

## MSME Financing in China: Problems and Proposals

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**Abstract:** Many surveys on MSMEs financing show that accessing finance of MSMEs still remains a big problem in China. By contrast, the financing status of MSMEs is better in many Asian countries and regions. This paper suggests that China should further improve the scale and efficiency of MSMEs finance by innovating financial service modes to expand financing channels, strengthening government laws and policy support, improving enterprise credit system, and promoting whole life-cycle capital management of MSMEs.

### 1. Introduction

Accessing finance is one of the most difficult problems that all micro, small and medium-sized enterprises (MSMEs) face in the process of development. Solving financing is of great significance for MSMEs to further dynamic and healthy development. In recent years, accessing finance of MSMEs in many Asian countries and regions have been effectively alleviated and improved, whose situation is far better than that of China. In the face of current financing difficulties of MSMEs in China, this paper puts forward some policy proposals to further improve financing of MSMEs.

### 2. Financing Gap between Demand and Supply of MSMEs in China

#### 2.1. MSMEs Have a Large Scale and Strong Financial Demand

The large scale and rapid growth of MSMEs in China are the main force to create national wealth and absorb the employment population. MSMEs in China have the typical characteristics of "five six seven eight nine", that is, they contribute more than 50% of tax revenue, more than 60% of GDP, more than 70% of technological innovation, more than 80% of urban employment, and more than 90% of the number of enterprises. It is advisable to keep all the given values.

According to the statistics of China Enterprise Listing Service Alliance, the potential financial demand of China's MSMEs is up to 4.4 trillion US dollars at present, with a capital gap of 1.9 trillion US dollars, of which 41% of enterprises exist credit difficulties. According to the Bankers' Questionnaire Report for the First Quarter of 2020 released by the People's Bank of China, the loan demand index for micro businesses reached 66.0% in the first quarter this year, 0.6 percentage points higher than the previous quarter. In 2019, the balance of Inclusive micro loans was 11.59 trillion RMB, a year-on-year increase of 23.1% and 7.9 percent higher than that of the end of previous year. It can be seen from the data of the past five years that the financial demand of MSMEs in China has always been in a thirsty and vigorous state, and the loan demand of MSMEs is much higher than that of large enterprises.

#### 2.2. The Financial Cost is High and Financial Efficiency is Low of MSMEs

In recent years, under the macroeconomic regulation of restructuring and deleveraging, the downward pressure on China's economy has increased. Under the deleveraging financial policy, many MSMEs have encountered a more stringent financing market. In the first quarter of 2020,

China's MSMEs Development Index (SMEDI) fell to the lowest of 82.0 within five years affected by coVID-19, while the cost index hit a new high of 111.8. As the proportion of getting the low-interest loans, new special loans, loan extension and loan renewal policies obtained by MSMEs is lower than that of large enterprises, in addition to difficulties in production and sales, capital turnover and liquidity, the risk of capital chain rupture is increasing. Furthermore, the newly released China's MSMEs Inclusive Financing-Small and Micro Index shows that the efficiency of MSMEs in obtaining financing has dropped to 163.65, down 10.69 points from the previous quarter.

### **2.3. Accessing finance for MSMEs Is Still Difficult and Expensive**

From July to August of 2018, the author chose 51 typical MSMEs in Beijing city to field investigation of enterprises, including sectors of information services, technology services, business services and manufacturing. With the method of face-to-face structured interview and survey questionnaire, we found it still existed some typical problems and bottlenecks on accessing finance for MSMEs. Survey shows that 17.6% of enterprises have little access to credit, and even 7.8% have no access to credit. Accessing finance of enterprises mainly comes from self-owned funds (52.9%), bank loans (33.3%), venture capital (13.1%) and other channels. The main reason for financing difficulties is imperfect credit system (37.2%), less collateral mortgage and high discount rate (35.3%), less financing channels (31.4%), small short term loans and high cost (25.2%). It turns out that the financing difficulties of MSMEs is still main obstacle to their business.

#### **2.3.1. Accessing Finance is Difficult**

The financing difficulties reflected by the investigation mainly lies in: first, there are many requirements, high difficulty and long time for obtaining bank loans. Bank loan is the main source of external financing of MSMEs, but because of its small scale of assets, less fixed assets and less effective collateral, banks usually have strict censorship standards and long process lending to MSMEs in consideration of lending security. The urgent fund demand of MSMEs often cannot rely on bank credit in time. In some Banks, the lending standards are not open and transparent, such as the inconsistent requirements on enterprises' tax credit, which makes eligible enterprises unable to obtain loans or enjoy preferential loan interest rates and other policies. Second, financing channels are narrow and funding is restricted. Although channels such as venture capital, stock and bond issuance can also be used, they have a limited impact on alleviating the financing difficulties of MSMEs. When operating difficulties arise, self-raised funds cannot be sustained and new financing cannot be obtained, funds can only be obtained from informal channels such as private lending. However, the lending interest rate is as high as 24%-36%, which implies huge risks. Third, the credit system is not sound. Due to their irregular financial data or low transaction amount, many start-ups or MSMEs have relatively weak credit enhancement measures and low credit rating in Banks. Unsound credit system leads to high credit risk, as banks cannot fully know the credit status of enterprises. Therefore, banks are less willing to lend to MSMEs only on the basis of their credit.

#### **2.3.2. Accessing Finance is Expensive**

The financing cost reflected by the investigation mainly lies in: first, the risk premium of MSMEs is high. Most MSMEs have the problems of blurred property rights, unequal ownership and management rights, and defective management mechanism. Meanwhile, Competitiveness and quality of management is not high for most MSMEs, which leads to the risk premium of higher than other financing subjects. Second, MSMEs lack effective collateral. As the financial records and credit records of MSMEs are not sound, it is difficult for commercial Banks to accurately assess their credit risks. In order to reduce credit risk, commercial Banks usually require MSMEs to provide collateral for guarantee. But most MSMEs operate light assets, with no plant, land or other fixed assets which bank can be approved as collateral. Third, MSMEs loan transaction costs are high. Compared with large enterprises, the single loan application scale of MSMEs is small, and it is difficult for commercial Banks to exert scale effect. In order to reduce operating costs, Banks are less willing to provide loan services to MSMEs, and the loan interest rate for MSMEs is also higher.

### 3. The Financing Status of MSMEs in Many Asian Regions is Better than That of China

**Table 1.** Rank of Getting Credit Index in Doing Business by the World Bank

Location	Getting Credit Rank	Strength of legal rights index (0-12)	Depth of credit information index (0-8)	Getting Credit score (0-100)
India	25	9	7	80
Cambodia	25	10	6	80
Mongolia	25	9	7	80
Vietnam	25	8	8	80
Malaysia	37	7	8	75
Singapore	37	8	7	75
Hong Kong	37	8	7	75
Israel	48	6	8	70
Indonesia	48	6	8	70
Thailand	48	7	7	70
Korea, Rep.	67	5	8	65
China	80	4	8	60

More than 96% of Asian companies are MSMEs, providing two-thirds of private sector jobs and playing a key role in Asia's economic recovery and growth. The World Bank's annual *Doing Business Report* focuses on MSMEs in each country and region, providing an objective assessment of business regulations and enforcement in their first-tier cities. One of the indexes is Getting Credit, measuring how easy it is for MSMEs to borrow. China lags far behind Singapore, Hong Kong SAR, The Republic of Korea, Israel and other developed Asian countries and regions in terms of this individual index. In contrast, some developing Countries in Asia, such as India, Cambodia, Mongolia, Malaysia, Vietnam, Indonesia and Thailand, perform well in this index ranking, and some countries even surpass the ranking of developed countries and regions in Asia (Table 1). It is worth noting that China's ranking of getting credit in year of 2020 is falling to 80th, seven places behind the previous year's ranking.

**Table 2.** MSMEs Finance Gap in Some Asian Countries

Country	Number of MSMEs	Potential Demand	Finance gap	Financial Gap/GDP	Potential Demand/GDP
Cambodia	376,069	4,281,103,339	3,709,338,045	21%	24%
China	74,000,000	4,374,280,889,891	1,890,328,123,161	17%	40%
India	63,388,000	369,518,752,038	230,062,869,817	11%	18%
Indonesia	62,922,617	222,465,176,826	165,852,545,872	19%	26%
Malaysia	645,136	91,390,116,799	21,454,214,934	7%	31%
Mongolia	72,473	1,992,136,048	1,293,202,307	11%	17%
Nepal	320000.00	4,332,106,804	3,601,276,163	17%	21%
Solomon Islands	3,050	217,052,732	173,839,087	15%	19%
Thailand	2,872,026	153,521,201,625	40,743,237,597	10%	39%
Vietnam	5,648,000	34,814,572,619	23,609,833,957	12%	18%

According to the latest MSME Finance Gap Report released by the World Bank, the SME Finance Forum, and IFC in 2018, 131 million or 41% of formal MSMEs in developing countries have unmet financing needs. China has the largest group of MSMEs among Asia-Pacific regions and developing countries, with a total number of 74 million MSMEs, accounting for a half of Asian countries. It is also one of the three countries with the largest number of MSMEs in the world, accounting for 67% of the total number of MSMEs in the world, together with Brazil and Nigeria. Among them, China has 12 million SMEs, accounting for 56% of all SMEs in developing countries, 44 million small and micro businesses, and accounting for 31% of all small and micro businesses in developing economies. According to the data of financing gap of MSMEs, the potential demand of MSMEs in developing economies is \$8.9 trillion, while the current credit supply is only \$3.7 trillion, with the capital gap of \$5.2 trillion, equivalent to 19% of GDP, which is about 1.4 times of the current credit supply scale. Among China's MSMEs, 41% have difficulty in getting credit. More than 23 million MSMEs are either completely unable to obtain external financing from the formal

financial system, or the external financing obtained from the formal financial system cannot fully meet their financing needs. Among Asian countries, the absolute amount of financing gap in China is the largest. The financing potential demand of MSMEs accounts for as much as 40% of GDP, and the financing gap accounts for 17% of GDP. The capital gap is still large and the financing demand is in short supply (Table 2).

#### **4. Proposals for Improving Accessing Finance of MSMEs in China**

##### **4.1. Innovate Financial Service Modes and Expand Diversified Financing Channels for MSMEs**

Credit guarantee funds for policy-based financing should be promoted to play a greater role. We should improve financing guarantee funds at both national and local levels. An effective risk diversification mechanism should be built to increase financing guarantee and re-guarantee for MSMEs. At present, there are already many local government guarantee funds established. The State Financing Guarantee Fund Co., Ltd. was also founded at the end of July 2018. The establishment of the fund plays an important role in improving the credit availability of MSMEs in the start-up stage in credit market. Risk-sharing mechanism should be improved to change the previous state of ineffective fiscal investment, decentralized guarantee resources, asymmetric industry information, and risky guarantee agencies. The capital leverage function of banks and other financial institutions should be effectively enhanced in combine with government guarantee fund and commercial banks investment. With risk and interests sharing together, the healthy long-term guarantee fund can promote sustainable development of MSMEs.

Financial institutions should be guided to increase credit to MSMEs. Steady progress should be made in promoting inclusive finance, increasing special business in financing and other services for MSMEs. Through special resource allocation, expense incentive, performance assessment, loss compensation and other measures, MSMEs credit can be increased. Monetary policy tools such as relending and rediscount by the Central Bank can be used to optimize the cost funds of enterprises, support financial institutions to issue special loans, handle rediscount bills, and guide the gradual decrease of loan interest rate of MSMEs.

The scope of the mortgage and guaranty shall be extended for MSMEs which are in good operating condition. Equity, intellectual property rights, inventories, certificates of deposit, government procurement contracts and bills should be in the scope of the mortgage and guaranty to those MSMEs with stable operation and good reputation. The financing process of intellectual property pledge should be optimized, and financial products such as performance guarantee insurance loans can be innovated for financial institutions. Through the innovation of financial credit products, we can meet the targeted financing needs and realize the win-win situation among MSMEs, banks and the government.

##### **4.2. Enhance Government Support and Improve Laws and Regulations**

More preferential policies should be enhanced to guide financial resources to favour MSMEs. linkage pilot of Investment and loan joint financial model should be deepen in scientific and technological innovation, such as supporting the development of linkage business of commercial banks in the manner of reward, subsidies. In addition to the targeted reduction of the required reserve ratio for inclusive finance, the trials of mortgaging rural land management rights can be prudently carried out and mortgage loans for rural housing property rights can be orderly explored. Re-guarantee cooperation programs should be worked out to further expand the scope of policy-based guarantees. Various technology financing service platforms such as Science Parks and Maker Spaces should be set up to promote the effective integration between industry and finance.

The government should strengthen legislation, revise and supplement relevant laws and regulations on financing MSMEs. China's Law on Promoting the Development of SMEs was implemented in 2003 and revised in 2017, but the corresponding matched normative documents or rules on finance, guarantee, fund, risk sharing and other aspects have yet to be issued and revised.

The current Guarantee Law and Corporation Law need improvement. Relevant legal norms on management of MSMEs financing, credit guarantee, and agency need to be worked out the framework of guarantee systems for SMEs. For the post-event risk compensation mechanism, we should take investment risk mitigation measures or loan loss risk compensation measures to encourage the development of chattel financing, and implement risk compensation for banks that provide financing of accounts receivable and inventory mortgage to MSMEs. On the one hand, in view of the imperfection of the corresponding supporting systems and policies for MSMEs financing, relevant laws and regulations should be issued to guarantee MSMEs financing. On the other hand, the system should also strengthen the legal protection ability of bank creditor's rights, preventing from allowing enterprises to evade bank debts, reduce concern about lending in financial institutions.

#### **4.3. Promote the Application of Social credit to Establish a Sound Credit System for MSMEs**

The development of credit system for MSMEs should be accelerated. The credit system plays an important role in optimizing credit information so that financial institutions can rest assured to provide credit support to MSMEs. Therefore, it is necessary to accelerate the transformation and upgrading of financial credit information database. The platform for monitoring and analysing new financial forms should be built to promote the construction of a unified registration system for chattel financing and an accounts receivable financing service platform. The function of registration and inquiry of financial leasing business should also be introduced to support the improvement of public credit information service platforms. Credit information generated in the financial sector should be developed and employed in financing and lending, administrative management, production and operation, transaction negotiations and other social economic activities.

Financing and credit granting services in line with customers' credit status and ratings should be launched in financial institutions, which can paint a portrait for MSMEs. Enterprises and individuals with good faith are given preferential facilities in terms of credit line, credit cost and repayment method, etc. Instead, MSMEs with bad default credit records are listed into blacklist to restrict their loan financing behaviour, which can strengthen the implementation of the reward and punishment mechanism. Besides, MSMEs credit financing loans can be vigorously promoted relying on MSMEs loan risk compensation funds.

A credit investigation system should be constructed. A number of credit rating and commercial credit investigation agencies with strong market credibility and international reputation should be introduced and cultivated. Meanwhile, cooperation between banks and tax authorities should be promoted so that financial regulators and banking financial institutions can judge the scale of financing according to ratepaying by MSMEs in tax authorities. The cooperation mechanism can be carried out based on mutual recognition of credit investigation, user authorization, information sharing, and risk control of bid data, offering products through the full credit business process. Big data technology can be used to integrate the credit information resources scattered in various departments and units, and a unified credit platform is built by collecting, investigating, storing, summarizing and analysing enterprise credit information.

#### **4.4. Enhance Management Risk Awareness and Complete Capital Lifecycle Management**

The risk awareness and management level of MSMEs should be improved to elevate their financing ability. First, many MSMEs have insufficient human, material and financial resources at the start, and their risk awareness is relatively weak. They do not pay enough attention to their own credit construction and risk management, which will often lead to potential hidden dangers of improper use of funds and rupture of capital chain in the future. Second, we should improve the quality and management level of managers. Managers should be familiar with all kinds of current financial policies and special policies of MSMEs, learn relevant knowledge, use modern financial knowledge and innovation channels, and strive for financing from banks and various financial institutions in match with their own development. Third, it is necessary to strengthen their core competence of MSMEs in technological innovation or intellectual property. Not only should we improve the scope of intellectual property and technology mortgage or pledge of accessing finance,

but also we should improve core competitiveness and fundamentally advance their overall financial capabilities.

Perform well in financial planning and overall management of MSMEs in different stages of life cycle. Enterprises need to match different financial strategies in corresponding product life cycle. Therefore, the life cycle of MSMEs in start-up, development, maturity, decline and redevelopment, different stages have different capital demand. Generally speaking, the financing behaviour of MSMEs presents a dynamic transformation process from mainly relying on internal financing, to external financing, and then to internal financing. The periodicity and volatility of enterprise development requires to take the initiative to adjust financing behaviour such as financing channels, methods and structures for different stages of the whole life cycle, which will improve financing efficiency and vitality of MSMEs at the technical level.

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