Analysis Study of Chinese SMEs Financing Challenges

By

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B.E. Electronic Engineering
Tsinghua University, 2010

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MASTER OF SCIENCE IN MANAGEMENT STUDIES
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Management Studies.

ABSTRACT

Financing small and medium size enterprises (SMEs) is a prevalent challenge for most of
countries, especially developing countries. Chinese SMEs have been suffering from difficulty in
financing themselves for long. This thesis presents an overview of China’s financial system
development and current status and explains different financing sources for SMEs in China.
Basing on the understanding of China’s financial landscape, I described and summarized the
financing challenges that are faced by Chinese SMEs and analyzed both the fundamental and
temporary causes behind the challenges. In the end, I proposed a number of solutions to cope
with Chinese SMEs financing challenges. Both statistical data and empirical studies are
introduced in the thesis for demonstration and analysis.

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Title: Associate Professor of Finance
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For their invaluable academic guidance and enlightenment

To MSMS Classmates
For their support and care for me

To my dearest family
For their unconditional support in my academic pursuit at MIT
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1. Executive Summary

With its GDP growth averaging approximately 10 percent a year for more than 10 years, China is undisputedly regarded as the most dynamic economy in the world and has already became the second largest. As the economy grows, the Chinese financial system has gone through a process of reform and development that not only aligns with the need to finance the fast-growing economy, but also fulfill Chinese government’s control and influence over the economy. Numerous studies and researches into Chinese financial system have been carried out, and the topics have been widely various, ranging from the efficiency analysis of the capital market to the study of financial system reliability. This thesis intends to probe into one specific defect that has always been complained about the Chinese financial system: predicament of Small and Medium Enterprises (SMEs) financing in China.

SMEs have always played an important role in the Chinese economy, contributing more than 60% of the country’s GDP and more than 70% of employment opportunities. However, comparing to other economic entities such as state-owned enterprises (SOEs), most of SMEs would find it extraordinarily difficult to fund their businesses for continuous operation and growth under the current Chinese financial system. These financing challenges have consequently leaded to severe lack of robustness and innovation among SMEs, which has put SMEs in financially risky positions and therefore hinders both the steady operation of financial system and the sustainably fast growth of economy. In order to help understand the background of SEMs financing, the first part of the thesis will describe the overall landscape of Chinese financial system, which mainly consists of banking system, non-banking financial institutions, capital markets and informal financial sector. Then the thesis will describe the development and current challenges of SEMs in China. For the third part, how SMEs are practically financed through various financing sources will be presented and explained. Based these studies, the thesis will then devote into summarizing and analyzing the causes of Chinese SMEs financing challenges, from the perspectives of both the long-term fundamental reasons and the temporary causes. And then the thesis concludes with a set of proposal to solve the issue.
2. China’s financial system

In order to gain a thorough and precise analysis of SMEs financing in China, we find it essential to firstly have a brief and clear understanding of the Chinese financial system, especially the financial institutions that involve in SMEs financing activities. Therefore this part will respectively introduce the development history and current status of major sectors of the Chinese financial system.

2.1 Banking system

On December 1\textsuperscript{st} 1948, People’s Bank of China (PBOC) was officially set up by the central government of China, signaling the starting of China’s financial system buildup. As the only financial institution that was allowed to practice banking businesses, PBOC functioned as both a central bank and a commercial bank, serving all the financial and fiscal duties of China’s planned economy till the end of 1970s.

In 1978, as Deng Xiaoping stepped up onto the top of China’s political system and decided that economic openness and reform is the right direction of China’s future, the economy started to transform from central plan based to market based and the Chinese financial system started a series of significant reforms at the same time. The reforms started from the banking system. Between 1979 and 1984, four state-owned commercial banks (Bank of China, Agricultural Bank of China, People’s Construction Bank of China, Industrial and Commercial Bank of China) were successively established, respectively focusing on different sections of commercial banking businesses. These four state-owned commercial banks later grew to be the most dominant players in the Chinese banking industry and were known as the “Big Four”. The Big Four gradually took over and split up the commercial banking businesses that were originally practiced by PBOC. Thus, PBOC would exit the commercial banking business and focus on its role of central bank ever since. The Big Four were directed to deal with different sectors of banking businesses respectively and were supposed to avoid any competition among them in the beginning. Then in 1984, central bank PBOC decides to allow the Big Four to expand their service sectors and compete for business, which leads the Big Four to engage in providing loans to fund the
dynamically growing businesses of community-owned SMEs. Thus, China managed to form its initial financial system, which essentially is a banking system still with certain level of planned economy characteristics, consisted of a national central bank and four large commercial banks that are owned and controlled by the central government.

As reform and openness of economy continued and escalated, more incentives were created for further development of the banking industry. In 1987, PBOC brought forward the proposal of forming a socialistic financial system that is led by PBOC and composed of various types of financial institutions, especially various types of banks. As the leaders of reform envisioned, commercial banks were expected to function more as enterprises than as government departments. However, the Big Four often found it contradictory to both provide policy-type credit loans following government orders and commercial credit loans following market choices. Consequently, three state-owned policy banks that specialize in policy-type credit loan business were successively established in 1994: the Agricultural Development Bank of China, the Export-Import Bank of China, and the China Development Bank. These policy banks were responsible for funding state-led development projects ever since, leaving Big Four gradually evolve into pure commercial banks that solely owned by the state and managed as independent enterprises. Almost during the same period of time, many other types of banks came to stage and joined the economic reform and development. In 1986, the fifth largest commercial bank was formed: the Communication Bank of China, in the form of join-stock entity. And 12 more join-stock commercial banks were set up in succession afterwards. At the end of 1996, the Big Four state-owned commercial banks consisted of around 153,000 branches and more than 1,680,000 employees, while the 13 join-stock commercial banks together had 3,750 branches and more than 85,000 employees. During the same period of time from 1986 to 1996, postal savings bank was set up as an additional specific type of financial institutes, intending to collect deposits and use the money to help fund economic growth. And in 1995, the first municipal commercial bank emerged in China: Shen Zhen Commercial Bank. 18 more municipal commercial banks were formed before the end of 1996. Thus, China achieved setting up an early stage banking system that is dominated by the Big Four and includes various types of banks that geographically covered different markets. Nevertheless, the extensive establishments
banks with multi sizes and functions did not necessarily equal to a market based mechanism of the banking system. Issues like agency problems were extraordinarily severe in the Chinese banks, mostly due to the very fundamental fact that the government dominantly owned the banks and often went against the market mechanism by giving banks fixed quotas for the amount of deposits and loans or by forcing banks to provide funding for specific state-owned enterprises and local development projects. For example, in late 1980s and early 1990s, local governments could directly appoint local branch managers of state-owned commercial banks. This means that local governments had easy and unreasonable access to bank loans, which together with local governments' preference of aggressive economic growth led to a rapid credit and inflation growth.

Since 2002, as China joined the World Trade Organization (WTO) and the economic contribution from private sectors became increasingly influential, a more open and market-based banking system were urgently needed. So foreign banks started to provide specific services in Chinese market and competed with Chinese banks. The competition from foreign banks also to some extent stimulated further improvement of Big Four and other Chinese commercial banks. In the meanwhile, as the banking system became much more comprehensive and complicated, systematic risks of financial sector accumulated further more. In face of such challenges, the Chinese government found it necessary to further strengthen supervision and regulation of commercial banks, as part of its efforts to advance the reforms of banking industry. Subsequently, China Banking Regulatory Commission (CBRC) was officially formed in 2003, and many modifications of the Law of Commercial Banks were passed to legitimize CBRC's role of regulating banking industry and making related policies. With a more comprehensive set of financial laws and a better-designed regulatory system, banks started to be managed with higher level of professionalism and financial risk in banking industry significantly decreased. For instance, bad debt rate of major commercial banks fell from 23.5% in 2002 to 6.8% in 2007. Meanwhile, further joint-stock system reform is opposed upon major commercial banks, especially the Big Four. The government intended to make the Big Four develop into most influential and powerful financial institutions so that strong and stable financial support could be guaranteed for the rapid economic development. The Big Four successively became listed
on stock markets both in China mainland and Hong Kong, each of the four gradually becoming one of the largest commercial banks in the world. Lastly, as the overall economy developed, people were much more incentivized to consume than before, which led to the widespread development of banking services in consumption credit loans, in addition to banking services for companies or commercial projects. Together with the vast development of real estate and automobile markets, various types of banking services were provided to individuals, widening and deepening the involvement of banks in the Chinese overall economy. Till now, banking system has undisputedly become the most influential in the Chinese financial system.

Figure 1. Total assets of banks in China from 2003 to 2013 (in trillion RMB)

Source: People’s Bank of China; CBRC

Figure 2. Bank deposits in China from 2003 to 2013 (in trillion RMB)

Source: People’s Bank of China; CBRC
Figure 3. Number of foreign banks in China from 2004 to 2013

Source: CBRC

Figure 4. Financial system structure in comparison, 2013

Source: CSRC, CBRC, BIS, IMF, World Bank, World Development Indicators

Figure 5. Share of selected bank groups in China in the total balance in 2013

Source: CBRC
2.2 Other financial institutions

2.2.1 Trust companies

Trust companies have gone through many major reforms and significant changes within its history in China since 1979. Chinese government has reshaped the role and positioning of trust companies for several times, in order to support the developing financial system that is absolutely dominated by major banks and accompanied by other financial intermediates as well. In short, trust companies in China are not exactly equal to trust companies that are normally seen in the western world. Commonly in China, trust companies are referred to as trust banks and investment companies that participate in a certain range of financial services, not only restricted to how the term trust is applied in the west. As China applies a financial system that is separately operated and supervised, trust companies are the only financial institutions that are allowed to participate in money market, capital market and direct investment. This gives trust companies obvious advantages in involving in various types of financial services and deals, therefore trust companies in China are very opportunistic in nature, always adjusting to the changes of regulatory policies and rolling out new services in response to market changes.

The start of China's trust companies dated back to October of year 1979, when China International Trust & Investment Company (CITIC) was formed. CITIC was formed under Deng Xiaoping's request of setting up a financial company that helps Chinese companies attract foreign investments. In the middle of the following year, PBOC issued the notice of actively promoting and establishing trust businesses in China. As a result, 241 branches of banks across 21 provinces set up trust companies and started trust businesses before the end of the year. Later on, non-financial institutions also joint in setting up trust companies. As trust sector expanded unruly ever since, there were around 620 such trust entities by the end of year 1982. One of the major reasons behind the fast expansion was central government's lack of clear and systematic regulation and laws on the trust sector development. Since trust companies were simply regarded by the government as a supplement channel of financing to the banking system where there was still strong governmental control of lending through banking system, large amount of lending was
realized through the utilization of trust companies, and most of the lending goes to the enterprises and investment projects owned by the local governments that were overly motivated to boost economic growth. Meanwhile, as trust companies could participate across money market, capital market and direct investments, a lot of opportunistic practices and speculative behavior in lending market and security market were carried out through trust companies. With a lack of clear development direction and insufficient risk control ability, trust companies took large amount of non-performing asset and some went bankrupt. In 2000, the International Monetary Fund estimated that the debt of Chinese trust and investment companies totaled between 12 billion USD and 20 billion USD. Thus, five times of major regulation and reorganization of trust sector were performed between year 1980 and 2000, defining business boundaries and eliminating unqualified players. Before the Trust Law was put into practice in 2001, only 68 trust companies still remained their existence in China. To summarize, as a pioneer of China's financial reform, trust companies have been actively trying businesses that are market-oriented but not regulated by the government yet, thus trust companies' ever-changing practices gradually stimulated the overall regulation and reform of the financial system. While blocking and restructuring the trust sector between 2001 and 2007, the government also set up and applied a series of rules and laws that classify, supervise and regulate trust businesses. This ever-developing legal system placed a solid foundation for the rapid development of trust companies since 2007. The amount of assets managed by China's trust companies grew from 1,200 billion RMB in year 2007 to 14,000 billion RMB in 2014, with a compound annual growth rate of more than 30%. Realized operational income in 2014 reached as high as 95.50 billion RMB, and profit mounted to be 64.23 billion RMB. Currently, trust companies mainly involve in two areas: to put the money and other assets entrusted by individual and institutional clients (mainly commercial banks) into various types of investments; to invest in financial institutions’ equity or financial products with trust companies’ own principal capital. As economy grows and trust companies participate more actively in financial services, the first area becomes the dominant source of income for trust companies. Especially with the financing need of SMEs and local governments’ infrastructure investment not satisfying by commercial banks, trust companies became a major component of a China’s vast shadow
banking. The trust funds could be classified based on different industries where the investments go into.

Figure 6. Trust company assets in China

Source: China Trustee Association

Figure 7. Industry breakdown of trust product issuance

Source: China Trustee Association

2.2.2 Financial leasing companies

Financial leasing is a financial agreement under which an asset or property is purchased by the lessor from the supplier at the request from the lessee and provides the uses of this asset or property to the lessee against payment of a leasing fee. The start of leasing industry in China dated back to year 1981, when China Orient Leasing Company Limited was formed. From 1988 to 1998, a series of defaults in leasing companies led to a sluggish development of the industry. The following application of several leasing related laws and
regulations, together with the vast increase in export trades due to joining WTO since 2001, has not only created a fast-growing market need for leasing services, but also brought in a number of foreign leasing companies that contributed in the optimization of China’s leasing industry structure. In 2007, CBRC issued Measures for the Administration of Finance Leasing Companies, allowing and encouraging Chinese commercial banks to set up financial leasing companies. With advantage of easy access to loans and shared client groups provided by their parental commercial banks, these financial leasing companies grew at a much faster pace than normal leasing companies and foreign leasing companies. The annual leasing volume of these financial leasing companies increased from 9 billion RMB in 2007 to 860 billion RMB in 2013. One of the forces that stimulated such a fast growth was the 4 trillion RMB investment plan in 2008, which encouraged investment in infrastructure and heavy industry and thus led to high demanding of equipment leasing. The number of all three types of leasing companies in total increased from 93 in 2007 to 1026 in 2013, among which the number of foreign leasing companies grows fastest due to their fast and convenient approval of establishment. While there are only 23 financial leasing companies at the end of 2013, their assets compose 80% of the assets of the whole leasing industry. Financial leasing companies, which are frequently referred to as bank lessors, have become the leading player, while captive lessors and third party lessors are placed at the second and the third. Bank lessors and most of large foreign captive lessors mostly focused on serving large companies (especially state owned enterprises and multinational corporations) with an average deal volume of more than 100 million RMB, while third party lessors (both domestic and foreign included) are almost the only suppliers of leasing services to SMEs in China. In recent years, Ministry of Commerce and CBRC, two regulatory bodies of China’s leasing industry are taking increasingly positive initiatives to make leasing more accessible to SMEs.
### Table 1. Number of leasing companies in China

<table>
<thead>
<tr>
<th></th>
<th>2013</th>
<th>2012</th>
<th>Growth</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial Leasing Companies</strong></td>
<td>23</td>
<td>20</td>
<td>15%</td>
<td>2.2%</td>
</tr>
<tr>
<td><strong>Domestic Leasing Companies</strong></td>
<td>123</td>
<td>80</td>
<td>53.8%</td>
<td>12%</td>
</tr>
<tr>
<td><strong>Foreign Leasing Companies</strong></td>
<td>880</td>
<td>460</td>
<td>91.3%</td>
<td>85.8%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1026</td>
<td>560</td>
<td>83.2%</td>
<td>100%</td>
</tr>
</tbody>
</table>

**Source:** China Leasing Association

### Table 2. Volume of leasing deals in China

<table>
<thead>
<tr>
<th></th>
<th>2013 (Billion RMB)</th>
<th>2012 (Billion RMB)</th>
<th>Growth</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Financial Leasing Companies</strong></td>
<td>860</td>
<td>660</td>
<td>30.3%</td>
<td>40.9%</td>
</tr>
<tr>
<td><strong>Domestic Leasing Companies</strong></td>
<td>690</td>
<td>540</td>
<td>27.8%</td>
<td>32.9%</td>
</tr>
<tr>
<td><strong>Foreign Leasing Companies</strong></td>
<td>550</td>
<td>350</td>
<td>57.1%</td>
<td>26.2%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2100</td>
<td>1550</td>
<td>35.5%</td>
<td>100%</td>
</tr>
</tbody>
</table>

**Source:** China Leasing Association

### Figure 8. Business volume of leasing companies in China (in billion RMB)

**Source:** China Leasing Association
2.3 Capital market

After its decision of economic reform and opening-up policy, China's economy gradually underwent a transformation from a centrally planned economy to a market-oriented one. To support such a sophisticated transformation and to serve a fast-growing financing demand across the nation, central government realized that a financial system constituting of only banks and non-banking financial institutions was not enough. The need of market-oriented financing and the government's consent of experimental trials led to the initial establishment and development of China's capital market in early 1980s.

The development of China's capital market could be mainly divided into three phases.

From 1978 to 1992, China's capital market emerged and went through its early stage of trials and explorations. In 1979, China's reform and opening-up policy started to be implemented. In 1981, initial form of trading of treasury bonds started in China. In 1986, public trading of stock appeared in Shanghai. In 1987, the first professional securities firm in China, Shenzhen Special Zone Securities firms was established, in response to the nationwide expansion of treasury bonds trading. And more securities intermediaries came to emergence afterwards. In 1990 and 1991, tow stock exchanges were opened respectively in Shenzhen and Shanghai. In 1992, a special kind of stocks called B-shares started to be issued for foreign investors on domestic market, in order to attract foreign capital to China. To summarize, the first phase was the period when China's capital market evolved from a number of regional trials and schemes, which was not sufficiently regulated and supervised by a regulatory system. But the goal of Chinese government was to transform SOEs into joint stock companies and allow them to raise funds through capital market.

The second phase is from 1992 to 1999, a period when a nation-wide capital market was formed and further developed, with a more sophisticated system of regulation being developed simultaneously. In 1992, China Securities Regulatory Commission (CSRC) was enacted as the regulator of the national securities market and a centralized regulatory and supervisory framework was gradually formed ever since. In 1997, Chinese government
decided to separate the regulation and supervision of the banking, securities and insurance sectors. Also, a more comprehensive legal framework started its formulation through the effort of CSRC. Between 1993 and 1998, such laws as The Provisional Regulation on Stocks Issuance and Trading were gradually promulgated and implemented. With the presence of CSRC, stocks could then be issued through public offering to all domestic investors. But an approval system that sets quota for the number of stocks to be listed was applied by the CSRC with its intention of preventing possible excessive speculative investment in an immature market by immature domestic investors. Also during this phase, the two stock exchanges continued developed in terms of increasing transaction efficiency, market transparency and information disclosure. During this phase, securities intermediaries grew fast and securities investment funds started to emerge in China. In summary, China’s capital market quickly grew into a centralized national market that is supervised under a newly established system of laws and regulations.

From 1999 to 2007, further adjustments to the mechanism and regulatory system of the capital market were implemented to support its fast growth that originated from China’s further growth in the volume of exports and domestic investment in infrastructure and real estate industry after joining WTO and further opening up the market. During this period, further efforts were put into the enforcement of regulations and laws in capital market so as to refine the overall system and remain a healthy market environment. The non-tradable stock reform was widely regarded as the most influential advancement in the improvement of efficiency in China’s capital market. Also, SME Board and the Share Transfer System were both launched to meet the diversified demands of return and risks of different investors, thus a multi-layered capital market started to form. Meanwhile, development of the bond market was initiated during this phase. The bond market in China is comparatively small in its volume, due to a lack of authentic credit-rating system and overlapping regulations. So the development of the bond market was slow and restricted to the settlement of legal framework and market mechanism. In 2002, Qualified Foreign Institutional Investor (QFII) program was introduced and more foreign capital started flowing into China’s capital market. The QFII program has changed the competition landscape in the fund management industry in China. Large SOEs started to be encouraged to raise funds through overseas
listing and issuance. To summarize, more comprehensive developments were executed during this phase, to bring more systematically efficient regulations and more market mechanism to China's capital market.

Figure 9. Market Capitalization of China's stock market (in USD)

Source: CSRC, World Bank

Figure 10. Total market capitalization and number of listed companies in China

Source: CSRC

Soon after the start of its economic reforms, the Chinese government also started to issue government bonds to finance the reforms and to suppress the inflation that accompanied
the economic growth. As economy continued growing, the issuing size of government bonds also increased, as well as the level of bond market infrastructure development. Two exchange bond markets and the national interbank market were opened in succession, so as to allow the circulation of government bonds in secondary markets and to nurture a market-oriented bond market. With the improvement in issuing and trading system and the introduction of the market pricing mechanism, the government bonds grew significantly from 4.9 billion RMB in 1981 to 800 billion RMB in 2008. Corporate bonds started to appear in mid 1980s, when SOEs were allowed to issue corporate bonds (also named as enterprise bonds) in addition to raising funds through bank loans. Without a mature regulatory system in place and with the special agency issue in SOEs, corporate bond issuance quickly became overheated, resulting in a high default rate. So the government almost suspended the issuance of corporate bonds and took measures to strengthen the regulation of the bond markets. From 1995 to 2004, the corporate bonds issuance grew very slowly under strict regulatory system with limited quota given by the government. The size of issuance was small, and the circulation of corporate bonds was also stagnated. With a series of laws and regulations gradually established, issuance of corporate bonds rejuvenated in 2005, when the issuance of corporate short-term bills was encouraged to help enterprises gain access to direct financing. In addition to corporate bonds, financial bonds have also gone through significant development since early 1980s. In 1990s, policy banks were the major issuers of financial bonds, and the size of the issuance is only subject to that of the government bonds. In early 2000s, a certain group of commercial banks and securities companies selected and approved by the government also started to issue bonds to raise capital.

After a quarter of century’s development, the bond market in China is now a multi-layered market with three segments: the interbank market, the exchange market and the bank counter market. The interbank market is the largest of the three, taking more than 90% of the overall Chinese bond market volume. Among all the bonds on the market, non-financial corporate bonds function as an alternative way for corporation in China to raise capital other than by taking loans from commercial banks. Till the end of 2013, the size of corporate bonds takes 44% of the total issuance of Chinese bond market, with an
approximate number of 3.6 trillion RMB. While government bonds and financial bonds take 24% and 32% respectively. There are mainly three types of corporate bonds: Listed Corporate Bonds, Enterprise Bonds, and Short-term Corporate Financing Bills.

Table 3. Characteristics of three types of corporate bonds

<table>
<thead>
<tr>
<th></th>
<th>Super Short-term Commercial Papers (SCP)</th>
<th>Commercial Papers (CP)</th>
<th>Medium-term Notes (MTN)</th>
<th>Listed Corporate Bonds</th>
<th>Enterprise Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Approval</strong></td>
<td>Registration System</td>
<td></td>
<td>Verification and approval system</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Determination of Issuing Rate</strong></td>
<td>Tender issuance or book building</td>
<td>Determined through market inquiry by issuers and sponsors</td>
<td>Determined by the enterprise according to the actual market condition</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Major Trading Platforms</strong></td>
<td>Inter bank market</td>
<td>Exchange market</td>
<td>Cross-market trading, mainly in Inter bank market</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: CSRC, NDRC, POBC

Among the issuers of corporate bonds, SOEs are dominant players and private companies that are listed play an important role as well. But SMEs are not significant issuers in the market at all. And among the holders of corporate bonds, commercial banks take more than half of the market volume, leaving the rest shared by funds institutions and insurance companies. The development of the Chinese corporate bond market has been substantially stimulated by the government’s intention of better meeting the financing needs of SOEs.

Table 4. Ratio of issuance of corporate bonds by issuers, in 2013

<table>
<thead>
<tr>
<th></th>
<th>SOEs</th>
<th>Central SOEs</th>
<th>Local SOEs</th>
<th>Private Companies</th>
<th>Foreign Companies</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>SCP</td>
<td>100%</td>
<td>98.6%</td>
<td>1.4%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>CP</td>
<td>66.2%</td>
<td>21.2%</td>
<td>45.1%</td>
<td>22.2%</td>
<td>7.2%</td>
<td>4.4%</td>
</tr>
<tr>
<td>MTN</td>
<td>78.2%</td>
<td>16.1%</td>
<td>62.1%</td>
<td>12.6%</td>
<td>6.1%</td>
<td>3.1%</td>
</tr>
<tr>
<td>Enterprise bonds</td>
<td>94.9%</td>
<td>3.2%</td>
<td>91.7%</td>
<td>3.2%</td>
<td>1.3%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Listed Corporate bonds</td>
<td>27.3%</td>
<td>7.6%</td>
<td>19.6%</td>
<td>46.6%</td>
<td>6.2%</td>
<td>19.9%</td>
</tr>
</tbody>
</table>

Source: China Bond

The turnover ratios of corporate bonds are also quite low, ranging from 0.6 to 1.2 between 2008 and 2012, and further decreasing to 0.2 in year 2013 and 2014. Considering the low
turnover ratio and that SOEs and commercial banks are respectively major issuers and holders of corporate bonds, it is believed that bond market is substantially another form of bank lending market in China.

Figure 11. Size and Composition of China's Domestic Bond Market

![Pie chart showing the size and composition of China's domestic bond market.]

**Source:** China Bond, as of July of 2014

Figure 12. The balance of bond custody and the number of bonds 2003-2012

![Graph showing the balance of bond custody and the number of bonds from 2003 to 2012.]

**Source:** CSRC, PBOC
2.4 Informal financial sector

2.4.1 Private Equity and Venture Capital

Private Equity was also a form of financial vehicle that Chinese government tried to learn from the west and introduce to China as an additional force that provides capital needed for the fast growth of China’s economy. Private equity and venture capital are generally regarded as different concepts in the US, as US private equity firms mostly focus on LBOs and the acquisitions of small and medium enterprises while venture capital firms exclusively invest in startups and small firms. This difference of private equity and venture capital is comparatively less apparent in China, for that both private equity and venture capital focus mainly on investing in startups and SMEs that would later get listed on stock markets. There are not enough LBO deals in China for private equity to get into. Private equity and venture capital have been one of the fastest growing financial sectors in the past ten years. Now the sector is packed with larger foreign private equity firms, government-backed firms and small or medium cap firms. The development of private equity and venture capital in China could also be divided into three phases.

From mid 1980s to mid 1990s, private equity industry was gradually introduced and established in China. In 1985, the first venture capital fund in China was set up by the central government with an intention to encourage the development of science and technology. Later on more local governments joined the efforts of establishing technology-based venture capital firms so as to propel regional technical and economic development. The reorganization of SOEs in early 1990s also attracted more formation and participation of private equity firms in China, as well as some foreign private equity firms. As China's legal framework that regulates the market-oriented economy gradually formed, foreign private equity and venture capital funds became more interested in the investment opportunities in China, which was exactly what central government was trying to achieve: attract foreign capital to invest in China.

Since late 1990s, China's private equity and venture capital market picked up its pace significantly. Firstly, due to the release and implementation of a series of laws and
regulations that encouraged both domestic and foreign private equity funds to invest in certain fields such as industrial development projects, more venture capital funds were set up and more industries gained access to venture capital. Chinese political leaders such as Vice Prime Minister Zhu Rongji also pushed for greater expansion of China's private equity and venture capital industry. During this period, government-backed PE and VC funds gradually left the market the private and foreign funds. Secondly, as Internet boom effect came to China, a lot startups in Internet industry are in great need of capital from PE and VC, since the banking system at that time would not provide financing for such highly risky small companies. So a lot of such startups tried to seek for funding from PE and VC firms in the U.S. and this turned out to open a window for U.S. PE and VC firms to look into the great investment opportunities in China's Internet industry. So more foreign firms came to China and the VC industry developed fast with the professionalism and practices that these firms brought in.

From 2000 to 2010, more sophisticated regulation system was gradually formed to develop China's stock market into a more stable and healthy one. This not only attracted more capital invested into the stock market, but also made China more attractive to both foreign and domestic PE and VC firms, since a stock market that is regulated under a strong legal structure means a more predictable execution of exit strategy for PE and VC firms. Also, many domestic private equity funds were established to finance small businesses in particular industries like manufacturing, biotechnology and Internet. These domestic funds took a significant advantage over foreign funds by facing less regulatory delay or restrictions imposed by governments. The 2008 global financial crisis put a pause to the development of PE and VC industry due to difficulty in fundraising and exit, especially for foreign firms. However, Central government's 4 trillion RMB stimulation plan re-activated the economy boom, leading to another round of fast growth in PE and VC industry in China. As more capital and more talents jump into the industry, it is widely expected that China's PE and VC sector would continue growing fast both in investment volume and in the diversity of the target industry.
2.4.2 Private lending

Private lending has always been a choice of financing for SMEs, especially when SMEs lack access to bank loans, which happens a lot under the current Chinese banking system. Due to many systematic reasons, many private companies could not acquire financing from either banks or capital market. If more working capital or investment is needed for further business growth for these private firms, entrepreneurs often have no choice but borrow from individuals, who would ask for a higher rate of return than the bank loan interest that is regulated by central bank. On the other hand, since China's stock market has been widely regarded as full of speculation, people don't find it wise to invest in stock market. And such lower risk market as bond market is also very underdeveloped in China. Actually Chinese people don't have many good options for investing their money. Thus, lending money to SMEs is one of the practical choices for individuals. Gradually, some private firms are formed to collect money from individuals and lend the capital to the SMEs in the name of the firm, so as to improve efficiency in finding proper targets and managing the pro-lending supervision. There is no accurate statistics on the volume of such private lending in China, but it is estimated that the number should be around 6 trillion RMB at the end of 2013, which is around 8% of the total amount of loans provided by Chinese banks. Private lending is a significant component of shadow banking in China, taking around 20% to 30% of the total shadow banking volume. Other shadow banking market participants are non-bank financial institutions, such as trust companies, financial leasing companies, brokerage firms and financial guarantors. Private lending has been an indispensable source of financing that has stimulated the growth of private sector in China's economy, especially that of SMEs. It is also a financial sector that is hard to regulate and supervise, thus presenting a risk.
3. SMEs in China

Currently, SMEs are recognized among seven economic sectors – industry, construction, wholesale, retail, transport, post and hotel & restaurant. Generally speaking, companies with sales between RMB 30 million and RMB 300 million with a workforce ranging from 300 to 3000 employees are regarded as SMEs in China.

<table>
<thead>
<tr>
<th>Size Category</th>
<th>Industries</th>
<th>Employment-based</th>
<th>Total Assets</th>
<th>Business Revenue</th>
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<tbody>
<tr>
<td>Small</td>
<td>Industry</td>
<td>&lt;300</td>
<td>&lt; RMB 40 million</td>
<td>&lt; RMB 30 million</td>
</tr>
<tr>
<td></td>
<td>Construction</td>
<td>&lt;600</td>
<td>&lt; RMB 40 million</td>
<td>&lt; RMB 30 million</td>
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<tr>
<td></td>
<td>Wholesale</td>
<td>&lt;100</td>
<td>&lt; RMB 10 million</td>
<td>&lt; RMB 30 million</td>
</tr>
<tr>
<td></td>
<td>Retail</td>
<td>&lt;100</td>
<td>&lt; RMB 10 million</td>
<td>&lt; RMB 30 million</td>
</tr>
<tr>
<td></td>
<td>Transport</td>
<td>&lt;500</td>
<td>&lt; RMB 10 million</td>
<td>&lt; RMB 30 million</td>
</tr>
<tr>
<td></td>
<td>Post</td>
<td>&lt;400</td>
<td>&lt; RMB 10 million</td>
<td>&lt; RMB 30 million</td>
</tr>
<tr>
<td></td>
<td>Hotel &amp; Restaurant</td>
<td>&lt;400</td>
<td>&lt; RMB 10 million</td>
<td>&lt; RMB 30 million</td>
</tr>
<tr>
<td>Medium</td>
<td>Industry</td>
<td>300-2000</td>
<td>RMB 40 million - 400 million</td>
<td>RMB 30 million - 300 million</td>
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<tr>
<td></td>
<td>Construction</td>
<td>600-3000</td>
<td>RMB 40 million - 400 million</td>
<td>RMB 30 million - 300 million</td>
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<tr>
<td></td>
<td>Wholesale</td>
<td>100-200</td>
<td>RMB 10 million - 150 million</td>
<td>RMB 30 million - 150 million</td>
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<tr>
<td></td>
<td>Retail</td>
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<td>RMB 10 million - 150 million</td>
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<tr>
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<td>Hotel &amp; Restaurant</td>
<td>400-800</td>
<td>RMB 10 million - 150 million</td>
<td>RMB 30 million - 150 million</td>
</tr>
</tbody>
</table>

Source: SME Promotion Law of China, 2003

At the end of year 2014, about 43 million registered enterprises were classified as small and medium enterprises in China, accounting for more than 99% of all the corporations in the country. The development of SMEs has increasingly contributed to China’s economic growth. In 2014, SMEs’ output value accounted for more than 65% of China’s overall GDP, generating more than 75% of employment opportunities in China and contributing more than 50% of taxes. However, SMEs have received no more than 40% of total credit loans released in 2014. Apparently, SMEs are playing an increasingly crucial role in China’s economy, while they still remain in an unfavorable position comparing to state-owned enterprises and foreign large international corporations. Difficulty in financing is one of the most urgent challenges for Chinese SMEs.
3.1 History of SMEs development in China

SMEs' history of development dated back to 1978, when China's economic reform started. In 1978, as economic reform initiated from rural areas, productivity increased significantly and thus abundant labor forces are looking for jobs out of agricultural sector. Under such a situation, a large number of collective enterprises were established to absorb these labor forces. Central government encouraged such collective enterprises to participate in the trial of market economy. After decades of planned economy, China's saw a great demand of consumer goods as soon as it started the reform of transferring to market economy. Naturally, all these collective enterprises gradually turned from producing agricultural products to making consumer goods for greater profitability. These collective enterprises were all small in their scale and juvenile in their operations. Still, with such a huge market demand and the backup from the government, collective enterprises grew fast. Some township enterprises owned by the local governments were a major constituent of these collective enterprises. Encouraged by national policy of economic reform and intention of creating jobs for rural surplus labor, local governments spared no efforts in cultivating local township enterprises. Statics show that township enterprises contributed to more than 20% of GDP on average from 1982 to 1992. Bank loans were instructed to favor local township enterprise and this not only stimulated the growth of these SMEs, but also led a lot of non-performing loans, which hindered further development of SME sector in China. The first phase of SMEs expansion made great contribution to the development of economy and the improvement of people's living standards in the beginning years of China's reform and opening-up.

As these state-owned SMEs proved the success in the economic reform and enjoyed massive growth, many private SMEs were established as well. They mostly joined the business related to consumer goods. The large amount of non-performing loans of state-owned SMEs revealed the fact that state-owned enterprises were managed with low efficiency and severe issue of agency problem. As part of the measures of the market economy reform, central government decided to reduce the state's ownership in SMEs and focus on running large-scale state-owned enterprises. Measures were taken to change the
landscape of SMEs in China, such as joint stocks, merger & acquisition, contracting, and sale of assets. A lot of private SMEs took the opportunity to acquire the assets of these state-owned SMEs, gaining unprecedented advantages in quickly scaling up their businesses. Thus the period from 1992 to 2002 saw rapid development of private sector economy in China, and most of large private firms in China now actually started their accumulation of wealth during this golden age for SMEs and gradually grew into large enterprises. The SMEs development was also accompanied by major advancement of China's financial system and corporate legal framework formation, as we mentioned above. These SMEs went through privatization process and more active participation in the market economy, boosted by the entrepreneurship of private owners. In all, private SMEs underwent massive growth during this period while state-owned SMEs gradually went through privatization.

The third phase of SME development began in 2002, when government promulgated the SME promotion law. Realizing the importance of SMEs in contributing to the overall economy and social stability, Chinese government started taking measure to boost and direct the SMEs' growth. Laws were passed to remove the institutional barriers that restricted the extension of involvement of SMEs across different economic sectors. Consequently, private SMEs were allowed to compete with state-owned enterprises in more industries. And local governments established industrial parks to attract SMEs and provide them with systematic support in financing, technical innovation and so on. As a return, SMEs created GDP contribution to the local government and provide jobs to the local labor. The industrial parks model also boosted the local infrastructure development. As China joined WTO in 2002, a even larger market demand from the globe set the foundation of another round of vast growth in SMEs. Taking advantage of China's cheap labor, Chinese consumer goods gained great market demand from the world with their low prices. A lot more entrepreneurs took the opportunity and set up SMEs to produce goods to be sold overseas. So a lot of SMEs clusters appeared in different areas across China, mostly in southeastern China, each specializing in manufacturing a certain type of consumer goods. In addition, SMEs took innovative steps in the hi-tech and Internet industries. Major
Internet giants in China nowadays all started as SMEs during this period, leading business and technical innovations in China.

### 3.2 Challenges for SMEs

SMEs in China are very weak in technological innovation, comparing to SMEs in the Europe or the State-owned large enterprises in China. Technological innovations are generally brought to enterprises from three sources: internal R&D, licensing of intelligence patent and R&D in research institutes. Licensing of technologies from western enterprises is mostly acquired by China’s state-owned large enterprises, because only state-owned enterprises have the support from government and banks to set up joint ventures with foreign companies, as a major measure to bring in technological innovations. Achievements of R&D in research institutes would most be acquired by SOEs as well, for that only large scale SOEs are financially able to provide large amount of funds needed to finance the R&D projects in research institutes. Internal R&D is the only possible source of technological innovations for SMEs in China. However, due to high risk of fail in the R&D investment and the severe lack of IP protection in China, SMEs tend not to spend money on R&D. Lack of innovations means that SMEs are mostly placed at a lower position along the value chain of industries. Products made in China are therefore widely regarded by the world to be of low quality. This also leads to Chinese SMEs’ lack of competitiveness under a increasingly globalized trade market.

Inadequate financing is another challenge faced by SMEs. Due to several complicated reasons, China’s current financial system is not performing well in terms of serving and supporting the development of SMEs. The basic challenges of SMEs are high cost of financing, under-developed direct financing, competition from SOEs for capital and the lower position in the bank-SME relationship. The details about how SMEs are financed in China, as well as the reasons that have caused the financing challenges for SMEs, will be further discussed later on.
The third challenge faced by SMEs is the increasing cost of labor in China. As widely known, one of Chinese SMEs’ core competitiveness is low pricing, which could not be realized without the abundant supply of labor in China. However, as China grows into an aging society with smaller portion of its population to be qualified labor forces, the decreasing supply of labor leads to increasing cost of labor for SMEs. The drop in profit margin, together with the difficulty in acquiring capital for automation that could replace the human labor, imposes an urgent challenge for SMEs in China.

Another challenge for SMEs is the excessiveness of domestic competition. Although Chinese government is taking measures to allow private SMEs’ access to some industries that have traditionally been exclusively open to SOEs, SMEs are still facing additional regulations and restrictions in certain industries, such as financial sector, fundamental facility sector and education sector. Thus, SMEs are competing fiercely with each other in the limited industries that the government decides to leave for them. In addition, with limited access to financing and talents needed for business expansion to other industries and overseas markets, SMEs in China found it hard to grow into large firms. While more than 90% of firms in China are private SMEs, more than 90% of top 100 largest firms are state-owned.
enterprises. It's extremely rare for SMEs in China to grow into large-scale firms that operate nationally.

Last but not the least, the lack of management expertise and talents also hinders the development of SMEs. Most of Chinese SMEs started from family businesses or partnerships. The entrepreneurs proved to be good at grasping opportunities in the early stage of their enterprises, when the business did not require much management capability. As their enterprises grew, a more sophisticated management structure and the according team of professional managers are needed. However, Chinese entrepreneurs tend to trust themselves more and important decisions are still made by family members. In addition, talents in management would favor working for large firms and foreign corporations over SMEs in China. Without a professional and proven management structure, SMEs find it hard to gain external support and trust, especially when they seek for financing or technical cooperation. Credibility of SMEs also decreases with such a weak management capability.
4. The Sources of Financing for SMEs in China

SMEs acquired financing services from different sources. As we discussed before, getting external financing has always been difficult for SMEs in China. So most of SMEs had no choice but to rely on internal financing for the survival and development of the enterprises. However, SMEs in China generally don’t generate high profits through their operations, meaning that internal financing with retained earnings is certainly limited. With rapid growth of China’s economy, SMEs have enormous potential and opportunities to build and escalate, which could barely be supported by internal financing. That’s why SMEs are actively and constantly seeking for proper sources of external financing. Under a financial system that has been developed for no more than 30 years and has a lot room for further improvement, there is no standard answer to how SMEs should be financed and who should provide external financing for SMEs. Everything is a process of regulations and adjustments in this sector of financing. We will cover the primary sources of SMEs' financing and classify them into four categories – banks, shadow banking, capital market, private equity & venture capital.

4.1 Banks

SMEs take banks as their primary intermediary to raise funds. SMEs take loans from banks for more investment in working capital or start new projects. Bank loan is the cheapest source of external financing for SMEs. The process of acquiring bank loans is straightforward. SMEs apply for a certain amount of loan, promising to pay back the principal and the agreed interest in a year. Most of bank loans that are available to SMEs are one-year loans. Then the banks would carry out some basic credit assessment of the SMEs and in most cases ask for collaterals. Due to the cost of liquidation in cases of default, the banks would require the market value of the collateral provided to be 30% to 60% higher than the value of the loan, which means that owners of SMEs must already have large amount of assets before they seek for financing through bank loans. However, most of SMEs don’t have such assets available, especially startups that are still in the early years of operation and haven’t accumulated any assets yet. The fundamental reason behind this is the lack of trust from bank in the credibility of SMEs and the difficulty in credit rating of
firms in China. This is also the rationale why the period of the loan is restricted to one year. Banks would be able to reassess and decide whether it's secure enough to further continue the loan to SMEs. Practically, if SMEs use the bank loans for more investment in working capital, which is needed for business development and could not be transferred into cash to pay the banks after just one year, they would have to borrow from other sources to pay back the bank loan first and then get the renewed bank loan for another year. This also adds to the cost of getting bank loans for SMEs. In order to close the gap of trust between banks and SMEs, some credit guarantee companies are established to work as a bridge. These companies will provide credit guarantee of the SMEs to banks and in case of default of the loan, the credit guarantee companies will pay the banks. What these companies ask from SMEs in return is also collateral, together with an additional guarantee fee, at around 3% of the value of the bank loan for a year. Various types of banks provide loans to SMEs, such as commercial banks, policy banks, postal savings bank, and Small-and-Medium-Sized rural financial institutions. Commercial banks dominate the bank loan market, especially the Big Four state-owned commercial banks. But Big Four tend to favor large enterprises and state-owned enterprises over SMEs, since they are in an absolutely advantageous position in the market and they don't need to explore SMEs’ market for better financial performances. In addition, SMEs mostly operate only in local areas, since they are not large enough to have many facilities or branches that operate in various regions. Thus, city commercial banks become one of the major players in providing loans to SMEs. These city commercial banks are not able to compete with Big Four and national policy banks in financing large state-owned-enterprises, especially those owned by the central government. So city commercial banks turned to SMEs. And some joint-stock commercial banks also participate actively in financing SMEs. These joint-stock commercial banks have operations across the nation, so they often put resources in studying certain industries and focus on lending to SMEs from these industries in different regions. Postal savings bank played an important role in the SMEs’ financing from 1980 to 1992, when the township enterprises boomed with easy access to loans from postal savings bank. This led to a large scale of bad debt in early 1990s and the government started to enforce stronger control on loans to SMEs since then. The last type of banks that provides loans to SMEs are small-and-medium-sized rural financial institutions. They purely focus on making loans of small amount to
agricultural small businesses. Under government's intention to support such agricultural small businesses, various types of such financial institutions are promoted to establish, such as rural credit banks, rural commercial banks, township banks and rural mutual cooperatives.

Figure 14. China's total social financing as of % of GDP

Source: PBOC, National Bureau of Statistics

Figure 15. China's lending rates and deposit rates from 1996 to 2012

Source: CBRC, PBOC
4.2 Other financial intermediaries

Trust companies also provide financing services to SMEs. There are three types of transactions that can be made through trust companies to finance SMEs. The first approach is to finance a group of SMEs with a certain trust product. Since SMEs' annual financing demand is comparatively small, a single demand from an SME would not be fit to set up a trust to raise funds. But if a group of SMEs' loan demand could be bound together, the volume of the loan would be large enough for trust companies to launch a trust product and raise the capital needed and lend to this group of SMEs. So local governments would often play a role in selecting and binding together a group of local SMEs. These SMEs' financing plans should have similar length of loan and payment date in a year, so that the loans could be released and paid back as a whole at a particular time. The benefits of lending through trust companies are the following – customized loan length and interest rate, lower agency cost comparing to banks, and higher ratio of loan value to collateral value. Due to the control of CBRC and central government’s economic regulations, commercial banks are occasionally prohibited from lending to firms of certain industries, such as real estate. However, trust companies are not restricted to such regulations. So banks could entrust the money to trust companies, and then trust companies would lend the money to the target firms that banks intend to finance. This is a significant part of shadow banking in China, and it's hard for the government to supervise and regulate this sector. Some SMEs in such industries as real estate and mine development acquire their loans through this approach as well, with a higher interest rate than normal bank loans. In addition, trust companies could launch a trust to raise funds for equity investment in SMEs. Trust companies are allowed to directly invest in corporations. If an SME has a good potential of growth and good financial performance and needs external financing that does not request collateral, trust companies could negotiate an equity investment term with the SME stipulating the exit time and price. So this is substantially a credit loan without request for collateral, meaning that trust companies have to carry out due diligence and credit rating assessment of the SME and will charge a higher rate of return than normal bank loans. Hi-tech SMEs are more likely to have access to this approach of financing.
Leasing companies are also a source of financing for SMEs, especially SMEs in the manufacturing industry. There are two types of leasing deals that essentially help finance SMEs. The first type is the standard financial leasing, where financial leasing companies would finance SMEs in the purchase of new equipment. When SMEs have a growing business and they need to money to buy more manufacturing equipment or facility to increase production capability, they could choose to acquire loans from commercial banks, if they have enough collateral. However, financial leasing seems to be a better option under this situation. Financial leasing company would purchase the facility from the supplier and then rent it to the SME that needs the facility. SME would then have the right to use the facility with its obligation to maintain the facility well and pay a yearly leasing fee to the financial leasing company. The financial leasing company will have the ownership of the asset. In the financing agreement among financial leasing company, SME, and the supplier, the length of the lease and the leasing fees will be stipulated. Generally, the length of the lease contract would be similar to the estimated usage life of the facility and the SME would have the right to purchase the remaining value at the end of the lease. This type of financing is beneficial to both sides. SMEs don't have to provide assets as collateral for the loan needed, and this type financing does not increase their debt ratio, which is favorable in case SMEs need more debt financing in the future. In addition, the leasing contract is generally more than 5 years, which means the burden of paying back is much less than normal bank loans. Financial leasing companies could control the risk of providing financing by making sure the money is used in the purchase and usage of the facility, and they keep the ownership of the asset until the principle and the interest are fully paid. The second type of leasing deal is just the other way around. When SMEs need more cash for more working capital or other investment opportunities, they could sell their own facility or equipment to financial leasing companies for cash, while financial leasing companies would lease the asset back to the SMEs. In the transaction, the ownership of the facility would be transferred to financial leasing companies and SMEs get cash in return, but SMEs still keep the right to utilize the facility by paying the leasing fees. So this is essentially like a bank loan with facility as collateral, which commercial banks generally don't accept. This help SMEs to better utilize their fixed assets for financing. Of course, the interest rates for this type of transactions will be higher than normal commercial bank loans.
For SMEs that are not in manufacturing industry or are comparatively smaller in business volume, neither financial leasing nor trust companies are practically ideal financing sources. Some micro-credit companies focus on serving these small enterprises. Basically these micro-credit companies will accept collaterals that banks don’t accept, and they also ask for higher interest rates. In addition, in order to control the risk of default, micro-credit companies would do more due diligence work to assess the credit of the small enterprises.

4.3 Capital markets

There are two major stock exchange markets in China – Shanghai exchange and Shenzhen exchange. But the major board called A Board on these two exchanges have very high standard of requirements for the candidate listing companies in terms of registered capital, annual revenue, net assets and profit margin. So the companies that are listed on A Board are mostly large firms that already have accumulated a lot of assets. SMEs are not qualified to raise capital on major stock markets, since most of SMEs don’t meet the standards set by the regulatory organizations. With an intention to help SMEs raise funds through stock market, the government gradually opened two minor stock boards that are designed for SMEs – SME Board and GEM Board. SME Board started in 2004, focusing on listing the SMEs that could are eligible to list on A Board but still meet a certain standard of requirements in terms of registered capital, net assets and profit margin. The boundary between SME Board and GEM Board is quite blurring. Actually, the government intended to introduce GEM Board in around 2001, as an intention of learning from NASDAQ of the U.S. But it was pointed out that the regulation and supervision system wasn’t ready for such a highly volatile stock market. So the compromised plan was to set up a board that combine the characteristics of both main board and high-tech GEM board, and hopefully this transition plan would work before a real GEM Board is established. As economy continued growing, some high growth companies started standing out and some technology related industries started booming, such as Internet industry. These fast-growing and highly technological companies generally focus on their marketing and R&D competency, instead of the fixed assets that are often needed for growth of companies from traditional industries. So equity financing through stock market would be a better and more suitable
financing option for such companies. Then in 2009, GME Board officially started. GEM Board places even lower listing requirements, intending to facilitate the financing of the high-tech companies that don't generate much revenue or profits currently but do have a very promising future and enjoy a fast growth. To summarize, both SME Board and GEM Board are appropriate choices of financing for SMEs. Till the end of 2013, there are approximately 800 companies listed on SME Board with an aggregated market value of around 4 trillion RMB and there are approximately 380 companies listed on GEM Board with an aggregated market value of around 1.8 trillion RMB. Considering the large number of SMEs in China, this market volume is still very small.

Realizing the extreme difficulty of SMEs' attempts to raise bank loans for financing, the government took further steps to encourage equity financing for SMEs by opening up its over-the-counter stock market to them late in 2013. Before this, only unlisted companies that are located in high-tech economic development zones of four cities and are recognized by the local governments as high-tech companies could be eligible for raising funds through share sales on the OTC market, called National Equities Exchange and Quotations System. This OTC market was created originally as a trial to help the companies that have good performance but still fail to meet the requirements of listing on the main board. The first trial was carried out in Beijing in 2006 and then the OTC market expanded to other three cities in 2012. Now the government decided to further expand to the whole nation. Comparing with SME Board and GME Board, it requires even less for companies to raise funds through sales of shares on OTC market. Before opening-up to the whole nation in late 2013, there are around 300 companies on OTC market, and till the end of January of 2015, there are already 1600 companies listed.

Issuance of corporate bonds is also a method for Chinese SMEs to raise funds. However, with a lack of credit rating system in place, it is hard for SMEs to gain confidence from bond investors. Even if the credit rating works, the rating of SMEs is certainly much lower than that of SOEs and listed corporations. Still, with an intention to find approaches of direct financing for SMEs, the government decided to allow the issuance of a specific corporate bond called SME collective bond. A selected group of SMEs would join together as the
issuer of the collective bond, with each SME taking a certain portion of the issuance amount. The collective bond will be guaranteed by guarantor organizations, be rated by credit rating agencies and be audited by accounting firms. Under such an approach, the rating of the bond would be higher than that when SMEs issue corporate bonds respectively, and the cost of financing would be lower than the cost of getting loans for SMEs. The annual cost of SMEs’ financing through collective bonds is around 35% lower than that through commercial bank loans. What’s more, the lengths of the corporate bonds are generally around five years, so SMEs don’t pay pack the principle yearly as they have to do so when they finance through bank loans. This also significantly decreases the substantial cost of financing for SMEs. However, the market volume of SME collective bonds is still small comparing to that of bonds issued by SOEs and listed corporations. The major reasons are the lack of confidence in the transparency and governance of SMEs in China and investors’ absolute favor for SOEs.

As an effort to help solve SMEs' difficulty in financing, CSRC promoted issuance of another innovative corporate bond, called SME private placement bond in mid 2012. Comparing to other types of corporate bonds, such as short-term commercial paper, enterprise bonds, medium-term notes, and listed corporate bonds, the SME private placement bond set much lower requirements for the issuers in terms of net assets and profitability. In addition, credit rating is not strictly required for issuance of SME private placement bonds, and very simple accounting audit is needed for the assessment as well. Guarantee is not required either. The intention is clearly to diminish the entry barrier as much as possible. So more than 200 such bonds were issued within a year, and a lot more SMEs are trying to join. This massive demand in issuance leads to the increase of the interest rate of these bonds. The overall annual cost of issuing SME private placement bonds is as much as 12% now, which is not significantly lower than that of bank loans for SMEs. While issuers are quite proactive, investors hold a suspicious attitude towards the SME private placement bonds, believing that SMEs’ performances are highly volatile and the lack of transparency would lead very high default rate. As a matter of fact, among the SMEs that successfully issued the bonds, more than half are substantially subsidiaries of SOEs or large corporations controlled by local governments. So the openness of this bond market does not satisfy its original
intention of serving the financing of private SMEs that have limited access to bank loans, but instead provide another channel for SOEs and large corporations to raise funds.

<table>
<thead>
<tr>
<th>Year</th>
<th>SME Collective Notes</th>
<th>SME Collectives Bonds</th>
<th>SME Private Placement Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number of Bonds</td>
<td>Amount (Billion RMB)</td>
<td>Number of Bonds</td>
</tr>
<tr>
<td>2009</td>
<td>4</td>
<td>1.3</td>
<td>0</td>
</tr>
<tr>
<td>2010</td>
<td>19</td>
<td>4.7</td>
<td>2</td>
</tr>
<tr>
<td>2011</td>
<td>17</td>
<td>5.2</td>
<td>3</td>
</tr>
<tr>
<td>2012</td>
<td>34</td>
<td>7.1</td>
<td>5</td>
</tr>
<tr>
<td>2013</td>
<td>3</td>
<td>0.5</td>
<td>15</td>
</tr>
</tbody>
</table>

Source: China Bond Com

Figure 16. Issuance of corporate bonds in China (in Billion USD)

Source: CSRC, POBC

4.4 PE & VC

While PEs in the well-developed western markets involve mostly in deals like merger & acquisition and LBOs, PEs in China remained focused on growth capital. So both PE and VC activities tend to serve SMEs a lot more than well-established large firms or listed corporations. Both foreign and domestic PE firms have been enjoying great opportunities for development in China in the past 10 years, not only because China’s economy continues growing rapidly and tremendous investment opportunities exist among excellent SMEs, but also because SMEs need the values added by PEs and VCs. In addition, the Chinese
government also sees the importance of PE activities as a financing tool for large number of SMEs that have long been hindered by the thirst of financing, that’s a regulatory system that intends to facilitate the development of PE industry in China has been quickly established since 2008, the year when SMEs started suffering from sharp decrease in export trades. In addition to working as a useful tool for directly financing best SMEs in different regions of China, PE also contributes to SMEs by helping them internationalize and strengthen business models. With their familiarity with overseas markets and expertise in international operation, foreign PE funds in China could function as a valuable platform that helps SMEs either exploit overseas markets or find international strategic partners. Chinese domestic PE firms are also willing to support the SMEs they’ve invested in terms of globalization, which in turn facilitates their own ambition to internationalize. As PE industry grows in China, more PE funds join to compete for investment deals with prominent SMEs, which are not easy to find. PE funds have to compete not only in finding good potential investees, but also in convincing the owners of SMEs to choose them. So PE funds tend to respectively focus on a certain group of industries or on certain geographic areas, where they could either leverage their expertise in the industries or their strong local connections or government support in specific areas. Investment from PE funds provide SMEs with both the capital and the upgrading in management, which are equally important for SMEs to grow fast and meet the financial performance standards set by PE funds.

The challenges of SMEs' financing through PE and VC mainly come from two aspects at the present. Firstly, PE funds tend to invest in SMEs that are managed with sufficient professionalism and transparency, which is fairly important to PE funds as equity investors. However, most of owners of SMEs don't feel like having their firms be totally exposed to external investors. And unlike its counterpart in the U.S, private equity investment is still not widely accepted by SMEs that are in their growth stages, since their owners tend to keep equity to themselves under their obsession with the notion of ownership. So good deals of PE investment are not easy to find in China, needless to mention the increasingly fierce competition. Secondly, the exit strategies for PE investments are fairly underdeveloped. IPO has been the major choice of exit for PE funds in the past ten years.
However, with massive speculation on the Chinese stock market and the government's strict regulatory authorization mechanism of stock issuance, it takes more than good business performance and competency for corporations to successfully get listed. This hurdle of exit also stops PE activities from covering more SMEs. In addition to IPO, merger & acquisition is also a choice of exit, but has still been of limited contribution so far.

Figure 17. Number of PE funds and capital raised in China (in Million USD)

Source: Pedaily.cn report 2014

Figure 18. Number and capital of PE investments in China (in million USD)

Source: Pedaily.cn report 2014
4.5 Private credit lending

Typical Chinese entrepreneurs tend to borrow from families and friends to finance their startups. As these startups grew into SMEs and needed more external financing for business expansion, they would probably still have to borrow from other individuals and households if they are not able to get loans from commercial banks. As we mentioned already, SMEs’ access to bank loans has been fairly limited and SMEs’ need of capital for operation and expansion has been urgent. On the other hand, due to lack of good investment products on market, private credit lending has been left to be the most feasible and practical way for individuals and households to realize good capital returns with their cash at hand. Such private credit lending is made based on the mutual trust of borrowers and lenders, so in some occasions borrowers are friends or relatives of lenders. As the need of capital increases with the growth of business, borrowers would go out to find more potential lenders and convince them into the deals, usually by the promise of an annual return of 10% or more, which is quite lucrative to lenders. And some intermediaries started to arise, borrowing from different individual lenders or investors and lending the accumulated capital to enterprises that have financing needs. These intermediaries earn profits by charging the enterprises a higher rate of return than what they pay the lenders. These intermediaries and enterprises involved into an informal credit market that is not officially supervised by governments. Private credit lending activities often take place within the local regions and cities, where local funds satisfy the financing needs of local SMEs. Among all the regions, Wenzhou is undoubtedly the most well known for its large volume and constant vitality in private credit lending activities. According to the estimates by the PBC in 2011, around 90% of Wenzhou’s households and 60% of enterprises are constantly involved in private credit lending activities. In the early stage of its development, the informal credit market was mainly supplying liquidity to local industrial and commercial enterprises that were not be sufficiently served by commercial banks. Thus the return rates of such private loans were kept at a reasonable level. As economy grew fast, capital needs that arise from speculative investment incentives are enormous, thus both borrowing enterprises and these intermediaries would compete for funds from individual lenders. This competition leads to increasing the overall interest rate of informal credit
market. So a lot of SMEs had to pay higher interest rate for such private credit lending and this subsequently led to decreasing profitability of SMEs. In general, such private credit lending market has been a practical source of financing for SMEs due to lack of provision of financing for SMEs from formal banking system and capital markets. It's a more market-oriented financial market, but it's also functioning in the shadow without sufficient supervision and regulation from governments. That's why such private credit lending activities have led to some large-scale defaults in history and posed risks on the financial and social stabilization in such regions as Wenzhou. Government has been trying to take measures to have this shadow credit market under control and regulation, while it also realizes the key is to further develop current formal financial system so as to sufficiently serve SMEs' financing needs.
5. SME Financing challenges and Causes

Financing challenges have always been one of the primary challenges for further development of enterprises, especially small and medium enterprises. The forms and characteristics of these challenges differ among various economies, due to the difference in financial systems and overall economic situation. With SMEs’ significant importance to the economy and society, all the governments have been taking continuous efforts to cope with the financing challenges. Here we will explain on the major forms of challenges for Chinese SMEs’ financing and the causes behind.

5.1 Challenges

The first challenges for SME financing is the severe limitation in the choices of financing sources and channels. As we mentioned, China’s financial system is a system dominated by banking sector. Although the capital markets have been quickly developed in the past decade and have grown to play more influential role in the overall financial system, the banks seemed to remain fundamentally strongest. Most enterprises depend their financing on the provision of credit loans from banks. The volume of bank loans is still much larger than the volume of funds raised on stock market and bond market. As bond market and stock market develop, some large enterprises, especially state-owned enterprises are allowed to raise funds through such capital markets as well. But SMEs are mostly not qualified to raise funds through capital markets, simply because they are not large enough in scale and they are not managed with enough professionalism and corporate regulation.

The second challenge is the high cost of financing for SMEs. Chinese regulatory organization PBOC would set a benchmark of loan rate, and allow the commercial banks to decide their own loan rates based on market. So the loan rates are generally based on both the central planning and the market mechanism. At the end of 2014, average loan rate that Chinese financial institutions charge was 7.33%, which is 19% higher than the number at the end of 2013. In practice, SMEs have to pay not only the loan interest rate set by the banks, but also some intermediary fees and implicit costs during the process of acquiring loans. In order to get loans from banks, SMEs would often have to pay some financial
consultation fees of around 3% of the loan principle. Such fees are essentially an extra charge that banks pose upon SMEs, but not applicable to large enterprises such as SOEs. There are many measures that banks have been taking to virtually increase the cost of financing for SMEs. For instance, some banks would require the loan to be given in the form of bank's acceptance bills rather than cash, which means that SMEs would have to pay an extra charge if they want to convert the bills into cash for instant use. And some banks would only agree to provide loans to SMEs under certain terms. For example, SMEs would have to agree to deposit 50% of the loan back into the bank as soon as they get the loan. This not only cut the actual money SMEs receive into half, but also largely increase the substantial interest rate of the loan. Adding some other transaction fees that arise from the process of applying for the loans, we would surprisingly find that virtual cost of bank loan financing for SMEs are way more than 10% of the principle per year. And we should note that this is the rate for SMEs that have good financial performance and enough high quality fixed assets as collaterals. If an SME with mediocre business performance and scale intends to acquire such loans from banks, the cost would be around 15% or more. Because these SMEs have to look for credit guarantee in order to get loans, which would cost them extra 3% of guarantee fee at least. In some districts where SMEs' access to bank loans is extremely limited, such guarantee fees would be as high as 8%. That's why it not surprising to find some SMEs' cost of financing through bank loans to be 20% per year. In addition, such transaction fees and implicit costs would be even higher at specific times throughout the year, such as end of month or year, when banks need to keep enough deposits so as to meet the requirement set by PBOC and CBRC.

The third challenge is the difficulty in qualifying for the requirements set by banks for loans. Commercial banks have a set of standards to refer to when they assess the loan applications from enterprises. These standards are mostly set based on judgment of the revenue, profit margin, growth rate and fixed assets of the applicants. Basically, commercial banks don't assess risks by analyzing the enterprises case by case, they tend to control the risks by setting standards for stability and accountability in business performance and abundance in fixed assets. Comparing to large-scale enterprises and state-owned enterprises, SMEs are generally weak in technical strength, management capability and
market influences. Except for very few medium scale enterprises that possess some superiority in the market, most SMEs are not eligible for bank loans. In addition, banks often take back the loans and deny further requests simply because banks think it necessary to control risks. When banks have to take back some loans from current borrowing enterprises, they would certainly choose to withdraw loans from SMEs first. Such loans offered to SMEs are often short-term that need to be reassessed and reoffered yearly, which helps banks to control the risks. So every year, SMEs have to borrow cash from other costly financing sources to pay back to banks and then acquire the loan again for another year. This means an additional cost of financing for SMEs if they need the short-term loan for long-term use. It’s even worse if banks suddenly decide to take back loans permanently, SMEs would have not be able to pay back these costly short-term lenders, and the accumulated interests would often result in bankruptcy of these SMEs. Surveys have shown that more than 50% of SMEs that went bankrupt have borrowed from such highly costly financing sources.

5.2 Causes

5.2.1 Long-term fundamental reasons

There are four major long-term reasons behind the challenging situation of Chinese SMEs' financing.

The first one is apparently the information asymmetry between banks and SMEs and the ethical risks that come along with it. This information asymmetry makes it least possible for banks to trust SMEs' presentations of their operational and financial performances. Comparing to large enterprises that have been in operation for a longer time, SMEs are generally short in history and weak in business performance. SMEs are risky and volatile in nature, so it’s quite often that SMEs would not provide factual information about their operation when they apply for bank loans. In addition, SMEs are naturally more likely to break a contract since they are small in scale and they don’t mind defaulting as much as mature and large enterprises. Without a well-developed credit rating system in place, it is
fairly hard for banks to trust SMEs and properly assess the risks of the loans. Considering that most dominant players in bank industry are all owned or controlled by the government, if a specific loan ends up in a default, the decision maker of the offering of this loan would most likely have to claim the responsibility, which is extremely bad news for a career in Chinese banking industry. So most of banks would rather give up the credit loan businesses with SMEs, so that they would avoid the potential ethical risks embodied in deals with SMEs.

Secondly, banks tend to engage in large deals so as to increase the overall operation efficiency and decrease the managing cost per deal. The average amount of the loan requested by a typical SME is between 500,000 and 20,000,000 RMB, while the loans offered to large enterprises are mostly around 100,000,000 RMB or even more. It takes banks certain amount of time and number of employees to process each loan deal, from credit assessing to collateral confirmation, and from initial consultation to post-loan management. To achieve a same yearly volume of loans, banks would encounter higher cost if they do more deals from SMEs. So it’s quite reasonable and natural for banks to favor larger deals over smaller loan demands from SMEs. Although some municipal commercial banks and small banking institutions have been promoted by the government to serve SMEs, they don’t have enough loan financing capacity to significantly satisfy the needs of SMEs, needless to say that they would also favor large enterprises if they have such potential deal opportunities.

Thirdly, banks tend to favor SOEs and government financing vehicle enterprises. Since most banks are owned and controlled by the government ultimately, the executive managers of banks are more likely to build good relationships with leaders of state-owned-enterprises. With the widely agreed implications that government would not easily allow an SOE go bankrupt and that a default incident of loan to an SOE would not be regarded as a severe fault of banks, most banks are bold in lending to SOEs. In the eyes of banks, all the credit loans to SOEs are to some extent substantially guaranteed by the government credit. In addition to SOEs, some local governments also join to compete for credit loans from banks. In order to further boost local economy, local governments need to raise funds for
infrastructure investment projects. Of course governments are not eligible entities to borrow from commercial banks. So local governments would set up a number of municipal investment enterprises that will carry out the fund raising and investment activities. These enterprises are often referred to as government investment vehicles. Banks would also be more than willing to lend to these government investment vehicles, since they are either implicitly guaranteed by the local governments or they could provide governments' lands as collaterals. With banks favoring such government-supported enterprises, it only becomes harder for SMEs to finance themselves through bank loans.

The forth reason is the lack of financial sectors that are specially developed to server SMEs' needs of financing. As we mentioned, capital markets' entry standards are too high for SMEs to qualify. Although government has established some minor stock boards that are positioned to financing excellent SMEs, such as SME Board and GEM Board, the overall contribution is still limited. The overall market volume is still small comparing to the enormous volume of SMEs' financing needs. And there are already many speculation activities within the market, making it less attractive for institutional investors. In addition, some SMEs that get listed on the market that are actually controlled by local governments, and they intend to raise funds for the local governments to use. These kinds of phenomenon are definitely going against the initial intention of establishing such a minor stock market to boost SMEs' development. And without a solid credit rating system, it will take a long time before SMEs are able to raise funds through corporate bond market. And the small financial institutions are also not supervised and regulated properly to support SMEs with higher efficiency and lower cost, such as credit guarantee companies. The high cost of SMEs' financing is often a result of extra cost from various layers of financial intermediaries between SMEs and commercial banks.

Lastly, complicated relationships with banks add to extra cost of financing for SMEs. In order to get loans from banks, owners of SMEs would often have to build and maintain good relationships with the leaders of banks. The leaders of banks could make final decisions on whether to approve a specific loan or not. If such decision power is not totally in the hand of these leaders, they could still pose significant influence on the decisions. In a
loan deal between banks and SOEs, both sides would consider the deal to be mutually beneficial, thus both sides are in an equal position in the negotiation of the collaboration. However, this harmony does not exist naturally between SMEs and banks. Since banks are originally less willing to lend to SMEs, SMEs have to not only try hard to prove themselves in terms of creditability and accountability, but also keep a favorable relationship with banks. Practically, owners of SMEs would go to dinner with leaders of banks and even bribe them, which ultimately adds to the total cost of financing for SMEs. As competition for loans gets fierce, these additional implicit costs increase insanely.

5.2.2 Temporary causes

Apart from the fundamental reasons behind SMEs’ financing challenges, there are also some temporary causes that have further aggravated the situation.

The first temporary cause is the exceeding capital needs and lack of provision of money in China. Looking at absolute supply of broad money in China, we would say that the number is huge. According the PBOC, the volume of remaining M2 at the end of 2014 was about 122.84 trillion RMB, with an increase of 12.2% from previous year. The total amount of financing in 2014 was around 16.46 trillion RMB, 0.8 trillion less than the previous year. And among the total amount of financing, approximately 9.78 trillion RMB was realized through bank loans. The ratio of M2 to GDP of China is around 1.93, comparing to a number of 1.98 in 2013. Considering that the M2/GDP ratio of the U.S is around 0.7, it seems that China has enough amount of capital needed for its GDP growth. But if we notice the decreasing rate of increase in the capital provision, we could see that there is a temporary shortage of supply in capital. If we define the degree of monetary easing in this way: currency supply increasing rate – GDP growth rate – inflation rate, we would find that the result has been fluctuating between -5% and 18% at an average rate of 6% since 1990. At the end of 2014, the number is around 3%, meaning that the current degree of monetary easing is minor to the average level of the past 15 years. One explanation is that the current lack of capital supply is a result of extreme stimulus package of 4 trillion RMB after global financial crisis in 2008. The promised additional 4 trillion RMB capital injected into the
economy turned out to be leveraged by more than two times, and the majority of these capital was invested into infrastructure development and related heavy industries. These investments did boost another round of fast growth of economy in the first few years. But now the effect seemed to start diminishing, since more capital is needed to match the larger scale of economy but the supply seemed not to be growing as fast as before. So generally speaking, the overall supply of financing in China is starting to squeeze, and this consequently further reduce the amount of financing available for SMEs.

The second temporary cause of SMEs’ financing challenges would be banks’ negative reaction to the policy of monetary tightening. When there is insufficient supply of capital in the market, credit loans to SMEs would first be cut down and this often leads to some cases of default or bankruptcy of SMEs. Hearing such news of defaults and considering the overall tightening monetary market, banks would certainly worry about the risks of loans to SMEs most, because they believe SMEs are the most vulnerable to the shortage in supply of capital. In order to avoid incidents of default, banks would proactively stop renewing the loan contract with SMEs until the overall market signal has become positive again. In a word, when the economy is good and SMEs are operating well, banks would be willing to offer financing services, while when the financial market is going downward and SMEs are in most need of financing support, banks would abandon SMEs first. That’s why SMEs often have no choice but to borrow from private lending companies who charge exceptionally high rates of interest after banks withdraw loans ruthlessly. And these highly costly private lending activities would in turn further accelerate the default and bankruptcy of SMEs since they could not really undertake such high interest rates.

The third temporary cause is the decreasing profitability of SMEs. When SMEs are operating with fast growth and high profit margins, they still could get loans from banks, since the high profitability is a strong guarantee of SMEs’ capability of paying back the loan principle and interest. However, if SMEs’ profit margin decreases significantly, banks would regard it as a negative signal. As we mentioned already, after two decades of fast growth, SMEs have already started suffering from increasing costs of resources and labor in recent years. The gross margin of manufacturing enterprises have been decreasing almost every
year, and the average growth rate of revenue has been declining from 30% in 2011 to 9% in 2014. In addition, as SMEs are more leveraged than before and they generally pay high interest rates for debt financing, their financing cost of SMEs are increasing to a large extent, which further squeeze the profitability. With a decreasing profitability, SMEs would only find it harder to convince banks or other financing institutions for debt financing.
6. Proposed solutions

Based on the discussions above, we realize that the problem of SMEs’ financing is a complicated result of both systematic flaws and temporary economic impacts. The problem would not be easily solved by a single solution. It would take a series of proper reforms that fit in the overall financial system and comply with the economic condition. Government has been continuously taking measures to cope with the SMEs’ financing challenges. However, designing a solution does not equal solving the problem. It’s more important to make sure these measures would be actually executed. Here we summarize some proposed solutions:

Firstly, government should promote the establishment of credit rating system in China. With a sound and complete credit rating system in place, commercial banks could efficiently find SMEs that have excellent performances and good growth potential, and provide them with sufficient bank loans without many over-demanding requirements. Internet infrastructure development and utilization of big data would be of great help in developing the credit rating system. And most important of all, united support and collaboration from various departments of both central and local governments would be crucial to the success of the system. Ultimately, good SMEs would have sustainable access to financing through banks with reasonable costs, while ill-performing SMEs would be squeezed out of the market due to low credibility.

Secondly, more small banks should be established to support local SMEs. As most large state-owned commercial banks would definitely favor large loan transactions with SOEs and large enterprises, small banks that don’t have enough capital or liquidity to provide large loans would be fit for financing SMEs. With its operational focus on the local enterprises, small banks would take more efforts in localizing and understanding local SMEs and financial environment. The information asymmetry would be minimalized by the close relationship between small banks and SMEs, and small banks would better execute the risk control for that they primarily serve SMEs.
Thirdly, the scope of capital market’s openness to SMEs should be further increased. By building a more transparent and active stock market that would value-based investment, a larger number of qualified SMEs would be more encouraged to list and raise funds through equity issuances. And in return, private equity and venture capital industry would further boom since the PE and VC firms could rely on a sustainable and accountable way of exit after investment. Thus SMEs would have more access to PE and VC equity financing, which also brings management upgrades to the SMEs and further increase their financing capabilities.

Lastly, more innovations in small-scale financing should be allowed for experimentation under proper regulations. Some municipal or joint-venture commercial firms have been constantly innovating to figure out ways to finance SMEs. And other financial institutions have always intended to serve SMEs’ financing needs as well, such as internet-loan companies, crowd funding companies, and various types of investment companies. Without proper regulations opposed upon, these institutions would function as two sides of a coin to SMEs. When the economy is good, they serve SMEs with financing and thus fill the gap left by commercial banks, while they are also often the invisible hand that drags SMEs into bankruptcy when the economy and financial market are going downward. So more regulations should be opposed, and more innovations should be allowed. In a word, let the market mechanism try to fix the challenges of SMEs’ financing and also place some proper regulations at the same time.


