Wu Xiaoling: Speeding up financial innovation and promoting development of the small and medium-sized enterprises

Speech by Ms Wu Xiaoling, Deputy Governor of the People's Bank of China, at the High Level Seminar on Development and Investment of Small and Medium-sized Enterprises (SMEs) in East Asia, Beijing, 27 October 2005.

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Ladies and Gentlemen:

I am very pleased to attend the first High Level Seminar on Development and Investment of Small and Medium-sized Enterprises (SMEs) in East Asia. The rise of SMEs has not only become an important force behind the rapid, sustainable and sound development of the economy, but also played an active role in structural adjustment and job creation. Hence, governments have attached increasing importance to the development of SMEs.

In recent years, the financial sector of China has taken concrete measures in accordance with the *Act on Promoting Small and Medium-sized Enterprises* and other policies of the state. Progress has been made in providing quality financial services for SMEs. According to the survey launched by the PBC, loans to SMEs have accounted for more than 50% in total credit assets in the past few years, roughly equivalent to the contribution of SMEs to GDP. Nevertheless, it remains hard for many SMEs to obtain financing and many entities expect to improve the management of loans to SMEs. I would like to touch upon three issues on this occasion:

I. Strengthen credit management and foster growth of customers

Most SMEs have incomplete corporate governance, loose management, and lack of transparency in accounting information, resulting in difficulty in obtaining financing. It is not difficult to discover that SMEs at various stages differ in financing needs and channels.

SMEs at starting stage face high uncertainties in production and operation. They have little capacity to provide collateral, nor do they have credit record and transparent information. Hence, it is difficult for commercial banks to accurately judge the yield and risk of the potential loans, thus impeding the lending. As a result, these SMEs mainly rely on internal financing, limited direct financing and private borrowing to raise funds. Some high-tech SMEs also get money from venture capital.

SMEs at growing period gradually foster some capacity to provide collateral and accumulate credit records as they expand their business over time. Their internal information and relationship with commercial banks become increasingly transparent. Usually these SMEs are eager to expand and strongly need credit. However, given their incomplete internal management and financial operation, it remains hard for them to meet the credit examination criteria and obtain credit.

Mature SMEs face declined uncertainty in their operations. With sufficient credit records and relatively transparent information, creditors and investors are in a better position to grasp internal information of these SMEs, and the SMEs have the capacity to provide sufficient collateral. In this context, these enterprises usually are quality customers that financial institutions compete for. Their loans would grow rapidly. The most successful SMEs may become large enterprises, thus being able to access direct financing. These enterprises may raise funds by issuing bonds or stock shares, thus facing little constraints in obtaining financing.

SMEs are a big group of customers. To differentiate among SMEs and corresponding financing channels could actually enhance the allocation of social resources. The central bank shall provide credit guidance for commercial banks from a more macro perspective. In this process, commercial banks shall strengthen loan management, enhance its efficiency, and discover and foster potential customers. With the rapid development of the financial market, the direct financing channel of large enterprises would be further explored, and its share increased. Commercial banks will face challenge in terms of their customer structure. Hence, it is urgent for commercial banks to discover and foster stable customers from the bunch of SMEs.

Credit market and capital market mainly differ in the fact that there is a one-to-one negotiation between commercial banks and their customers. Hence, commercial banks are in a better position to get management information, make judgment on risks and price the loans. Therefore, commercial banks can tailor their products for SMEs according to their financing needs at various stages. Meanwhile, commercial banks shall have a long vision to explore the potential of customers and help SMEs quickly transit from starting stage towards mature stage.

II. Appropriately price lending risks with SMEs

Lending rate is actually the price of credit products. The pricing of credit products mainly includes cost of capital and risk premium. The pricing capacity of Chinese financial institutions is generally weak. One reason is that there have been many administrative restrictions where many prices were determined by the government. Financial institutions had no pricing power and no experience to autonomously determine the price. Moreover, financial institutions had no incentive to make autonomous pricing duce to the institutional weaknesses.

Chronically, there has been a perception that we shall provide preferential interest rate for the industries and areas we would support. In general, banks' lending to large customers is like wholesale business and that to SMEs is retail. Loans to SMEs are usually featured by small amount, many batches and sophisticated procedures. According to a survey, the administrative cost of SME loans is on average 5 times that of large enterprises. If there is too strict restriction on lending rate, banks may have little incentive to conduct feasibility assessment for SME projects. As a result SMEs will have limited access to bank loans and thus face more severe situation. Hence, we shall change the traditional way of thinking and encourage commercial banks to price the risk associated with SME loans so that they can explore new source of profits. Of course, it might to some extent increase interest expense of SMEs. Nevertheless, it is less important compared with the increased access of SMEs to loans. In particular, some high-tech and high-risk enterprises and private enterprises will benefit. Since the People's Bank of China removed the ceiling on lending rates on October 28, 2004, we have observed that some banks began to utilize the new policy to foster their risk pricing capacity.

Of course, the government and social intermediaries can help SMEs reduce risk and financing cost through risk sharing and compensating measures. On the one hand, guarantee institutions shall be supported through such market operations as recapitalization and improved risk control mechanism. On the other hand, local governments can diversify the systemic risks associated with guarantee for SME loans through direct guarantee or re-guarantee. With risk of SME loans shared, they will be subject to less risk premium and lower lending rate.

III. Reform of credit system management with respect to SMEs

Credit system management involves banks' credit management, risk control, asset disposal and supervisory mechanism. In recent years, with the deepening of China's financial reform, banking sector has been increasingly aware of credit risk, leading to centralization of credit approval power and opposition of SMEs. On the one hand, local branches of commercial banks have less power to approve credit and most loan requests had to be reported to branches of provincial level or even the headquarter. As a result, it takes a long time and sophisticated procedure to process loan application, making it hard to meet the financing needs of local SMEs. On the other hand, local branches of commercial banks in the lagged areas have become 'savings bank', which transfer the savings to developed areas that need large amount of money. The savings bank thus could earn spreads, while the local enterprises could not obtain credit.

Frankly speaking, the centralized management pattern is in line with the development trend of international banking industry. However, it needs to be adjusted to meet the needs of SMEs. The current credit management has two problems. First, a large commercial bank is a single legal entity, making it hard to provide frequent short-term loans to SMEs in a swift manner. Second, credit rating method for SMEs is significantly different from that of large ones. The current credit risk rating system adopted by commercial banks does not accommodate the operations and accounting information disclosure patterns of SMEs.

Given the long processing procedures of large banks, the People's Bank of China has been actively promoting the institutional innovation of joint-stock banks and the establishment of community banks so that they can build up close relationship with local SMEs and provide sound financial services for them by simplifying processing procedures. Meanwhile, commercial banks are encouraged to improve credit management and develop new products oriented towards SMEs including loan approval, credit rating, collateral, guarantee, pricing and loan management. The China Banking Regulatory Commission has promulgated the Guidance on Bank Loans to SMEs and commercial banks are making efforts to probe the way.

To support SMEs is not only in line with the needs of the macroeconomic development, but also an important channel for financial sector to explore new source of profits, adjust credit structure and diversify credit risk. In the period ahead, we will further use monetary and credit policy to help develop the channel of financial services for SMEs and enhance efficiency of financial institutions in this regard.

The development of SMEs is a long and sophisticated process, involving joint efforts of government agencies, banks and enterprises as well as the introduction of advanced experiences abroad. I believe that to establish a broad and multi-layer financing system for SMEs will give rise to more rapid development of these enterprises.

Thank you.