funds (capital). The source of guarantee funds is mainly the private sector. As credit guarantee institutions are small, it is impossible for them to accumulate the guarantee funds required by the society, and credit guarantee institutions cannot maintain high maximum ratio of guarantee.

Actually, most credit guarantee institutions in China have reached the maximum ratio of guarantee shortly after establishment and cannot manage to increase guarantee funds. Maximum ratio of guarantee stays at 2 - 4 times on average, and guarantee funds are around RMB20 – 30M. The number of transactions of credit guarantees per year is around 100 at most.

3) Undeveloped credit guarantee institutions engaged solely in credit guarantee

Although the SMEs Promotion Law was issued, specific operating rules including “The regulations for SME credit guarantee management”(**中小企业信用担保管理办法**) are still in the course of preparation. A legal system required for establishment of credit guarantee institutions engaged solely in credit guarantees and for operation of liquidation of collateral and ownership has not been put forward yet. In addition, no re-guarantee system exists.

On March 10, 2003, a restructuring of the State Council was approved at the National People’s Congress. SETC was discontinued and the Division of Small and Medium sized Enterprise affiliated with SETC was put under the National Development and Reform Commission (former State Planning Commission, State Development Planning Commission).

As shown in the SMEs Promotion Law, this Division of Small and Medium sized Enterprise and the People’s Bank of China will strive for improvement of the present situation by enacting detailed regulations of the credit guarantee system, and will become the main bodies to construct systems/institutions having really effective credit guarantee function in the end.

We strongly expect that problems will be recognized from this development study project and that implementation of specific policies against them will be realized.

2.5.2 Results of the field survey and problems

This development study project is comprehensive, covering all of China. We aimed to leave no gaps in our understanding of the credit guarantee system by collecting opinions through questionnaire surveys, hearing surveys and seminars. Especially noteworthy results obtained from these activities are described below.

(1) Scale of the study

Table 2.5.6 Number of institutions covered by the questionnaire survey

	Number of institutions
Beijing district	15
Wenzhou and Taizhou district	15
Dongguan and Shenzhen district	15
Xian district	15
Weihai district	15
Total	75

Survey period: November to December 2003

Table 2.5.7 Number of institutions covered by the hearing survey

	Number of institutions
Beijing district	2
Wenzhou and Taizhou district	11
Dongguan and Shenzhen district	7
Xian district	10
Weihai district	7
Total	37

Survey period: November to December 2003

(2) Realities and problems seen in the results of the questionnaire survey

1) Credit guarantee institutions are in a transition period

Most credit guarantee institutions were established between 1999 and 2003 (93%) and most have operated approximately three years. It can be said that institutions are in a trial and error period. Problems do not come out into the open, but remain invisible regarding both the system and individual institutions. In the current stage, guidance from the central government/financial authorities is expected.

Operations of credit guarantee are closely related to the life cycle of SMEs, which enjoy credit guarantee. Many SMEs that were newly founded after the reform and openness policy are in the initiation period for future development. Possibility of default of such companies is low. This gives business managers prediction that credit guarantee operations will continue to go smoothly. They are optimistic in general and have a vague consciousness about problems that will come up most surely.

Table 2.5.8 Rate of default seen in results of the questionnaire

Year	Achievements of credit guarantees		Subrogated payment		Rate of default
	Number of transactions	Amount (RMB 10.000)	Number	Amount (RMB 10.000)	
2000	462	15,769	3	45	0.29%
2001	734	34,701	7	338	0.97%
2002	1,236	76,990	5	1,255	1.63%
2003.9.	1,002	65,247	3	216	-

2) Tight guarantee funds

It is also shown in the results of the aforesaid investigation by Division of Small and Medium sized Enterprise that, for the most part, credit guarantee institutions were founded with governmental funds. In the questionnaire survey, the result also shows that 51% were founded with government finance.

Among business managers, those from governmental organizations make up 54%. Both fund base and personnel base appear to be stable. They, however, are operating credit guarantee institutions for the first time, and do not have specific skills of management although they recognize the potential demand for credit guarantee. In addition, because of mass amounts of local fiscal expenditures during a term of rapid economy growth, additional injection of guarantee fund by government cannot be expected. It is necessary to change the way of thinking from dependence on the government to active self-operation.

As will be mentioned later, even in the guidance of the Ministry of Finance, the maximum ratio of guarantee is no more than ten times. Actual maximum ratio of guarantee is 3 to 5 times and 4.1 times on average. Such a low ratio cannot be considered as satisfactory level of credit guarantee institution.

As actual achievements of credit guarantees rise, the upper limit of the maximum ratio of guarantee will already be reached 2 to 3 years after establishment and new credit guarantees will become impossible. Of course, the upper limits will rise if guarantee funds increase. It is, however, difficult to obtain additional funds in the present state of affairs. Small credit guarantee institutions acting in limited areas are obliged to be dormant.

3) Credit guarantees for private (non-state-owned) companies

At least from the results of questionnaire, 50% of the amount of subrogated payment is made for private companies and the percentage of wholly state-owned companies is limited to 25%. Although it is not very meaningful to evaluate at the stage where a satisfactory credit guarantee system has not yet been established, the role of the credit guarantee system to support private SMEs seems to be played to a degree. That operation of private SMEs is far off from what was confirmed from this investigation and it is expected that this state of the system will be maintained.

4) Securities and mortgages of real assets

The issue of collateralism in finance industry of China is being discussed due to the introduction of the credit guarantee system. In other words, credit guarantee institutions (operators new to the Chinese finance industry) bring in new problems to conventional practices of collaterals and mortgages.

The realities were also clarified by the results of the questionnaire that showed credit guarantee institutions deal with collaterals and mortgages differently from conventional financial institutions. It shows that there are circumstances where operations cannot be carried out without doing so.

Chinese financial institutions have conventionally respected real asset as collateral while considering the value and maintenance as an easy conversion to cash. On the other hand, credit guarantee institutions seem to consider the prospects of products, levels of internal control, and structures of profit and loss, while respecting prospect and the possibility of growth of companies without pursuing facts, nor taking financial performance into consideration. This is caused by the circumstance that they must provide credit guarantees to SMEs without any track record of operation, any relationship with financial institutions, or any real assets as collateral.

Facing such new important assignments, Chinese credit guarantee institutions are always pressed to decide what should be given the most weight among various risks, such as the creditability risk of SME itself, sector risk, and the operational risk of credit guarantee institutions.

The problem of collateral and mortgages is not a matter of credit guarantee institutions only, but a matter of the whole financial industry. We consider that the government should take the following measures:

- To reconsider legal description related to liquidation of collateral, assignments of mortgages, and ownership. Particularly, reconsideration of the practice of “collateral against guarantee” (反担保) (see Chapter 2.4) which imposes a heavy burden on SMEs.
- Construction of a reguarantee system that is indispensable to the credit guarantee system.
- Establishment of fair accounting codes and an organization for supervision of them, both of which are indispensable to correct estimation of creditability of companies; and, furthermore, establishment of rules and regulations for fair valuation and liquidation of collateral assets.

(3) Summary of hearing from credit guarantee institutions

In the hearing survey, specific opinions and requests were heard from those who now operate credit guarantee institutions (chairman or general manager, etc.). Frank opinions could be heard directly. Noteworthy remarks among them are introduced below.

Most of institutions are small with capital of several tens of millions in RMB. And the maximum ratio of guarantee defined in the articles of association is low at three to five times the common rate. In addition, they cannot provide new credit guarantees because the balance of outstanding guaranteed liabilities has reached this maximum amount of guarantee.

Though in a small number, some institutions have increased capital in five to ten years after establishment. Some aim to be listed with large shareholders in spite of short time after establishment, while some are specialized in guarantees to hire the purchase of passenger cars. All of these phenomena were found in Taizhou where a private economy, in particular, has been developing in China. Of course, most opinions are complaints on hardness of finance and on the insufficiencies of the system. Above all, for the credit guarantee system itself, there is strong support in requesting clarification of the legal position, and specific administrative and policy lines for fostering and positioning the system.

As previously noted, "Trial institutions for the system" (at the first time and the third time) are about 20% of institutions in various locations that participated in this hearing survey. Confirmation was made to one of the trial institutions and the answer was that no specific benefit accompanied approval as a "trial institution for the system".

(See (Table 2.5.9: Actual condition of credit guarantee institutions participating in the hearing survey)

Table 2.5.9 Actual condition of "trial institutions for nationwide credit guarantee system for small-and-medium-sized enterprises ("credit guarantee institutions") participating in the hearing investigation

Institution name	Foundation (year)	Trial institution for the system	Capital (in RMB million)	Maximum ratio of guarantee (times)	Guarantee rate (%)	Guarantee fee rate (%)	Balance of outstanding guaranteed liabilities (in RMB million)	Subrogated payment	Problem	Request
(Beijing district)										
中国経済技術投資担保	1993	With other business	600	10			10,000			(Confident of future operation)
北京中関村科技担保	1998	With other business	350	10	100	1.8	3,500	1%	Guarantee limit, shortage of fund	(Confident of future operation)
(Wenzhou and Taizhou district)										
台州路橋区路橋街道企業担保	2002	-	2	5		0	18	-	Guarantee limit, shortage of fund	(Reguarantee institutions)
台州市椒江区中小企業経済担保有限公司	1999	-	26	5	100	1.2	39	-	Diversification of risk	Clarification of legal description
台州市尚信担保投資投資有限公司	2003	-	10	20	100	1.9	97	-		(Confident of future operation)
台州市金泰担保投資有限公司	2003	-								
台州双赢担保服務有限公司	2002	With other business					26			Clarification of legal description and system improvement
(Dongguan and Shenzhen district)										
深圳中科智担保投資有限公司	1994	-	400	3	80	2.0	900	0.2%		(Confident of future operation)
深圳市中小企業信用担保中心	2000	Specialty		6	80			-		(Confident of future operation) Looking forward to 100% guarantee
東莞市遠大信用担保有限公司		-							Fragile creditability	Clarification of legal description
深圳企欣信用担保有限公司	1999	-	1,700		100		1,400	0.5%		(Confident of future operation) Looking forward to being listed
深圳市華融投資担保有限公司		-							Uncertainty over development toward privatization	Clarification of legal description
(Xian district)										
西部信用担保有限公司	2003	-	4				1		Risk aversion	Clarification of legal description
陝西省中小企業信用担保公司	2001	-	0.5			2.0	0.5			
西安市経済技術投資担保有限公司	2000	-	1	5		2.5	4		Guarantee limit	Clarification of legal description
咸陽市中小企業信用保証担保中心	1999	-	0.2	3	100		0.3	0.1%		Clarification of legal description
楊凌示範区中小企業信用担保会社	1997	Specialty	0.2				0.5			Clarification of legal description

(4) Financial institutions' opinions on the credit guarantee system and institutions

The existence of credit guarantee institutions is widely known. As far as we have heard, however, track records of credit guarantee are significantly limited. It has been surmised that the main cause of this situation is that to judge the creditability of credit guarantee institutions is difficult because many credit guarantee institutions were founded two or three years ago. And, also, the system is not public. Therefore, financial institutions' awareness of the credit guarantee system and their understanding of its effects are poor.

The following table shows the major evaluations and opinions regarding credit guarantee institutions and the system, which were heard from financial institutions. Concerns about the creditability of credit guarantee institutions and indications of the unimproved system / procedure are conspicuous.

Table 2.5.10

Assistance from the government is necessary.
・ It is impossible to continue business by the private sector only. Assistance from the government is necessary (Wenzhou Commercial Bank) ・ Legal and public positioning is not clear. Assistance from government is necessary. (C, Taizhou) ・ Positioning is not clear; financial institutions or non-bank credit institutions (ICBC, Xian) ・ Excessively small capital (ABC, Taizhou)
Because of the unimproved credit guarantee system, the creditability of credit guarantee institutions is low.
・ Perception that the system is still at the trial stage. The use of it is postponed. (ABC, Dongguan) ・ The system has not been established. (C, Dongguan) ・ Responsibilities and obligations of credit guarantee institutions are unclear. (ICBC, Dongguan) ・ Legal matter related to ownership, particularly handling of collateral or mortgage, are unclear. (ABC, Dongguan) ・ Loan with security of credit guarantee is only 1% of the total. (Taizhou Commercial Bank) ・ It is judged that no improvement has been made to reach the condition aimed at by the philosophy of foundation. (M, Xian) ・ As the realities of credit guarantee institutions are unclear, they cannot be used. (ICBC, Xian)
The maximum amount and maximum ratio of guarantee are low.
・ The maximum amount of guarantee per credit guarantee institution is limited to 10% of capital or lower. (ICBC, Dongguan) ・ With maximum ratio of guarantee of 5 times, the maximum amount of guarantee is reached soon. (ICBC, Dongguan) ・ With maximum ratio of guarantee of 4-5 times, the maximum amount of guarantee is reached soon. (Wenzhou Commercial Bank)
Terms and condition of credit guarantee system is too rigid.
・ Some credit guarantee institutions charge guarantee deposits of 20% on beneficiaries. (ICBC, Dongguan) ・ The guarantee fee rate of 1.5% is too high (Wenzhou Commercial Bank) ・ Terms and conditions are rigid and costs of the use are high. (Xian Commercial Bank)
The subrogated payment function is not working.
・ Some credit guarantee institutions lost about 20% of capital of RMB 14M as a result of occurrence of subrogated payment of RMB 3M. (Wenzhou Commercial Bank) ・ It took five months to complete the procedure for subrogated payment. (Xian Commercial Bank)

"C" = Bank of China（中国銀行）, "ICBC" = Industry and Commerce Bank of China （中国工商銀行）, "ABC" = Agricultural Bank of China （中国農業銀行）, "CB" = Construction Bank of China (中国建設銀行), "M" = China Merchant Bank(招商銀行)

(5) SMEs opinions on the credit guarantee system and institutions

Of course, SMEs' valuations and opinions regarding credit guarantee institutions and the system depend on whether they have actually used them.

The actual scale of use of the credit guarantee system in China remains limited and small. As summarized in the following table, only limited opinions could be obtained from the hearing survey.

Table 2.5.11

Utilization of the credit guarantee system
・ We utilize the system effectively. We are a shareholder of credit guarantee institutions. (Sewing machine manufacturer in Taizhou) ・ We utilize the system effectively. We supply capital to credit guarantee institutions. (Plastic manufacturer in Taizhou) ・ We utilize the system. (Reflecting material manufacturer and distributor in Taizhou)
The system is incomplete
・ Application of the system is limited to large-and-medium sized companies. (Water-treatment company in Dongguan) ・ Only RMB 2M was guaranteed out of fund required of RMB 7M. (Company same as the above) ・ Credit guarantee institutions adopt the same principle of lending based only on value of real assets as banks. They do not weigh the value of intangible assets such as patents. (Software developer in Dongguan) ・ We requested a credit guarantee, but we could not get it because the institution to which we applied had reached the maximum amount of guarantees. (High-class alcoholic beverage wholesaler and retailer in Xian) ・ I have only seen the credit guarantee system during a tour of inspection abroad. (Machine tool maker in Xian) ・ Banks have a negative attitude toward credit guarantee institutions. (Controlling equipment company in Xian)
Terms and conditions are rigid.
・ Real assets are requested as collateral against guarantee . (Water-treatment company in Dongguan) ・ Though collateral against guarantee was requested, our company did not have such collateral value. (Auto seller in Xian) ・ 30% of the amount of guaranteed liabilities were collected as a guarantee deposit. (Manufacturer in Dongguan)
Credit guarantee fee rates are high.
・ A guarantee fee rate of 4% was collected. (Water-treatment company in Dongguan) ・ A guarantee fee rate of 3% is high. (Manufacturer in Dongguan)

2.5.3 Fundamental principle of credit guarantees

After discussion of what direction the credit guarantee system should take, we consider that it is timely to attempt to design a future system based on the questionnaire and hearing surveys, determine the ideal form of credit guarantee institution, and then compare and contrast them with the actual ones. The fundamental principle of credit guarantees is introduced below, not to mention, my long-time involvement in credit guarantee affairs.

(1) Basic model of credit guarantee functions

Today, credit guarantee systems prevail internationally and operate in various forms suitable for the social and economic circumstances of each country. They can be broadly divided into the following two categories:

- Systems for which emphasis is put on appraisal of subject companies' creditability, commonly used in Europe, which is the birthplace of credit guarantee systems (along with the U.S.A.). These systems are characterized by partial guarantees, specified lines of business, and a shut-in characteristic. Transaction volume is restrictive.
- Systems which have expanded from Japan through Korea and Taiwan to Asia and whose object is to realize national financial and economic policies based on large scale of transaction volume. Public systems that provide 100% guarantee and cover all places throughout the country.

These two systems are same in that credit guarantee institutions compensate the creditability of SMEs and security for financial institutions. However, for promoting economic policies as part of "national policies" and for achieving social effects, the latter is definitely more effective and efficient. So, we judge that this point should be emphasized in the selection of a basic model for credit guarantee systems in China.

Table 2.5.12 Comparison of credit guarantee systems in key countries and regions

Country or region name	Abbreviated institution name	Percentage of guarantee	Fee rate of guarantee	Number of guarantees annually handled	(Year)	Reguarantee system
Germany	**KGG**	**80-90%**	**0.5-1.0%**	**7,886**	1994	
Australia	FGG	85%	0.6%	4,687	1995	Government's reguarantee of 20%
Switzerland	GB	100%	0.5-2.5%	671	1993	
France	SOFARIS	50-100%	0.4-0.6%	6,647	1994	
Italy	CGS	50%	1.0-1.5%	1,827	1994	
U. K.	**DTI(*)**	**70%**	**1.5%**	**7,484**	1995	
Netherlands	MEA(*)	75-100%		3,533	1994	
Spain	**SGR,SCM**	**100%**	**1.0-1.4%**	**9,542**	1995	Company's reguarantee of 50%
Belgium	MGC	80%	0.2-0.7%	3,723	1993	Government's reguarantee of 50%
U.S.A.	**SBA(*)**	**90%**	**2.0%**	**599**	1995	
Canada	ISTC(*)	50-90%	1.0-2.0%	383	1994	
Indonesia	P.T.Askrindo	70%	0.65%	59,729	1996	
	PerumPKK	90%	1.5-6.0%	5,984	1996	
Malaysia	CGCMB	70-90%	0.5-1.0%	14,965	1996	
Nepal	CGCN	75%	1.8-8.0%	47,856	1996	
Philippines	GFSME	60-90%	1.8-3.0%	252	1996	
	SBGFC	50-100%		422	1996	
Sri Lanka	CBSL	60-90%	1.0%	-		
Thailand	SICGC	80%	2.0%	237	1996	
Taiwan	**SMBCGF**	**100%**	**0.75%**	**100,952**	1996	
South Korea	**KCGF**	**100%**	**1.0-%**	**144,274**	1996	
	KOTEC	100%	1.0-1.5%	40,359	1999	
Vietnam	CGCV	80%	2.0%	-		
Japan	**Credit Guarantee Corporations**	**100%**	**1.0%**	**1,669,584**	1999	Government's reguarantee of 70%

"Credit Supplement Systems in Asia, Europe, and North America/1997" (National Federation of Credit Guarantee Corporations)

(2) Functions of credit guarantee institutions

Credit guarantee systems have achieved diversified global development. In the case of China, an all-new concept and an all-new system will be introduced. Therefore, in developing a future system, a basic credit guarantee system must be central and should be established first without relying heavily on existing systems of other countries. Then, expansion of peripheral policies and bylaws for implementation and additional investment of financial funds should be carried out.

For example, in the case of Japan's credit guarantee system, the foundation, that is, credit guarantee institutions and a reguarantee system, was completed first. Then a wide range of supporting systems (safety nets) have been added in its long history, such as prevention of bankruptcy, credit guarantee with security of accounts receivable, private note guarantee, refinance guarantee, and establishment of organizations engaged solely in collection.

With confirmation items in this field hearing survey taken into account, essential qualities of the credit guarantee system, which are judged to be necessary for China, are pointed out below.

1) Basic philosophy

Credit guarantee is not a system to grant credit as a favor of a super-ordinate organization to SMEs. Its purpose is active and forward-looking and the work is to realize the future prosperity of diversified SMEs by promoting the creditability and expansion of business (essentially buried potential) through exact and appropriate appraisal, and then promoting them with funds. It is work from which people should seek the creative happiness of nurturing SMEs by getting into their job site, thinking together with them, and groping for and finding possibilities for business expansion with streams of perspiration pouring.

Credit guarantee is in the scope of services related to finance and creditability and is work that requires every participating person to have high ethical standards, fairness, and a sense of mission. Taking moral hazard measures seriously is important and is the foundation of continued existence for credit guarantee institutions.

2) Basic system

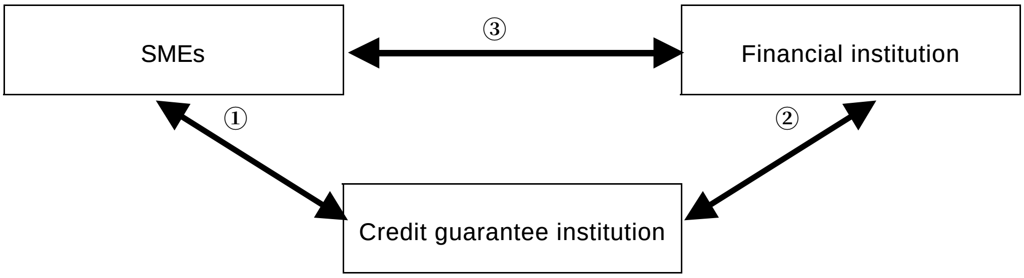
Credit guarantee systems lend to SMEs by providing credit guarantee to financial institutions in favor of the SMEs based on an appraisal of creditability of a SMEs. Once default occurs, namely, if borrower finds it difficult to carry out debt service as defined by terms of the agreement, a credit guarantee institution will fulfill the obligation of debt (subrogated payment) to the financial institution so long as prescribed conditions are met. After that, they will contribute to maintenance of the financial order and to fostering of the SMEs by supporting reconstruction.

a) Tripartite contract

There are three parties in a credit guarantee system: an SME (borrower), a financial institution (lender), and a credit guarantee institution (guarantor). They enter into the following basic agreements to realize finance and credit guarantee simultaneously without delay.

① SMEs・credit guarantee institution ---- “Credit guarantee consignment agreement”
② Financial institution・credit guarantee institution ---- “Letter of credit guarantee,” “Credit guarantee agreement” (by transaction)
③ Financial institution・SMEs ---- “General agreement on banking transactions,” “Loan agreement” (by transaction)”

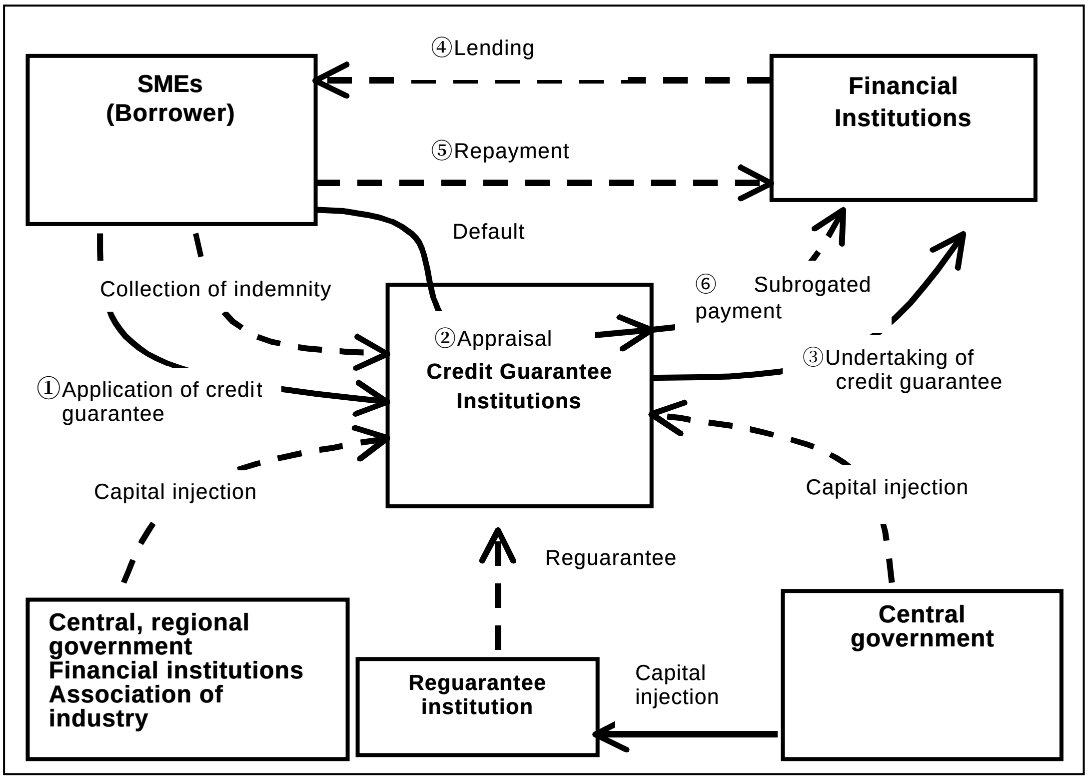
Figure 2.5.1



b) Operation of credit guarantee

The flow of the procedure and handling in applying for a loan from a financial institution by using the credit guarantee system is as follows:

Figure 2.5.2



①An application can be filed at the service counter in the responsible department of a local administrative agency, an administrative organ, or an association of industry. Or otherwise, the reception counter of a credit guarantee institution. In response to this application for credit guarantee, the credit guarantee institution investigates and appraises the applying company.

②In addition to field research by the credit guarantee institution itself, information such as the past record of banking transactions supplied by financial institutions is also used for investigation and appraisal.

③If the applicant is judged to be eligible as a result of appraisal, the credit guarantee institution gives the financial institution its undertaking of credit guarantee.

④In response to the undertaking of credit guarantee, the financial institution lends to the applying company with credit guarantee as security. The credit guarantee fee is paid at this time. Its fee rate is the rate of the basic income of credit guarantee institutions and, at the same time, is a burden added to interest for SMEs. Therefore, it is the most important matter for the credit guarantee system to determine fee rates. The formula to determine a credit guarantee fee rate is described later.

⑤The applying company (borrower) uses financed funds for the purpose of fund provided in the agreement, and repays as scheduled in the agreement.

⑥If borrower becomes difficult to conduct debt service as scheduled in the agreement, that is, if a "default" occurs, extending the repayments due and restructuring of repayment conditions will be considered based on prior agreements between the credit guarantee institution and the financial institution. If a settlement is not reached with these measures, the credit guarantee institution will repay the principal and interest to the financial institution instead of the borrower (subrogated payment). The full amount of principal and interest is subrogated in the system of Japan, Korea and Taiwan. At this point, the debt of the borrower to the financial institution ceases to exist, and a debt to the credit guarantee institution arises. As a result of the subrogated payment, the right of the credit guarantee institution to oblige the borrower to pay is called the “indemnity right.”

⑦While assisting the borrower, which became unable to make debt service as scheduled in agreement, in its reconstruction, the credit guarantee institution carries out work to collect “indemnity right” (that is, credit to borrower, spending the time to do so. If it is impossible to collect whole “indemnity right” even after the prescribed final due, the balance of the “indemnity right” not collected is the final loss of the credit guarantee institution, who should be amortizes as loss.

It must be said that credit guarantee institutions founded in China so far were trial institutions. The realities are as follows: for determination of credit guarantee fee rates which are the most fundamental income source of credit guarantee institutions and a burden for using companies as a quid pro quo for realizing financing, sharing of responsibility is determined between financial institutions and credit guarantee institutions; and ratios of guarantee sharing to avoid moral hazards of both parties are determined by individual negotiation for a financial institution, for a credit guarantee institution and for applying companies.

As to credit guarantee fee rates, opinions expressing hopes for unification of fee rates were heard from all companies, credit guarantee institutions, and financial institutions in the field survey. If the Chinese government looks forward to construction of a nationwide credit guarantee system, credit guarantee fee rates should be unified as a matter of course.

The reality can be understood that people concerned are obliged to choose partial guarantee in order to maintain the cooperative relationship between financial institutions and credit guarantee institutions, and to avoid moral hazards, under the situation where there is not such a nationwide public organization and system of credit guarantee institutions as in Japan. Based on the concept that credit guarantee systems are to essentially maintain the "sea of credit guarantee," however, there is no choice other than an open system. If partial guarantee is adopted, the sense of complication / troublesome / avoidance toward the credit guarantee system shall be not wiped out and it will be extremely difficult to realize the "sea of credit guarantee," because adjusting work will always arise between financial institutions and credit guarantee institutions regarding all ex-post administrative responsibility after the execution of credit grant -- responsibility for collection after default occurs, and the burden of obligatory rights, that is, "indemnity rights," must be invoked. This problem continues to be an issue for discussion for even such advanced systems as Japan's at all times. The Chinese concerned also recognize its importance.

The final security of credit guarantee systems is reguarantee. The SMEs Promotion Law stipulates that "The developmental fund for SMEs (国家中小企業発展基金)" shall be used for "Support in the establishment of the credibility guarantee system for SMEs" (Article l3), and that "The People's Governments above county level and departments concerned should promote and organize the establishment of SME credit guarantee system" (Article 19). Provisions preventing a reguarantee system are not found elsewhere. Introduction of a reguarantee system should be included in the reform of the credit guarantee system.

(3) Organization structure of credit guarantee institutions

Operations of credit guarantee institutions consist of 3 categories.

- Investigation and appraisal:
  Exact valuation of company creditability, accurate grasping of financial environment
- Loan administration after execution:
  Risk management of credit guarantee debts after undertaking of guarantee, assistance in operation of applying companies
- Administration of indemnity rights:
  Collecting work, assistance for reconstruction, legal matter, court affairs

In order to realize the assignment of 3 operations above, it is indispensable that administrative and planning divisions flexibly strive for close communications with related organizations in a service area. What is essential for this purpose is an application system with IT technologies such as networking and database processing.

As with other financial institutions, the fundamental characteristic of credit guarantee institutions is being an information agency. This characteristic is more important than in other types of financial business. Operations to administrate and process statistics and information are especially significant as a business information agency.

The credit guarantee system is an emerging business in China. There is no similar institution, existing system nor statistics to serve as a reference. Therefore, credit guarantee institutions themselves have no option but to accumulate everything by themselves. They have to extract, from their own actual performance of operations, appraisal standards, administration criteria after undertaking of credit guarantee, models to estimate default rates, and criteria of indemnity right collection. These can be obtained as effective methods of operations only after credit guarantee institutions themselves come in touch with management and financial affairs of SMEs, and accumulate and analyze them as statistics.

Accumulation of loan transactions with credit guarantee is expressed as the “sea of credit guarantee.” This “sea of credit guarantee” enables extraction of financial indicators of SMEs organized by category such as industry, size and region.

The mechanism of default occurrence of SMEs can be analyzed from the past track record of the course of indemnity rights generated from the “sea of credit guarantee.” It is then possible to formulate a model to estimate default rates and obtain management criteria of default cases.

All of these are realized by a highly accurate application system covering the whole country and based on IT technology. In China, it is important to construct, as an essential infrastructure, an application system enabling its nationwide organization and administration. Mutual exchange of various statistics covering all SMEs throughout the country is also necessary. IT technology is a prerequisite for the credit guarantee business.

(4) Basic requirements of a credit guarantee system

Considering the demands of society for a credit guarantee system, the following five items are indispensable basic requirements of a system. These are universal and are not affected by individual circumstances and backgrounds of countries. A credit guarantee system lacking even one item will deviate from the purpose of foundation sooner or later and will become a mere "waste treatment site" of bad debts, and continuous business development will not be realized, even if inexhaustible funds or resources are thrown in.

For example, once a financial institution falls in the situation where they deal with a credit guarantee system as an effective preservation (i.e. a security with the effect of dissolving both their ex-post administrative responsibility and their responsibility for collection) the system will break down because it brings about moral hazards simultaneously with its inauguration. In order to avoid such an event, careful discussion is required with due considerations to establishment of such detailed regulations that can realize cooperative activities of all related institutions in conformity to the purpose of the credit guarantee system.

Most of the many credit guarantee institutions founded across China are small and even about to having a financial crisis making it difficult for them to realize the primary purpose of credit guarantee work. Seeing this situation, we consider that lessons like this should surely be considered in the future system reform.

1) To be public institutions covering the whole country.

Fostering SMEs and improving financing procedures for them for this purpose must not be geographically limited, but rather cover the whole country. In Japan, credit guarantee corporations take charge of credit guarantee affairs in their jurisdictions as regional monopolies, and the National Federation of Credit Guarantee Corporations (全国保証協会連合会) exercises general control over them, makes adjustments to them and strives for unification of handling. Moreover, the Japan Finance Corporation for Small Business, a government-affiliated financial institution, undertakes reguarantee and act as the service counter for injection of national fiscal funds.

Taking the vast Chinese land area and differences in regional characteristics into account, we consider it reasonable that organizations corresponding to a Japanese credit guarantee corporation in each prefecture be set up in cities under direct jurisdiction, autonomous districts and / or provinces, and a central controlling organization be set up.

2) To be an institution engaged solely in the credit guarantee business where skilled professional staff members make decisions based on abundant examples of handled cases.

For credit guarantee institutions, it is indispensable to train staff member so that they will have expertise and extensive experience, to accumulate a database of ample case examples which will form the grounds for decisions, and to introduce a procedure for business handling that allows these resources to be organically and flexibly utilized to investigate and appraise many and various SMEs, while realizing appropriate decisions based on creditability. Their technical ability will be built up if expert staff comes in contact with abundant examples of handled cases and accumulated data daily. There is no precedent example of occupations of judging creditability of SMEs expertly in China. China is expected to construct and operate a system with a sense of mission.

In present China, the annual number of cases handled by credit guarantee institutions is only around 100 per institution on average, and the sphere of services of most credit guarantee institutions is limited. Even if individual staff members are strongly motivated and highly capable, the scope of business they can experience is small and it is impossible to acquire expertise. From this point of view as well, China is expected to work on expansion of credit guarantee affairs actively.

Credit guarantee affairs are closely related with the legal division handling complicated interests of disposition of securities and handling of mortgages. China is now in the course of reforming and improving laws related to rights now. The present environment is, however, extremely difficult; credit guarantee affairs are carried out and provisions of business affairs must be developed while laws and provisions remain to be improved. In other words, credit guarantee institutions undertake a role of a leader of the law reform.

3) A credit guarantee system should be open to all SMEs and financial institutions.

The given conditions of credit guarantee affairs include an unstable management base of SMEs and an unstable grant of credit to them from financial institutions. Credit guarantee affairs are a system based on the assumption of "actualization of defaults" or "occurrence of defaults." Individual credit guarantee institutions, which handle their business under the system with such a nature, cannot continue to exist unless they are always aware of the following two points and try to overcome them.

① Credit guarantee institutions assume a conflicting mission of obtaining their main revenue from the business of granting credit to companies with low creditability.

In order to overcome this contradiction, that is, to restrain occurrence of defaults and secure revenue, there is no alternative but to carry out appropriate undertaking of credit guarantee by improving the abilities of investigation and appraisal. In addition, the credit guarantee fee rate must be a rational one that SMEs assent to.

② Realization of "the sea of credit guarantees" makes the "law of majority" work, which results in a decrease in the rate of default occurrence.

To realize "the sea of credit guarantees," it is necessary to make the credit guarantee system widely available to both SMEs and financial institutions. For this purpose, it is necessary to set up reception counters in all subject areas.

It is surmised that over 1,000 credit guarantee institutions have been founded so far in China, but, in reality, both size of business and targets are significantly limited, as far as we know. The cumulative total number of credit-guaranteed loans remains at 100,000. We consider that it is a task to change to large, open-door organizations and such systems by means of consolidation. Although simple comparison cannot be made, one million and hundreds of thousand cases are handled annually in Japan and hundreds of thousands are done in Korea and Taiwan.

4) To secure a large amount of current assets and to realize high maximum ratio of guarantee in the financial aspect.

In order that credit guarantee institutions will achieve the purpose of foundation and will acquire a steady position in the economic society, it is necessary not only to depend on the legal background but to achieve and maintain high creditability themselves.

Strengthening of the creditability of credit guarantee institutions themselves all comes down to increasing guarantee funds (capital), which determine the upper limit of credit-guaranteed debts, as soon as possible. As "creditability" is the merchandise of credit guarantee institutions, low creditability means no merchandise to sell. Here is a reason that is necessary not to increase the internal reserve gradually, but to invest considerable financial funds from the establishment of institutions, differently from general business corporations. In spite of this, the biggest problem for many credit guarantee institutions in China at present is shortfall of guarantee funds (capital).

a) To maintain current assets

It is necessary to raise guarantee funds (capital) with high liquidity to surely and promptly pay subrogation accompanying occurrence of default. Therefore, investment in business is inappropriate and speculation is intolerable. These acts should be strictly prohibited.

Similarly, careful and severe business decision is required for purchase, in nominal terms of business property, of expensive assets that are apt to be affected by market conditions, such as non-movables.

As additional business operation is permitted in China, there are organizations where credit guarantee and investment compete in line to become the primary business. It is the compelling reality that this is an unavoidable measure for survival as a business unit by securing revenue. Such organizations, however, cannot be called credit guarantee institutions. To realize institutions engaged solely in credit guarantee business, it is expected that such institutions and others with greater emphasis on investment will be clearly separated by improving organizations and systems.

Specifically, bank time deposits are the most advisable form of asset holding. In addition to realizing the above objective, the deposits have the effect of security submitted by credit guarantee institutions, the guarantors, from the viewpoint of financial institutions. As time deposit with bank increases with increasing of the undertaking of the credit guarantee, there is also the effect of inducing banks to bring more cases to credit guarantee institutions.

b) Maximum ratio of guarantee

Maximum ratio of guarantee is a financial indicator for credit guarantee institutions to determine how many times the amount of capital the upper limit of balance of outstanding credit-guaranteed liabilities should be set at. Therefore, it is also a figure that expresses creditability of credit guarantee institutions most clearly.

As to actual maximum ratio of guarantee in China, partly because the Finance Department (corresponding to the Financial Service Agency, the Ministry of Finance of Japan) gives guidance that the upper limit of maximum ratio of guarantee of credit guarantee institutions that use fund from fiscal budget as guarantee funds should be ten times, it seems to be general that institutions determine five times, which is too small. Institutions whose maximum ratio of guarantee is below five times cannot be accepted as credit guarantee institutions any more. Such a thing can only bed said to be a kind of special indemnity-like measure.

Maximum ratio of guarantee of credit guarantee corporations in Japan is 50 to 60 times. In East-Asian countries, magnification of 10 to 20 times is achieved. In designing a system in China, we consider it to be reasonable that discussion be made with the goal of achieving maximum ratio of guarantee of 30 to 50 times.

A reciprocal of maximum ratio of guarantee is the upper limit of the rate of default occurrence. Namely, maximum ratio of guarantee of ten times is synonymous with 10% (1/10) being the upper limit of default occurrence and means that 100% subrogated payment is possible within capital in the meantime. (In the case of 20 times, 5% = 1/20)

If "the sea of credit guarantee" is actualized and a decrease in the rate of defaults is realized as a result, it is possible to further raise maximum ratio of guarantee and further expand the scope of SMEs and financial institutions that can use credit guarantee. Maintaining maximum ratio of guarantee of 50% at minimum in Japan means that the rate of defaults has been restrained at 2% or less.

5) To be institutions of capable personnel with high morals.

This is an age when people's lives cannot be maintained without IT technologies. IT infrastructure is introduced to handling of all guarantee affairs as with financial institutions. Functional requirements for business handling systems employing IT technologies are, however, analysis and decision of companies' creditability both of which have been accumulated for many years as such. Maintenance and development of business-handling infrastructure is not realized, even if IT infrastructure is introduced, without workers who get into the business site of medium and small companies, give counsel emphatically, grasp the exact realities, and support them with a warm heart. It goes without saying that moral hazards must be prevented.

Success of credit guarantee institutions is determined by securing such human resources. Therefore, it is indispensable to improve the practical ability of people, employed without nepotism nor through a personal connection, by rational training, to have them experience a wide range of work in “credit guarantee affairs”, and to further increase their level of skills.

In other words, development of credit guarantee institutions is achieved by continuously maintaining, not assistant workers for financial institution affairs, nor workers dispatched from government agencies, but the human resources of "experts of credit guarantee affairs." It is also necessary in China to make efforts to train staff members assigned to credit guarantee institutions to be "experts of credit guarantee affairs."

(5) Institutional characteristics of credit guarantee institutions

A credit guarantee system has very strong characteristics as an instrument of public policy and it is indispensable that its social position is supported by law.

In the SMEs Promotion Law, a credit guarantee system for SMEs is included in those to which funds are supplied from national finance to support their development. Moreover, it is provided that the " he regulations for SME credit guarantee management” (中小企業信用担保管理管理弁法） " shall be enacted by the State Council.

With a look at future development, it is expected that a "credit guarantee industry act" which advances a little more than administrative provisions will be established.

Through such development of the law system, characteristic properties (function to promote finance, function to complement credit, and function of intensive credit information management) of a credit guarantee system as a financial system acquire a legal foundation and the system will be recognized officially as one means to follow economic policies. This just means that procedures for both execution of business audit and introduction of financial funds are decreed by law and the position of the credit guarantee systems has been established.

In addition, laws related to SMEs in China are still incomplete. It is expected that laws associated with the credit guarantee system, as well as all legislation related to the credit guarantee system, will be improved.

(6) It is necessary for the credit guarantee system to take profits of financial institutions into consideration.

People involved in formulation, management, and handling of a credit guarantee system are apt to put emphasis on the public nature of the system or the aspect of measures for SMEs, and to think lightly of importance of financial institutions, which are their essential partners for maintenance of the system. Financial institutions are one of three main bodies to make up the basis of the system, along with credit guarantee institutions and SMEs. Financial institutes are also large equity partners. Namely, they are fellows of a community of credit guarantee.

As most of these financial institutions are private profit-making enterprises, the credit guarantee system must always give heed to profits, which financial institutions as fellows expect. Credit guarantee institutions themselves are public organizations, and cannot carry out direct profit capitalization, such as dividends against share of financial institutions on guarantee funds. However, they have to confer benefits arising from the use of the credit guarantee system, other than money, to financial institutions.

Specifically, these benefits include participation of financial institutions in operation of credit guarantee institutions, improvement of efficient credit guarantee procedures in line with customer prospecting and business expansion carried out by financial institutions, appropriate and flexible execution of subrogated payment, and flexible depositing of floating funds on hand to banks. For these measures, it is necessary to always try to facilitate exchange of frank opinions and communication with financial institutions in the area of their responsibility. Especially, attention should be paid to the point that the function of subrogated payment of the credit guarantee system brings about great profits that cannot be replaced for financial institutions as follows.

Financial institutions can actively cultivate lending to SMEs that have a large profit margin and quick turnover of transactions with 100% security.

Cooperation and coordination with other financial institutions shall also be actualized smoothly through credit guarantee institutions.

Deposits from credit guarantee institutions are a means of stable fund-raising for financial institutions, which increase automatically as the use of credit guarantee expands.

Financial institutions can achieve active contribution to national and regional policies by involving themselves in various policy financing systems with credit guarantee as a condition and then can raise name recognition.

That the credit guarantee system becomes a national system further increases benefits from the use for financial institutions.

In Japan, major city banks carrying out business all over the country have been increasing guaranteed loans for medium and small companies actively for the past twenty years. It is natural that the situation in which profit margins obtained from finance for SMEs is larger than those for major companies is an important factor behind this, as is the saturated state of financing to companies. Another important factor similar to this is that Japanese guaranteed loans are dealt with as lent assets whose financial risk is extremely low.

The creditability of financial institutions is measured with the capital over total asset ratio according to BIS regulation. Guaranteed loans are dealt with as assets with very low risk similar to loans of Japanese government bonds for intentional organizations. Therefore, even if they increase these loans, risk assets of financial institutions will not increase much. As a result, the amount of risk assets that represent a denominator to calculate the capital over total asset ratio under the BIS regulation does not increase and accordingly the capital over total asset ratio does not lower.

Guaranteed loans are dealt with in this way because the Japanese credit guarantee system is a national system and there is a reguarantee system supported by national funds in the end.

2.5.4 Recommendations for improving the credit guarantee system in China

The credit guarantee system in the People's Republic of China has passed the trial period and is now in "the stage of promoting based on legal definition"(依法推進) based on the SMEs Promotion Law.

However, many of the over 1,000 small credit guarantee institutions founded in the trial period are losing the function of credit guarantee expected fundamentally. It is expected that "the stage of promoting based on legal definition"(依法推進), which Chinese government mentions will improve laws so that the primary object of the credit guarantee system will be achieved.

Regarding points of concern in improving the future system, our opinions obtained by engaging in this development investigation project are cited below.

(1) Matters to be improved first

1) Sharp distinction of the credit guarantee system

In order to promote a foundation of credit guarantee institutions, the Chinese government encouraged the foundation of both credit guarantee institutions on the initiative of administrative organs and credit guarantee institutions with the private sector (as the main body) under the slogan, "one body with two wings," for securing funds to be guarantee funds while diffusing the system quickly all over the country. Just when vital private companies were becoming prosperous in various areas, great expectations were placed on capital of guarantee funds from them. In fact, 25% of capital of credit guarantee institutions was delivered from private companies. Therefore, the effect of previous policies should be highly rated.

Companies in the period of economic growth think that it goes without saying that profits can be enjoyed from all fund operations. China has been in the same situation for the last ten years. Private shareholders hated their share to go to waste and sought various profit-earning possibilities such as investment, brokerage, and consulting other than credit guarantee operations. They have achieved success in terms of revenue, and the share of income from such business apart from credit guarantee amounts to 26%. Without additional capital injection, however, such measures are only temporary. Indeed, things show just the same result now.

Credit guarantee systems in the People's Republic of China take two forms: 1) institutions engaged solely in credit guarantee business, and 2) credit guarantee institutions also engaged in other business. Each of them has achieved individual business development.

The SMEs Promotion Law permits " various forms of mutual aid financial guarantee " on the initiative of the private sector/industry (Article 21) together with promotion of foundation of "credit guarantee systems" on the initiative of the government or fiscal budget (Article 13-2 and Article 9). (See 2.5.1) Specifically speaking, in the nation-wide system of credit guarantee for SMEs preceding the SMEs Promotion Law since 2001, credit guarantee institutions fell into two groups: credit guarantee institutions for SMEs (Class 1 - Engaged solely in credit guarantee operations) and other credit institutions engaged in credit guarantee operations for SMEs (Class 2 - Also engaged in other business).

According to the basic principle of credit guarantee systems, credit guarantee funds supplied (i.e., capital) are the base of maximum ratio of credit guarantee and should be held with care in the form of current assets. Accordingly, immobilization of these funds by investment and resulting bad debts must be avoided strictly. With consideration given to credit guarantee affairs, which have a mission to respond to SMEs fairly and at small profit margins, in order to develop credit guarantee systems along the lines of the primary objective, it is undesirable to disperse vital power to be brought out as credit guarantee business by approving additional operations.

In enacting the "The Regulations for SME credit guarantee management" in the future, it is important to clearly stipulate standards of credit guarantee institutions for SMEs without other operations as those to which the state will give financial support. This is a key to establishment of credit guarantee systems in the People's Republic of China.

2) Formulation of nation-wide systems

Credit guarantee systems are effective at improving public welfare and fostering vital SMEs, supporting an open market economy, and provide economic benefits by promoting finance to them healthily.

The systems help stabilize local communities by giving aid to SMEs in the form of not only response to rapid changes in economic environment, but also response to damage from individual problems such as large bankruptcies, and response to natural disasters such as severe wind and flood damages.

A credit guarantee system should be understood not as a mere policy to promote finance in regional economies, but as an important social system. For this reason, the system should be made satisfactory by giving credit guarantee institutions assistance through the legal system, policies, and financial administration as a public institution. Benefits of the system should be then made available uniformly nationwide.

At present, foundation of about 1,000 institutions has been observed throughout China. Partly because voluntary participation of private resources in various places was expected based on the ethos of, "from where it can be done," locations of institutions are dispersed in a disordered manner and places of business are also lopsided. Review of systems should be based on administrative area classification. Specifically, credit guarantee institutions should be located as regional monopolies by allotting business territories based on provinces, cities under direct control, and other principal cities.

Of course, if there is more than one existing credit guarantee institution in the business place determined in this manner, they will have to be consolidated. For criteria of consolidation, it is reasonable to consider the amount of guarantee funds (capital), maximum ratio of guarantee, and achievements of business. Those at a low level as a business should be actively given guidance as targets of consolidation.

A nationwide organization (corresponding to the National Federation of Credit Guarantee Corporations in Japan), which will integrate and make adjustments for credit guarantee institutions is vital. It is necessary to take measures for alignment with the central government organs through it.

3) Unification of systems

At the same time, as consolidation of credit guarantee institutions occurs and a foundation of a nationwide network of organizations forms, unification of systems and procedures of credit guarantee affairs will become necessary. Specifically, it is expected that these will be actualized by formulation of the "The Regulations for SME Credit Guarantee Management" mentioned above.

Considering previous social system reforms in China, interest in foreign economic systems is strong. Insight should be, however, gained into decisions of what is required in Chinese economic society and what are problems. Advantages and disadvantages of introduction of systems of various countries should be then appraised without presuppositions and distorted views. As it is a good opportunity now when "promotion of yifa(依法)" by the SMEs Promotion Law is declared, resolution to reconstruct an optimum credit guarantee system for China is required still more.

To make a common national system that can be enjoyed throughout the country, concrete minor regulations for execution of business affairs, procedures and provisions for operation must be formulated in addition to establishment of the philosophy of the system. We consider that there is not much time. Matters to be discussed are listed below.

a) Necessity of a central government organization to formulate philosophy, system, and procedure.

- Coordination between People's Bank of China and Division of Small and Medium sized Enterprise of the National Development and Reform Commission (国家発展改革委員会中小企業司)
- Call-up and utilization of businessmen (policies, business practices, and law-related tasks)
- Inspection visit of Japanese system and learning and training of business affairs

b) Unification of systems and procedures

- Unification of credit guarantee affairs and terms related to business affairs (around 100 to 200 words)
- Forms of credit guarantee affair procedures and documents to be used
- Contracts (bank transaction contract, credit guarantee contract, credit guarantee consignment contract, etc.)
- Accounting procedure and audit standard
- Business management through figures (methods of analysis, methods of operation, and maintenance and utilization for management planning)

c) Requirements of credit guarantee business

- Areas for business
- Guarantee funds (capital) (maximum ratio of guarantee; liquidity ratio)
- Functional requirements as staff member of credit guarantee institutions

4) Reguarantee systems

Risks of the credit guarantee business can be mitigated through a reguarantee system operated by a special institution founded with contribution of financial funds. In Japan in 1950 when there was a movement in which credit guarantee systems were diffused all over the country, the Small and Medium Enterprises Agency of Japan developed a reguarantee system for credit guarantee affairs by referring to a credit guarantee systems for SMEs discussed in the U.S.A. For this system, a system name of "credit insurance" was adopted to distinguish it from the credit guarantee business, which had already started. As a result, it is often misunderstood as damage insurance of financial business. Different from the "insurance" business, which is based on statistical risk anticipation, a reguarantee system is a kind of a system of liquidation of loans receivable where the amount of subrogated payment made by a borrowing guarantee institution (i.e., a fixed part of the indemnity right) is temporarily paid without waiting for ex-post collection. The ratio expressing what amount of the indemnity right will be temporarily paid is called the compensation rate. In Japan, it is 70 to 80%.

Compensation a credit guarantee institution receives from a reguarantee institution is a suspense receipt for the institution. If the credit guarantee institution collects the amount of subrogated payment from the small-and medium-sized enterprise later, the credit guarantee institution will refund a fixed rate of the collected amount to the reguarantee institution. This is different from systems in which refund is not required once such liability insurance money is received.

From this system, credit guarantee institutions always obtain a definite promise of "liquidation" of held receivables by receiving money at a certain rate in subrogated payment made (indemnity right). For this effect of profit, credit guarantee institutions pay to reguarantee institutions a fixed fee as a reguarantee fee from credit guarantee fees collected from SMEs. That is, reguarantee fees are paid from credit guarantee institutions' own funds. Fees are determined from the policy viewpoint within the scope of credit guarantee fees with operation of reguarantee institutions taken into consideration.

The reguarantee system allows credit guarantee institutions to carry out activities to open up finance for SMEs more actively.

Formulation of a full-fledged reguarantee system is a future task in the People's Republic of China. The SMEs Promotion Law stipulates that, " the national developmental fund for SMEs (国家中小企業発展基金）,to which a large amount of financial funds are injected, shall be used for the formulation of the credit guarantee system for small business in the future (Article 13); moreover, that government organs and related divisions shall promote the formulation of the credit guarantee system for small business (Article 19). Provisions preventing reguarantee systems are not found in particular. Future active activities are expected. It is indispensable to introduce a "reguarantee" system when China reviews credit guarantee systems and determines measures for improvement.

We heard from the Small and Medium Enterprises Office in the hearing survey the explanation that injection of national fiscal funds clearly provided by the Small and Medium Enterprise Basic Law would be made soon for the credit guarantee system reform and that the nationwide reguarantee system was also included in this injection. Implementation of this is strongly expected.

(2) Main items of credit guarantee system

In the review and improvement of credit guarantee system in China, it is mentioned above that the formulation of a nationally-standardized system / procedure is indispensable. Basic items for this appraisal are listed below for reference.

Although these are obvious for organizations acting in various places in China, they represent a checklist as recommendations in this investigation project.

(%) mentioned in the list is ideal value.

1. Name:	"Credit guarantee for SMEs" will be upheld and sole engagement in credit guarantee business will be made clear. * "__Credit Guarantee Institute for SMEs": The operation area will be indicated in the part of "__." -> Ex.: Beijing Credit Guarantee Institute for SMEs
2. Base law:	China is expected to enact the "Credit Guarantee Industry Act" based on the SMEs Promotion Law.
3. Competent authorities:	Small and Medium Enterprises Office of the National Development and Reform Commission, People's Bank of China, local administrative organs
4. Judicial personality:	To be organized based on the "Credit Guarantee Industry Act" in the future.
5. Tax exemption:	The corporate income tax will be exempted.
6. Management organization:	Positions of executives and regular employees, executive organization (management team), personnel organization (e.g., size, corporate ladder, leading members, employment, training)
7. Business organizations:	Head offices will be placed at the center of provinces, autonomous regions, cities under the direct jurisdiction and principal cities. In addition to the method of allocating branch and local offices, units to be cooperated with will be also standardized.
8. Capital:	Guarantee funds (central government's fiscal funds (50%), local government's fiscal funds, budget of People's Bank of China, funds of financial institutions, and credit guarantee institutions' self-created funds (net profit to be carried over to the next year). * It is advisable that capital will be in the form of contribution without profit capitalization. Long-term borrowed money (e.g., government funds, People's Bank of China, private financial institutions) Forms to hold funds (i.e., time deposits, rate of holding current assets (80%), and specifying securities to be held (respectable),

prohibition of investment, capital supply, and speculation.
* Additional operations such as investment activities will be excluded.

9. SMEs: Providing credit guarantee shall be applied to SMEs.
Subject category of business (regional circumstances may be prioritized and local industries or strategic kind of business may be prioritized in the meanwhile.)
Subject category of business providing credit guarantee shall be applied to SMEs (preparation of a list peculiar to Credit Guarantee Institution) -> to be expanded

10. Financial institutions: state-owned banks, commercial banks, various kinds of important local financial institutions -> to be expanded gradually.

11. Reguarantee institutions:
To be institutions founded with financial funds
(Rate of reguarantee compensation: 70 - 80%)

12. Statutes, cabinet orders (弁法):
purpose, qualification as a judicial person, name, foundation, administration, credit guarantee affairs, supervision, dissolution, liquidation
Articles of incorporation (rules):
purpose, name, offices, business affairs, maximum ratio of credit guarantee, highest limit of assumption of credit-guaranteed liabilities, guarantee fund (capital), officer structure, merger, dissolution, attribution of residual property
* Because of the publicity of credit guarantee institutions, funds of outside capital suppliers shall be accepted as "contribution" (charitable contribution), which does not reduce profits. For residual properties, however, the demand for return of the appropriate amount will be able to be made when a credit guarantee institution is dissolved.
Written work method (guidance of operation):
object traders, limit of credit guarantee, rate of credit guarantee (100%), credit guarantee fees, performance of credit-guaranteed liabilities (= subrogated payment), extinguishment of indemnity rights, window for application, and scope of financial institutions
* Regarding the rate of credit guarantee, there is a question of whether or not a partial guarantee system will be adopted basically. Partial guarantee systems are general in credit guarantee systems in the People's Republic of China but it should be 100% in principle. Even if the partial guarantee system is employed, 80 to 90% will be desirable.

Accounting standard: periodic balance, margin, and proportion of current account balance (経常収支余裕と均衡), appropriation of fundamental properties
Fund management standard: cash reserve ratio (3%), limit of holding securities, limit of acquisition of immovable properties, and fitting up with computers
* Cash reserve ratio shall be two to three percent of the present amount of accepted credit guarantee or higher with the upper limit of the rate of subrogated payment as a rough standard.

Account titles: statement of assets, income, and expenditure account statement; balance sheet
Points of accounting
Business report

13. Regulations: office regulations; pay regulations; office work regulations. Rules for written work

14. Business contract and business standard
Credit guarantee consignment contract:
Credit guarantee institutions - small-and-medium-sized entrepreneurs, consignment, credit guarantee fee, guarantee, ex ante exercise of the indemnity right, subrogated payment, scope of the indemnity right, joint guarantor ("collateral against guarantee"), competent court, changes in contracts, etc.)
* "Collateral against guarantee" should be drastically reexamined.
Credit guarantee agreement:
Credit guarantee institutions - financial institutions (conclusion, validity, limit of changeover of debts contracted by the old outfit, rate of credit guarantee, performance of credit-guaranteed liabilities (i.e., subrogated payment), duration of the right of claim of performance of credit-guaranteed liabilities, indemnity, procedure, etc.)
Credit contract: Financial institutions - small-and-medium-sized entrepreneurs
Banking transaction contract:
Financial institutions - small-and-medium-sized entrepreneurs (scope of application, credit guarantee rate, interests, money for damage (i.e., interests of indemnity right), guarantee, ("collateral against guarantee"), guarantor, due-interest loss (期限利益損失) (i.e., subrogated payment), appropriation, indemnity, etc.)
Reguarantee contract: Reguarantee rate (70 - 80%)
Business criteria: Appraisal criteria, arbitrary decision criteria, administration criteria of credit guarantee obligation, administration criteria of indemnity rights and amortization criteria.
Business form (nationally-standardized form)
Statistic tables (general statistic table, business statistics, and management statistics.)

(3) Injection of fiscal funds in credit guarantee systems

Review and improvement of credit guarantee systems in China are very timely.

A full-fledged system reform was started according to the SMEs Promotion Law and injection of national fiscal funds is being discussed for review and improvement of the system. Specifically, while many conditions require improvement such as details that people on business sites expect, increased scope in public finance and an administrative structure within the system, the following recommendations are set out as a conclusion of the experts who finished analysis.

Box2.5.1 Amount of injection of national fiscal funds necessary for improvement of the credit guarantee system

In order to break through the blocked-up situation of the credit guarantee business, existing credit guarantee institutions numbering over one-thousand should be consolidated to about one-tenth that number, and, with accumulation of business knowledge so far utilized, a new system will be formulated whose operation will cover all places in China, which will be about two or three times the present total balance of outstanding guaranteed liabilities.

For this purpose, the groundwork of the credit guarantee system should be done by injecting fiscal funds of RMB 10B. In addition, without delay, a reguarantee system should be set up with injection of fiscal funds of RMB 5B.

(4) Table of approximate estimates of credit guarantee business in the People's Republic of China

Trial calculation of future forecast achievements was made to estimate how the credit guarantee business in China will develop if the above-mentioned recommendations are implemented and public fiscal funds are injected. Trial calculation of forecast future achievements is based on measurement of demand. As to credit guarantee business, only a few years have passed since foundation, and most of the existing institutions have experienced the business for only two or three years. In addition, the system is not spread evenly over the country.

Therefore, trial calculation of forecast future achievements was made not in the orthodox way of demand measurement, but based on conservative hypotheses that have a common understanding, with the expectation that, hopefully, a system of this level will be made after several years. We believe firmly that this trial calculation is also effective for understanding of the main coefficients used in credit guarantee systems.

1) Prerequisites (personal assumptions estimated from various kinds of statistics)

Macroscopic indicators: Economic growth rate of 8%, credit growth rate of 10%, increase rate of SMEs of 10%

Financial indicators: Total amount of loans of 10 trillion yuan, size of financial institutions of 2 million staff members in 150,000 offices, deposit interest rate (real rate) of 4%, credit rate (legal) of 5%

Credit guarantee business:

Reorganization to realize decrease the number of institutions from 1,000 at present to 100.

Guarantee funds of 3.5 billion yuan-> valid ones are 50% of them.
Business size of 100,000 contracts with 100 billion yuan; one million for one contract
Credit guarantee fee rate (expected) of 1.2%, rate of defaults (expected) of 2%, rate of collection of 50%
Maximum ratio of credit guarantee (expected) of 30 times-> to bring real magnification close to 10 times in the meanwhile
Credit guarantee rate (expected) of 100%

Reguarantee rate of 70 to 80%, reguarantee fee rate of 0.8% (to construct a system as quickly as possible.)

Salaries: Annual salary for specialist personnel of 80 thousand yuan, size of 50 people in one institution

Reserve accumulated funds:
Reserve funds for payment to maintain the function of subrogated payment shall be prescribed by the law. Two percent of undertaken credit guarantee or higher is appropriate. Although fee rates are set low in this trial calculation, considering that the system will have just been started, sufficient reckoning is necessary for ordinary fees.

2) Basic structure of income and expenditure

The main items of expenditure of credit guarantee institutions are simple. They only appear to be complicated because of items of various accumulated funds, reserved funds, and calculation with proportional division of the period.

Expenditures: Expenses + guarantee loss - (rate of defaults x rate of no collection) + various reserve accumulated funds

Income: Management gains (interests on deposit - borrowing interests) + credit guarantee fees

Difference between income and expenditure:
Income – expenditure

* Formula of credit guarantee fee rate:
Credit guarantee fee = cost + guarantee loss + various reserve accumulated funds - management gains

The balance of payment corresponds to net profit of general companies. Credit guarantee institutions, that are public institutions, do not carry out profit capitalization shareholders (contribution supplier to guarantee funds). Whole amount of this balance of payment is carried over to money guarantee funds. This is called "self-creation" of funds. Of course, if guarantee funds increase, a new frame of credit guarantee will be newly created.

3) Nature of small profit of credit guarantee business

Both credit guarantee fees which represent the revenue source of credit guarantee institutions and management gains are approximately 1 to 2% in contradistinction to the total guaranteed liabilities. On the other hand, expenditures are almost the same amount. To maintain the balance of income and expenditures necessary for continued existence of institutions, the ability to always carry out very careful operation under a strict administrative structure is indispensable. As seen in the next figure, credit guarantee fees paid by SMEs and customers of credit guarantee business, have a direct influence on maintenance and improvement of this balance of income and expenditures.

It must be understood that a credit guarantee system must be operated as a public system and that the system always depends much on the cooperation and assistance of financial institutions, which are partners in supplying funds. It must also be understood that this business has a structure in which the high interest rates of private investment companies and adventurous financial institutions cannot be expected.

Several years after the start-up of the credit guarantee business, the borrowing SMEs are in a growth period in their life cycle and defaults do not occur. Credit guarantee fees and deposit interests are obtained as scheduled. This gives operators an illusion that operation of credit guarantee business is profitable. The elbow room obtained in this period, however, should be reserved internally with care in preparation for operating costs which will move soon rise, such as through subrogated payment. The next table shows that the structure of income and expenditure of credit guarantee business is affected with very sensitive and delicate balance.

Table2.5.13 Proportion of profit and loss by credit guarantee operation and credit guarantee fee

Cash out flow of Credit Guarantee Institution			Over credit guarantee outstanding		Over whole cash outflow	
			At the beginning of system		At beginning	Target
Outflow for credit guarantee operation	Regurantee fee		0.80%	1.80%	55%	**40%**
	Loss by default		1.00%			
Outflow for management of institution	Expenses	Personnel Expenses, etc.	1.00%	1.50%	45%	**60%**
	Reserves		0.20%			
	Net loss	Carried over to capital	0.30%			
			3.30%		100%	100%

Cash inflow of credit guarantee institution		Over credit guarantee outstanding	Over whole cash inflow	
		At the beginning of system	At beginning	Target
Credit guarantee fee	id by borrowers of lending with credit guaran	1.20%	36%	**40%**
Fund profit	Interest received - interest paid	2.10%	64%	**60%**
		3.30%	100%	100%

（Made by Terashita Hideaki）

For financial management in credit guarantee institutions, it is appropriate to be totally based on the balance of outstanding guaranteed liabilities. Therefore, the outstanding amounts under account titles are expressed by percentage of balance of outstanding guaranteed liabilities. Counting at the start of the system represents actual conditions with private opinions mentioned previously employed.

The "six-to-four rule" simply expresses the method of managing income and expenditure balance in credit guarantee institutions.

Specifically, as for cash drain, reguarantee fees and guarantee losses, both of which are cash drain involved in credit guarantee operations, are almost mechanically determined from the balance of outstanding guaranteed liabilities. It is also necessary that cash drain required for maintenance of the organization, including accumulated funds/reserves and retained earnings (such as the different amount between income and expenditure) be transferred into fundamental properties. The latter can be adjusted with cost management (etc.) irrespective of the balance of outstanding guaranteed liabilities. It is ideal to exercise control so that the proportion of the former and latter will be 4:6.

Next, of course, it is necessary that cash inflow exceeds cash drain. For management of cash inflow, it is also desirable to exercise control so that management gains to credit guarantee fees mechanically determined from the balance of outstanding liabilities will be also 4:6.

The "six-to-four rule" is a completely empirical rule. I think personally that this proportion may be an optimum one which leads to the achievement of the goals without making people too biased.

4) Table of approximate estimates of credit guarantee business in the People's Republic of China

This clause explains the basis for counting in the table of approximate estimates of credit guarantee business in the People's Republic of China shown below.

In the trial calculation related to the credit guarantee business, the parameter of all is the size of "credit guarantee." Business size of general companies is based on annual amount of sales and volume of business. These correspond in the credit guarantee business to annual amount of guarantee undertaking. For the credit guarantee business, however, it is rational to set as a parameter the balance of outstanding guaranteed liabilities (to be more precise, annual average balance of outstanding liabilities), which represent a parameter of calculation of credit guarantee fees and loss expenditure, both of which form the basis of income.

A percentage value shown in the approximate estimate table in this clause is the proportion to the balance of outstanding guaranteed liabilities of each item.

* Year: A current value is reckoned in the column of the basic year for adjustment.

* Balance of outstanding guaranteed liabilities:
  It is assumed that the current balance of outstanding guaranteed liabilities is 100 billion yuan. It is assumed that the goal will maintain the year-on-year growth rate of about 20% every year and will increase it to 2.5 times in the next 5 years. (In the approximate estimate table, it is 2.37 after five years.) The amount for one contract is assumed to be 2 million yuan. (In the estimate table, it is 1.8 million yuan after 5 years.)

* Actual magnification:
  This is maximum ratio of guarantee. Present average maximum ratio of guarantee in China is four times, which is too small. Although 30 times or more is desirable, since the figure in the Financial Department' guidance is 10 times or less, it may be impossible to raise magnification at once. The aimed in the meanwhile shall be to reach 10 times as quickly as possible. (It is 8.9 times after five years in the estimate table.)

* Capital: This is guarantee funds. The current total capital is approximately RMB 35B. On the presumption that a considerable part of them is impaired by excessive liabilities because of the troubled situation of the credit guarantee business and misappropriation to investment business, RMB 12B was estimated as the real one. This is set as a starting point of the first year. For this reason, it is expected that "injection of fiscal funds of RMB 10B" will be made for the system reform as capital as quickly as possible.

* Liquidity ratio: It is a basic obligation of "credit guarantee institutions" to improve liquidity of held funds by reducing the use in investment and others and increasing deposits in banks, and 90% is a desirable ratio. At the beginning, however, as investment in fixed assets such as computers may be also necessary, 80% is expected.

* Credit guarantee fee rate:
  Percentage under the current policy guidance, 1.2%, is set as the datum. This shall be the basis of business balance in credit guarantee business, and will not be changed for the time being.
* Management gains:
  Although these gains fluctuate according to bank rate policies of China, it is expected under the present circumstances that 2.1% will be positively secured. Specifically, it is aimed that the ratio of current assets to total deposits of 15 - 18% will be secured by the interest income.
* Reguarantee: A reguarantee system shall be inaugurated about two years after the credit guarantee system revision. For this purpose, "injection of fiscal funds of RMB 5B" is expected. The rate of compensation by the reguarantee system of 70 to 80% and the reguarantee fee rate to be paid by credit guarantee institutions of 0.8% may be the maximum.
* Various accumulated funds:
  Because of the period of system construction, the rate shall be low at the beginning.
* Subrogated payment:
  As the life cycle of credit guarantee is as long as about ten years, the rate of default occurrence at the beginning of the credit guarantee system is low. This is why the rate is assumed to be 2%, as low as Japan. It is a matter of course that the rate will be higher commensurately after five years. The collection rate of the indemnity right is estimated at 50% and the effect of reguarantee will not appear in the meantime.
* Amount of difference between income and expenditure:
  The amount of difference between income and expenditure resulting from the balance of business in each year. Although it is as low as 0.2 to 0.8%, sound surplus operation is required every year.
* Number of credit guarantee institutions:
  Institutions shall be consolidated from 1,000 at present to 100.
* Number of executives and regular employees:
  The present 20,000-people structure shall be changed to a 5,000-people structure with highly efficient personnel over two or three years.

Table 2.5.14 Projection of credit guarantee system of the People's Republic of China

(Unit: RMB Million)

Year	Current	1st year	2nd year	3rd year	4th year	5th year
Policies	Standard year of reconstruction and reorganization	Reconstruction and reorganization of credit guarantee system, fiscal fund injection	Beginning of reguarantee system			Increase of reserve rate (0.2%→0.5%)
Outstanding of credit guarantee	100,000	110,000	132,000	158,400	190,080	237,600
（increase rate）	-	(10%)	(20%)	(20%)	(20%)	(25%)
Number of transactions	100,000	100,000	110,001	121,846	126,720	132,000
Amount per transaction	1.0	1.1	1.2	1.3	1.5	1.8
Actual rate of guarantee (times)	4	2	6	7	8	9
Guarantee fund (capital)	35,000	12,000	22,210	23,398	24,823	26,834
（Carried over from the previous year）	-	-	210	1,188	1,425	2,011
（Fiscal fund injected）		10,000				
Current Asset	12,500	17,600	17,768	18,718	22,340	24,150
（Current ratio）	(50%)	(80%)	(80%)	(80%)	(90%)	(90%)
Revenue						
Credit guarantee fee (fee rate :1.2%)	1,200	1,320	1,584	1,900	2,280	2,851
Fund profit (2.1%)	2,100	2,310	2,772	3,326	3,991	4,989
（Over current asset）	(16.8%)	(10.5%)	(15.6%)	(17.7%)	(17.9%)	(20%)
Reguranteed (Subrogation*0.3)	-	-	792	950	1,140	1,425
Expenditure						
Expense (1.0%)	1,000	1,100	1,320	1,584	1,900	2,376
Cost of reconstruction and reorganization	-	1,000	-	-	-	-
Reguarantee fee (0.8%)	-		1,056	1,267	1,520	1,900
Reserves (0.2%)	-	220	264	316	380	1,188
Loss by defaults (1.0%)	1,000	1,100	1,320	1,584	1,600	2,376
Subrogation (2.0%)	2,000	2,200	2,640	3,168	3,801	4,752
Collection (subrogation*0.5)	1,000	1,100	1,320	1,584	1,600	2,376
Net profit	-	210	1,188	1,425	2,011	1,425
(to be carried over to next year's capital)		(0.2%)	(0.9%)	(0.9%)	(1.0%)	(0.6%)
Number of institutions	1,000	100	100	100	100	100
Number of employees (including executives)	20,000	10,000	5,000	5,000	5,000	5,000

2.5.5 Contribution of the credit guarantee system to policies for SMEs

If the credit guarantee system takes root fully and its functions are brought out, the system will give vitality to fund-raising activities of domestic SMEs. At the same time, the system will achieve an effect as a basic function and prerequisite of state and local economic policies.

As an example of this, the actual condition of functions which the credit guarantee system carries out in small-and medium-sized enterprise policies in Japan is introduced below for reference.

(1) Actual condition of the credit guarantee system in Japan

The Japanese credit guarantee system is operated according to various laws based on the "Credit Guarantee Corporation Act" (1953), the "Small Business Credit Insurance Act (中小企業信用保険法)" (1950), and the "Small Business Credit Insurance Corporation Act （中小企業信用保険公庫法） " (1958). As of 2004, the system is of the following size. (See “Statistics” in Chapter 2.1.)

1) Size of credit guarantee

Table 2.5.15 Actual achievements of Japanese credit guarantee system (1)

Amount of annually accepted credit guarantees	15,196,461 million yen	1,382,701	108% on a year-on-year basis, 10.99 million yen per undertaking
Balance of outstanding guaranteed liabilities	31,102,201 million yen	3,944,998	93% on a year-on-year basis, 7.88 million yen per undertaking
Annual subrogated payments	1,021,650 million yen	119,930	
Amount of annual collection	334,630 million yen		
Subrogated payments/ undertaking of guarantees	6.7%		
Subrogated payments/balance of outstanding guaranteed liabilities	3.3%		
Guarantee funds (capital)	1,344,550 million yen		Of this, 825, 105 million yen is reserve funds
Maximum ratio of guarantee	50-60 times		
Real maximum ratio of guarantee	23 times		Balance of outstanding guaranteed liabilities/guarantee funds
Finance funds (government funds)	747,700 million yen		
Cash subsidies from finance funds	426,300 million yen		
Staff members	5,856		4,495 men and 1,361 women
Executives on a permanent basis	238		

Local government	80%
Financial institutions	20%
Contribution + cumulative total of burden charge of financial institution, etc.	752,710 million yen

Local government	77%
Japan Small and Medium Enterprise Corporation, Japan Finance Corporation for Small Businesses	23%
Borrowed money	2,396,735 million yen

Make-up of the origin of executives	
Full-time directors	24%
Local government	7%
Organization of SMEs	29%
Financial institution	30%

2) Situation of the use of credit guarantee

Table 2.5.16 Actual achievements of the credit guarantee system in Japan (2)

Number of small and medium entrepreneur managers all over the country covered by the system	42%
Lending outstanding for SMEs all over the country covered by the system	12%

Table 2.5.17 Organizations accepted of credit guarantee, by financial business category (composition rate of the amount of money)

City banks	14.2%
Local banks	38.8%
Second tier regional banks	16.2%
Cooperative banks	27.1%
Credit associations	2.8%
Commercial and industrial associations, People’s Finance Corporation, Japan Finance Corporation for Small Businesses	0.8%

Table 2.5.18 Organizations accepted of credit guarantee, by industrial classification (composition rate of the amount of money)

Manufacturing industry	24.1%
Construction industry	27.3%
Wholesale trades	15.7%
Retailing industry	12.0%
Service businesses	10.6%
Others	10.3%

Table 2.5.19 Undertaking of credit guarantee by guarantee period (composition rate of the amount of money)

0.5 year	9.7%
0.5-1 year	12.6%
1-3 years	12.4%
3-5 years	27.1%
Longer than 5 years	38.2%

3) Type of handling of credit guarantee

-Ordinary (general)

-Without security

-Without security nor guarantor

-Prevention of pollution

-Energy measures

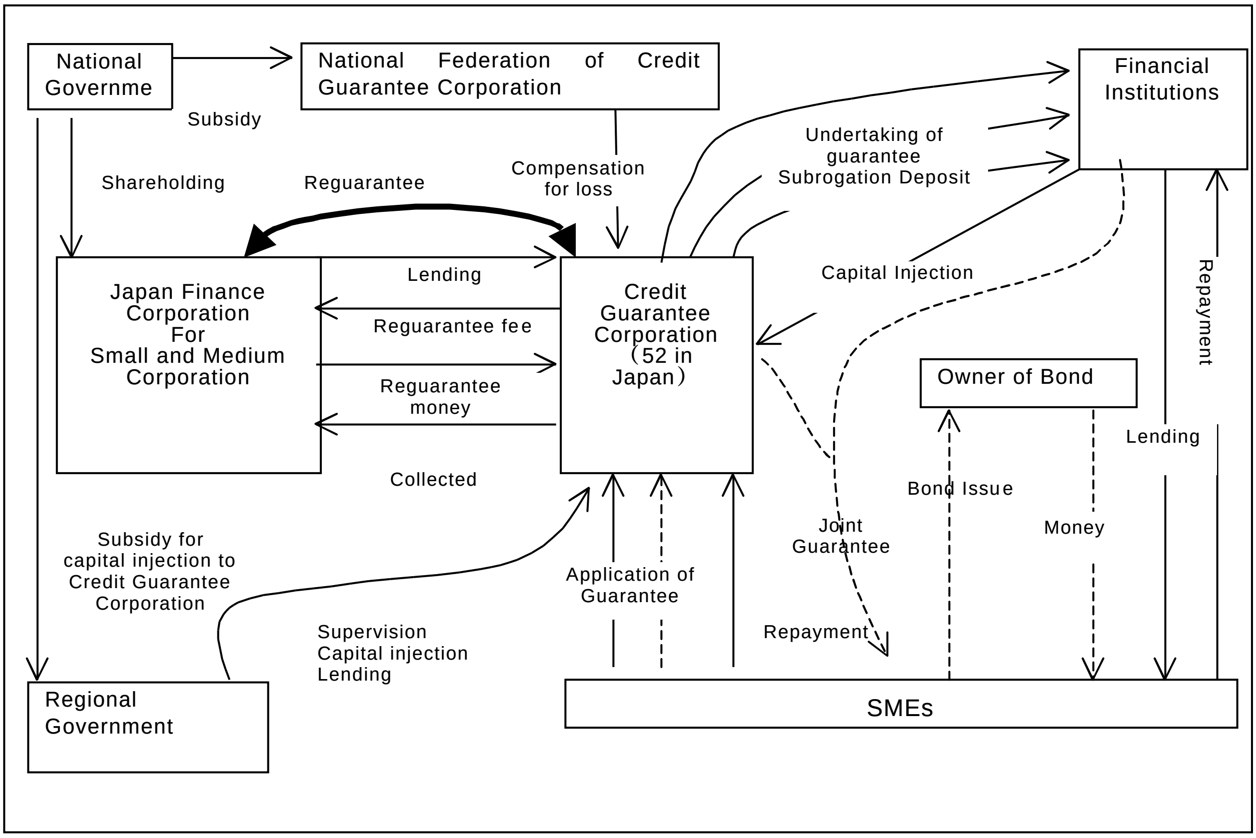
-Investment abroad

-Open-up of new business

-Specific corporation bond

-Security of obligation rights for receivables

Figure2.5.3 Diagram of Credit Guarantee System in Japan



Source: "Actual Conditions of Credit Guarantee," National Federation of Credit Guarantee Corporations (2004)

The Japanese credit guarantee system has now realized the "sea of credit guarantee" on the scale of balance of outstanding guaranteed liabilities of 30 trillion yen at present after its long history, and has established actual achievements and high evaluation as a public institution. The traditional process on the way toward this is not easy. There is the following recent example of this. After Japan entered into a long business depression as a result of the burst of the economic bubble, bad debts of financial institutions increased progressively, the whole financial structure in Japan declined, banks became reluctant to lend, and finance for small and medium companies dried up completely in the latter half of 1990s.

Expectation was then concentrated on credit guarantee corporations as a public body, and this hardship was also worked around by the government's active injection of fiscal funds and realization of a very special guarantee of JPY 20T. Of course, these measures caused rapid increase of subordinated payment and worse conditions of operation of credit guarantee institutions. Their operation, however, has recently become stable and well again at last. It was a symbolic situation where severe contradiction between expectations on the credit guarantee system and difficulty of its stable operation was shown.

(2) Measures for SMEs and the credit guarantee system in Japan

Measures taken by the Japanese government for SMEs are promoted by laws based on the Small and Medium Enterprise Basic Law (1963). A controlling organization is the Small and Medium Enterprise Agency, the Ministry of Economy, Trade and Industry.

As of 2004, measures for SMEs are as shown in the next table. When such smaller entrepreneur managers and associations borrow necessary funds from financial institutions, the whole amount is procured by the use of credit guarantee of credit guarantee corporations (Japanese credit guarantee institutions). Names of credit guarantee systems dealing with them are listed below.

These are the central government's measures for SMEs, and local governments in various places (cities, towns, urban and district prefectures) also carry out detailed measures for SMEs in response to local requests. These measures are usually implemented by setting up credit guarantee corporations and special guarantee systems as backing of funds in these systems. Generally, under special guarantee systems, it is possible to receive _ treatment in a framework different from conventional one, _ preferential treatment and aid, such as low interest rates and low credit guarantee fees, and _ special guidance and advice. Supporting measures for the basic part of them are strengthened by partial loss compensation, special handling of reguarantee in a different framework and application of the reguarantee rate of 80%.

Table 2.5.20 Measures for SMEs and credit guarantee systems in Japan

Governments' main item of measures for SMEs	Corresponding guarantee system of credit guarantee corporation
1) Facilitation and diversification of finance for SMEs	-Credit guarantee system (as a whole)
2) Assistance for revival of SMEs	-Funds for revival
3) Assistance for foundation, development of new business and management innovation	-Guarantee related to foundation Guarantee for opening-up of new business Guarantee related to creation of new business Guarantee related to opening-up of new business fields Guarantee related to management reform Guarantee related to management resource
4) Improvement of a regime for assistance of SMEs	-Funds of retailing industry and wholesale trade
5) Measurements for small business	-Guarantee related to research and development business
6) Promotion of technical development	-Funds for improvement of small-sized management
7) Promotion of measures for assistance of small-scale firms	-Funds of associations -Guarantee related to subcontracting promotion
8) Promotion of measures for organizations linked with SMEs	-Guarantee related to stable operation Safety net guarantee (related to bankruptcy)
9) Promotion of measures for subcontracting SMEs and measures for public agencies' demand	Disaster guarantee, pollution-prevention guarantee
10) Measures for stable operation of small business	
11) Tax system for small business	
12) Measures for internationalization of SMEs	-Guarantee related to investment abroad
13) Promotion of measures for employment and welfare	-Funds for fabrics, traditional crafts and local industry
14) Special measures	Guarantee related imports of specified products
15) Investigations and public information	