Financing without Bank Loans

Jiazhuo G. Wang · Juan Yang

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New Alternatives for Funding SMEs in China

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Jiazhuo G. Wang
School of Business
College of Staten Island
City University of New York
Staten Island, New York, NY
USA

Juan Yang
HSBC Business School
Peking University
Shenzhen, Guangdong
China

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Preface

On June 3, 2013 at a finance summit in Shanghai, Jack Ma of Alibaba "opened fire" on the commercial lending provided by the large state-owned commercial banks in China, criticizing the fact that their loans earned 80 % of all profits, but only served 20 % of the market's fund demand. Ma claimed that the financial industry should not be a "self-entertained" circle; instead, it needs to well serve the "outsiders" of the financial industry, allow the entry of external "intruders", and take steps toward financial reform and innovation.[1] As can be expected, Jack Ma's comments triggered enormous debate in the media, both inside and outside financial industries, on the whole basket of related financial issues. The most salient question was as to who comprised this lucky 20 % and who were the 80 % who were "leftovers?" Why could these "20 %" easily obtain the abundant funding they demand, and sometimes even beyond what they need, from large banks, but such funding barely covered the remaining 80 % who could not even secure much smaller amounts of money that they badly need? What can the Chinese financial industry do to address these issues, and will the long-waited financial reform take a real step forward? And, finally, will China's financial industry truly open the door for private capital and non-state-owned small- and medium-sized enterprises (SMEs)? These were all questions that burgeoned from Jack Ma's ostensible comments on June 3.

In China, there is a tacit understanding among participants in the financial industry that the very few, and very large, state-owned commercial banks are the primary legal fund suppliers in the financial market, and have been for many decades. It is also known that the primary recipients of the funds provided by these large commercial banks are the same state-owned, very large companies, which typically represent these lucky "20 %," as described by Jack Ma. On the other hand, the low income individuals and the small- and medium-sized enterprises (SMEs) that make up over 99 % of the total number firms in China become the "leftover 80 %," and have to struggle and compete for the remaining 20 % of funds in the loanable fund market. It should be no surprise, then, that the most of these latter

[1] http://money.sohu.com/20130604/n377910523.shtml.

companies and individuals end up with nothing in hand, and have to turn to "shadow banks" for funding—the fund market which, for the most part, are filled with the illegal underground fund providers charging extremely high interest rates, such as over 50 %, on an annualized basis. As a result, SMEs' struggle for financing has become a tremendous challenge, greatly impeding the growth and development of SMEs in China.

Historically, the role played by SMEs in China's economy was considered somewhat insignificant. Under the existing ownership structure, the majority of SMEs are privately owned firms that were either set up as a private one since their inceptions or transferred from state-owned during the period of time of ownership reform in 1990s. Compared to large state-owned corporations and their roles as the dominant force in the economy, SMEs were typically perceived as relatively trivial entities whose primary functionality is to fill market niches and cover the few segments uncovered by large state-owned corporations. As a result, SMEs and the financing of SMEs were not perceived as a top priority issue on the agenda of China's economic development.

However, that page of the China's economic growth has been turned over. After more than three decades of high-speed growth, China's economy is now at a crossroads, and SMEs stand near, if not at, the center. Overconsumption of non-renewable energies, and increasingly polluted land, water, and air have been the cost of rapid expansion. In addition, China's heavily investment and export-driven economy and competition based only on inexpensive labor make continued growth in the same vein unsustainable. The 2015 third quarter GDP growth rate, as recently released by China's State Statistical Bureau, fell below 7 % for the first time in the past 35 years.[2] The figure is a clear indicator of the changing diagram of the Chinese economy. So the question truly is: what new growth model will allow China to remain on track for the forthcoming decades?

History has repeatedly demonstrated that progress in economic growth is simply and persistently the result of "creative destruction," as Joseph Schumpeter pointed out several decades ago.[3] Innovation from the market place internally drives the growth of the economy, while entrepreneurs are the initiators and executors of such innovations. In trying to achieve the goal of sustainable economic growth, China cannot be an exception in this regard. Innovation-driven growth, along with the participation of entrepreneurs and millions of SMEs, will be the key to breaking the vicious cycle.

The participation of SMEs in innovation is certainly important for improvement in economic inclusiveness. However, their impact can go far beyond that. SMEs not only make up the majority of the total number of firms in an economy, and can conduct innovations in many areas that larger corporations cannot cover, but they also have stronger motivation to innovate in the first place. By nature, innovations—especially the fundamental ones—are changes or destructions in existing product

[2]State Statistics Bureau of China: http://www.gov.cn/xinwen/2015-10/20/content_2950474.htm.

[3]Schumpeter J., 2006, Capitalism, Socialism and Democracy, New Edition, Routledge, London.

and market structure, and the larger firms typically benefit more from the status quo. As a result, large corporations, usually, may tend to be less motivated to innovate than SMEs. Kodak, for example, was widely considered a classic case of a large corporation in a monopolistic position, who resisted new digital technology innovation due to a conflict of interest with its traditional film business, and eventually filed for bankruptcy. Therefore, SMEs are widely expected to play a much more critical and strategic role, instead of a niche one as before, in China's sustainable economic growth in the coming decades.

However, despite the new tasks that SMEs have been expected by the market to undertake, obtaining adequate funding to support innovation and entrepreneurship has been a difficulty for many such small and medium companies. In a monetary economy, conducting innovation without funding would be like driving a car without gasoline or electricity. The difficulties in financing SMEs under the traditional financial system in China remains a huge hurdle that companies must overcome before the Chinese economy can emerge from a nonsustainable growth model to a sustainable one. As a result, a financial innovation would be a necessary condition for a successful economic transition in China.

To be fair, the lack of sufficient funding for SMEs in China cannot be entirely attributed to lack of enthusiasm on the part of large state-owned commercial banks. It is more so that the characteristics of SMEs and the inherited risk associated with SME financing are difficult for such large banks to ignore. First, compared with large state-owned corporations, there appears higher degree of asymmetric information. In general, the outsiders of a company always know less than the insiders about what actually goes on at a firm, but the level of the imbalance would be more severe for SMEs, due either to cost considerations or protection concerns. As a result, SMEs are typically perceived as enterprises with much higher degree of uncertainty and risk.

Second, in addition to less disclosure to the general public, the financial information reported by the SMEs is, usually, less likely to be standardized in a format that is in compliance with the generally accepted accounting principles. Due to limited resources, SMEs usually cannot afford to hire financial professionals to prepare their financial documents, or contract public accounting firms to audit their financial statements. As a consequence, even when SMEs consent to providing their documents, not much of the information can be actually used by financial institutions when they make financing decisions toward SMEs' funding.

Third, because SMEs are smaller firms, the amount of assets that they can use as collateral for bank loans are typically less. When compared against the financing values that most SMEs request, the collaterals they possess are usually not adequate to meet the collateral requirements of most large banks.

Fourth, SMEs typically lack adequate credit records. However, credit records and credit history of the borrowers are what commercial banks commonly use as the critical point of reference when making financing decisions. Because many SMEs do not have any history of borrowing money from banks, thanks to the difficulties in securing bank loans in the first place, they are usually rejected for bank loans due to the lack of credit history. This creates what is apparently a vicious cycle. If an

SME does not have adequate credit history, it would not be able to get credit; but if it cannot get credit, it is almost cyclically banned from ever being able to obtain a loan.

Fifth, given the inherent risk associated with SMEs financing, there lacks the economies of scale needed as an incentive for financial institutions. From the perspective of commercial banks, regardless the size of the firm that requests the loans, the bank needs to take, at least, the same amount of effort and procedure to clear that firm for lending, such as application reviews, credit assessment, comprehensive analysis, on-site investigation, and final release of funds, all of which are a heavy consumption of time and resources. Given the relatively smaller size of SME loans, compared to those requested by larger corporations, it is difficult for the commercial banks to achieve the same economies of scale when lending to SMEs. Needless to say, commercial banks, on the whole, prefer larger corporations.

As a result, financial innovation in China requires alternative financing methods for SMEs. In addition to indirect financing with traditional bank loans and focus on the large amount of funding as provided by large state-owned commercial banks, infrastructure for direct financing and funding for smaller amount of financing request also needs to be in place. Felicitously, enormous financial innovations have emerged in China's financial market in recent years, including direct financing such as the bond and equity market, funding vehicles focused on the smaller amount of funding such as micro/small loans, innovative methods of funding SMEs without tangible collateral such as chattel pledge and supply chain financing, and financing through the Internet such as P2P online lending and crowdfunding. This book intends to analyze all these remarkable progresses in the financing of SMEs in China, and summarize some key takeaways for the readers and observers of Chinese economy, in general, and of SME financing, in particular.

This book covers all the primary innovations in SME financing in China from the past decades, including debt financing such as micro and small loans, guarantee and mutual guarantee, bond issuance, P2P online lending, chattel pledges, supply chain financing, financial leasing, and equity financing such as private equity, reversal merger, New Third Board, and crowdfunding. The book analyzes in detail the business models that were developed by each individual financing method, the method of operation and cash flow generation, as well as the risks intrinsic to each method and risk control. Each alternative method of financing is analyzed with actual SME financing case studies, and the prediction for their future development is also discussed. Some alternative ways of SME financing, such as pawn, are not included, as they are currently not in the main stream of new alternative financings, and are also less likely to be in the future. On the other hand, given the increased role that SMEs will play in China's economy in the coming decades, large state-owned commercial banks have also started to design and provide financing products for SMEs. Since state-owned commercial banks are still the dominant financing providers in China's financial market today, we added one chapter at the end to introduce some of the new financial products these large state-owned banks have designed for SMEs, in addition to some services that also involved in SMEs as discussed in other debt financing chapters; however, given the consideration of economies of scale, what additional "percentage" these large banks can serve in addition to the current "20 %" still remains to be seen.

As a book that covers all the important financial innovations in SME financing, and which combines theoretical analysis and real world practices in China's financial market, it could be of interest and value to a variety of readers, including, but not limited to, the following:

First, institutional and individual investors both inside and outside China may find this topic relevant and intriguing. Financial institutions such as security firms, investment banks, private equity funds, venture capital firms, commercial banks, other financial intermediaries, and individual investors including angels could gain a better understanding about the financing of SMEs, which covers 99 % of the Chinese business community. In particular, SME financing involves many smaller amount financial transactions, which will provide investment opportunities for smaller investors who may not be able to participate under the traditional financial regime.

Second, Chinese SMEs that are looking for financing should also be interested in this topic. As China adapts its growth model into a more innovation-oriented one, obtaining adequate funding becomes a critical prerequisite for success. Understanding what is available, and which method of financing can best meet SMEs' needs and match the nature of their business, would be of tremendous value for SMEs that are operating in China. For example, debt financing may better fit the working capital needs, while equity financing may be more appropriate for R&D and start-ups.

Third, investors and professionals who are running alternative financial entities, such as online platforms, may take an interest in this topic. Like the running of any other financial operation, running an alternative financing entity not only provides an innovative business opportunity for the parties that are engaged, but also exposes the alternative financial operators to the new risks associated predominantly with these new financial services. As a result, they would have an urgent need to supplement their knowledge and understanding about this changing industry, especially its risks and the potential downfalls, in order to maximize their bottom line returns and mitigate risk. Therefore, this book will indubitably be an important reference tool for them.

Fourth, bankers in traditional financial institutions might be interested in this book as well. New alternative ways of financing, especially Internet-related innovations, can be reasonably considered as both a formidable challenge and a lucrative opportunity for traditional financial institutions. Opening the door for private equity and the integration of finance and Internet has been recognized as both an indomitable and irresistible trend, and the "anywhere, anytime, anyway, customer experience" has become fundamental to all service industries, including finance. As this trend grows at an increasingly high pace, the question facing the traditional commercial banking system is how traditional banks can promptly meet this challenge, and in a more competitive market environment besides. Gaining thorough understanding of the status quo of the current financial market and new alternative financial innovations will become a priority item for traditional commercial bankers and their major shareholders, domestic and international. This book would certainly provide an important reference for that purpose.

Fifth, members of regulatory agencies could find value in this book as well. In China, the financial industry is strictly regulated, and any new "innovations" will be closely "watched" by regulatory agencies. Even though more explicit legislation regarding certain new alternative financing methods, such as P2P online lending and crowdfunding, has not been fully delineated yet, it is merely a matter of time before regulatory agencies bring the hammer down; this is true especially because the general public has become increasingly exposed to the risks associated with new alternative methods as the public gains more knowledge and understanding about these "innovations." The major dilemma in government regulation, however, is always the extent or degree to which regulations should be set up and implemented. While overregulation can unnecessarily hinder the innovations needed for business development and economic growth, underregulation may fail to control the risks that will damage said business development and economic growth. As a result, a comprehensive analysis and understanding about the new alternative financing is a prerequisite for the regulators, in order to help them achieve the optimal balance between regulation and market innovation. This book could offer some valuable insights.

Sixth, academics inside and outside China could be interested in this book as well. Because the growth model of the Chinese economy has fundamentally changed, and even more changes are expected down the road, the role of SMEs in Chinese economic growth in the next decades has been redefined, and SMEs' status has been repositioned. Understanding how SMEs can be financially funded so that they can survive and succeed is a key to understanding the new growth model of the Chinese economy. Any research on the China's future economic growth omitting the topic of SMEs and their relationship with financial innovation would be incomplete. In this regard, this book would provide such Chinese business researchers with a valuable reference.

In summary, as China increasingly becomes a key player in the world economy, understanding the structure, operation, and future changes of the Chinese economy becomes increasingly critical. As the impact of the recent RMB devaluation[4] and the dip in third quarter GDP growth indicated, the influence of the Chinese economy on the global one cannot be ignored. Given the RMB's joining the SDR of IMF,[5] the Chinese economy's influence could even grow larger. Therefore, we hope this book "Financing without Bank Loans—New Alternatives for Funding SMEs in China" will be a well-timed publication with important value for a wide spectrum of readerships, either as a reference book or as a guideline in understanding, gaining knowledge of, research and teaching, and making business decisions about China and issues related with China.

[4]Wall Street Journal: http://www.wsj.com/articles/china-moves-to-devalue-the-yuan-1439258401.
[5]https://www.imf.org/external/np/sec/pr/2015/pr15540.htm.

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