

## **Financing Micro and Small Enterprises: China's Approach and Increasing Role of the Credit Guarantee System<sup>1</sup>**

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**Glossary**

AMC	Asset Management Company
AMRO	ASEAN+3 Macroeconomic Research Office
bps	Basis points. One basis point is equal to 1/100th of 1%.
CBIRC	China Banking and Insurance Regulatory Commission
LPR	Loan Prime Rate
MOF	Ministry of Finance
MPA	Macro-prudential Assessment
MPA	Macro-prudential Assessment
MSEs	Micro and Small Enterprises
NBS	National Bureau of Statistics
NFGF	National Financing Guarantee Fund Co., Ltd.
NPL	Non-performing Loan
PBC	People's Bank of China
RRR	Required Reserve Ratio
SOE	State-owned Enterprise
SOE	State-owned Enterprise
VAT	Value-added Tax

## I. Introduction

1. **Ensuring financial support for micro and small enterprises (MSEs<sup>2</sup>) is a complex challenge in normal times and even more so during a crisis.** The 2020 global COVID-19 pandemic has battered MSEs across countries. Compared with large enterprises, MSEs have higher credit risks due to thinner capital and weaker liquidity and operating buffers, and are more reliant on bank credit for funding. Reduced bank lending to these MSEs during a crisis may lead to their insolvency and default. As MSEs account for the biggest share of jobs in most economies, strong and effective policy measures are needed to help them survive the crisis.

2. **This study aims to contribute to a thin literature on China's experience in providing credit support to MSEs, including by enhancing the role of the credit guarantee system.** China's MSE financing mechanism and policy development are not well documented and analyzed. This note seeks to make a modest contribution to the literature by examining challenges in MSE financing and the evolving approach that China has been taking to address them. The focus is on the recent experience and policy improvements during the pandemic, when the role of the credit guarantee system has been significantly enhanced. The note concludes with some policy suggestions.

## II. Challenges for MSE financing in China and support mechanisms before COVID-19

3. **In China, banks are the main source of financing for MSEs, but they generally have less incentive to lend to MSEs than to bigger corporates due to MSEs' high credit risks, the larger operating costs of banks, and lower profit margins.** Default rates of MSE loans are among the highest of all types of bank loans, and MSE-related non-performing loans (NPLs) are more difficult to dispose of than loans to large corporates. Operating costs for banks are high, due to the resource-intensive nature of reaching out to potential MSE clients, collection of information for pre-loan credit assessment, and post-lending monitoring of MSEs' creditworthiness during the loan tenure. High loan interest rates are needed to offset these risks and costs.

4. **With strong policy support, smaller banks are more willing to lend to MSEs, but for some, their limited capital buffer is a constraint.** Some small banks at the regional level – especially rural commercial banks – do see loans to MSEs as an opportunity for development. This is because, compared to larger banks, they are disadvantaged in serving large corporate clients and retail clients, but are advantaged in having a deep understanding of the local economy. Furthermore, many of these banks were set up precisely with a mandate to support MSEs and local economies. The MSE portfolio is therefore a source of comparative advantage. MSE lending accounts for about 12 percent of rural commercial banks' assets, compared with three percent of large banks' assets (Figure 1). However, further expansion of these small banks' lending to MSEs could be limited, as a number of rural and city commercial banks do not have comfortable capital buffers (Figure 2).

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<sup>2</sup>The definition of MSEs in China: according to the Ministry of Industry and Information Technology and the National Bureau of Statistics, operating revenues and employee numbers are used as benchmarks to categorize enterprises within each sector. For instance, in the retail sector, micro-enterprises are those with fewer than 10 employees or an operating revenue under RMB1 million, while small enterprises have fewer than 50 employees or an operating revenue under RMB5 million. Source: [http://www.gov.cn/zwgk/2011-07/04/content\\_1898747.htm](http://www.gov.cn/zwgk/2011-07/04/content_1898747.htm).

Figure 1. Lending to MSE by Bank Type

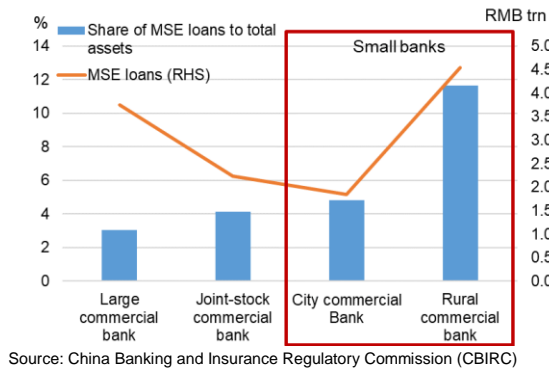
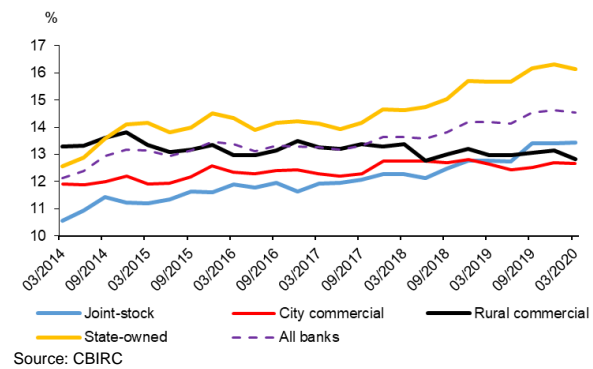


Figure 2. Capital Adequacy Ratios by Bank Type



5. **Recognizing these complex challenges, China's authorities have launched policy measures to encourage and facilitate banks' lending to MSEs.** The measures have been further strengthened since the outbreak of the pandemic.

### III. MSE financing policy support: Before COVID-19

6. **Before the COVID-19 period, a multi-pronged approach backed by coordinated efforts was used to bolster MSE financing.** The approach involved a variety of measures and policy coordination in the areas of monetary policy, banking regulation and supervision, technology, and risk-sharing (credit guarantee) mechanisms.

- **Monetary policy:** using tools such as targeted required reserve ratio (RRR) cuts to lower funding requirements for banks to lend to MSEs, encouraging banks to increase lending to MSE by including MSE lending as an indicator under the People Bank of China's (PBC) Macro-prudential Assessment (MPA) framework<sup>3</sup>, and supporting MSEs through window guidance<sup>4</sup> to the banks;
- **Banking regulation and supervision:** employing differentiated regulatory policies for different types of banks to enable small banks to increase lending to MSEs, urging banks to adjust their internal rules and management to support MSE lending<sup>5</sup>, facilitating small banks' capital-raising through various instruments, and supporting enhancement of NPL disposal capacity by facilitating the formation of provincial asset management companies (AMCs);
- **Technology:** strengthening the use of financial technology in credit screening and loan management, with some banks also teaming up with technology companies to improving

<sup>3</sup> The PBC has established the MPA system to assess whether financial institutions work in line with macro-prudential requirements. The MPA system contains a number of indicators, such as capital adequacy ratio, liquidity measures and other measures that reflect policy makers' objectives.

<sup>4</sup> "Window guidance" a policy by which authorities seek to directly guide financial institutions' activities through "moral suasion". While Chinese regulators have stronger and stronger preference to use less window guidance in recent years, it remains as a policy measure, especially in some usual moments.

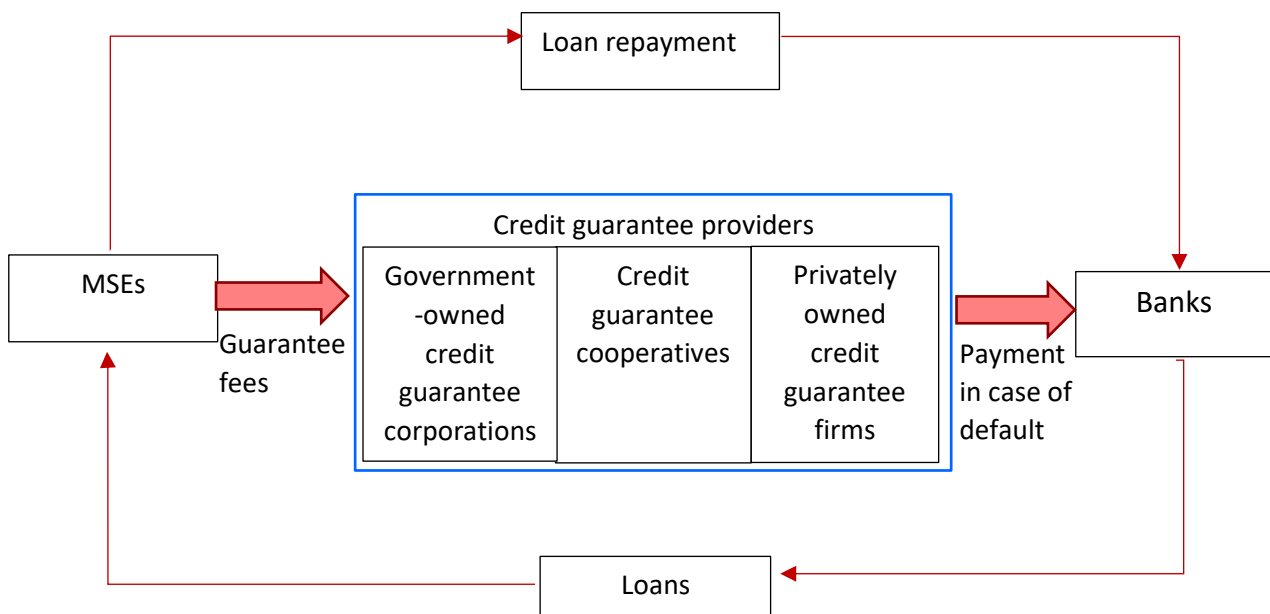
<sup>5</sup> The banks' internal rules and management should not discriminate against MSEs. For example, if the bank staffers have duly fulfilled their roles, they should not be subjected to unduly harsh punishment if the borrower defaults on the loan.

their risk management capacity. According to Guo (2020 b), fintech has fundamentally improved banking services to MSEs, individual businesses and rural residents;

- **Risk-sharing:** strengthening risk-sharing and credit-enhancement mechanisms, including through the establishment of loan guarantee firms that were eligible for funding and subsidies from local governments.

7. **The credit guarantee mechanism was an important element of the approach.** Under the mechanism, MSEs take out bank loans and, at the same time, pay guarantee fees to credit guarantee entities. These entities may be corporations or cooperatives; some are government-owned and some are backed by private capital. They in turn provide backing for banks, such that if the banks' MSE loans end up in default, these entities will bear the financial loss, so there is restitution to the banks. The risk-sharing ratio might vary, with banks still retaining a significant proportion of the credit exposure. The concept and operation of this mechanism is very much like a risk-pooling insurance scheme (Figure 3). Similar to other economies, these credit guarantee entities were not profitable. According to United Credit Rating Co. Ltd. (2019), the average return on equity of the largest re-guarantee firms was 2.2 percent.

**Figure 3. Credit Guarantee Providers and Mechanism in China**



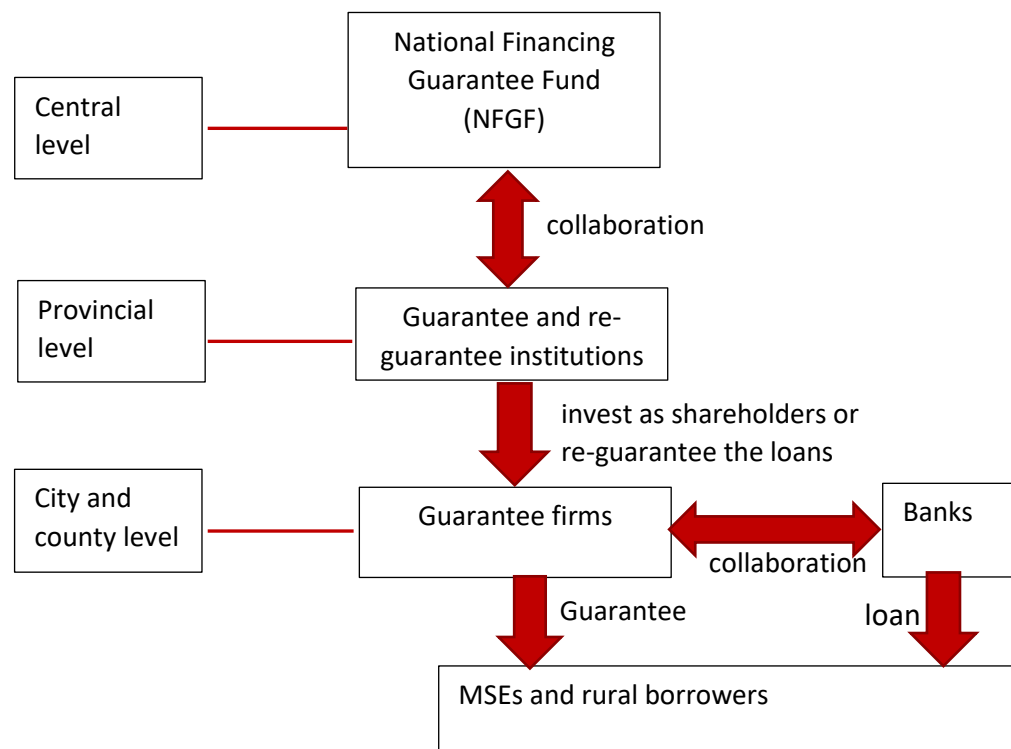
Source: AMRO

8. **To strengthen the role of credit guarantee firms in risk-sharing and funding, the authorities set up a three-tier credit guarantee system comprising the central, provincial and city-county levels.** Before July 2018, the model was quite decentralized. The credit guarantee system was localized, and relied heavily on financing guarantee and re-guarantee institutions at the provincial and city-county levels, including government-owned guarantee institutions, cooperatives of lenders, and private guarantee firms (Figure 4). These players differed from one another by focusing on MSE clients of different sizes and business profiles. In July 2018, the National Financing Guarantee Fund Co., Ltd. (NFGF) was established. Led by the Ministry of Finance (MOF), also its largest shareholder, the NFGF aimed to enhance risk-sharing and cooperation between banks and credit guarantee agencies within a three-tier guarantee system across China. The three tiers consisted of the NFGF,

provincial financing re-guarantee organizations, and guarantee institutions at the city and county level.

9. **This enhanced risk-sharing mechanism was expected to significantly reduce banks' risk in lending to MSEs** (Figure 4). Through such a three-tier guarantee system, the apportionment of credit risk is as follows: NFGF 20 percent, provincial re-guarantee institutions 20 percent, city-county guarantee institutions 40 percent and banks 20 percent. The authorities were hoping that with much-reduced exposure to MSE credit risks, banks would be more motivated to lend to MSEs.

**Figure 4. Mechanism of Credit Guarantee Re-guarantee System in China before the Pandemic**



Source: Ministry of Finance, NFGF, AMRO

10. **Despite these strong policy efforts, structural challenges remained.** The challenges related primarily to financial capacity, operational capacity, and coordination issues which need to be addressed to achieve sufficiently comprehensive coverage across a vast country. The sheer size of China, wide geographical dispersion of MSEs and banks, and uneven financial strength and management know-how of local governments all posed significant difficulties for policymakers.

11. **First, the size of the credit guarantee system as a whole was small relative to MSEs' financing needs, and a large share of its resources was spent in guaranteeing bonds issued by large corporates.** This reflects that overall, China's credit guarantee system is still at a fairly early stage of development. At the end of 2019, there were 5,562 credit guarantee entities. However, their overall paid-in capital was very small, at RMB1.2 trillion (1.2 percent of GDP). Moreover, as MSE loan guarantees were not profitable, credit guarantee firms spent a large share of their resources in guaranteeing bonds issued by large

corporates (China Financing Guarantee Association, 2016). As a result, only two percent of MSE loans in China were under guarantee, a coverage that the authorities are targeting to increase to 10 percent on average through a business cycle over the long run. Although some provinces – the more developed ones – have already reached 10 percent coverage, less developed provinces are well below the target. Moreover, while there are an average of about two credit guarantee entities per county, the distribution is quite uneven. Only one-third of all the counties nationwide have credit guarantee operations/businesses.

12. **Second, the financial strength of local governments and local banks is also highly uneven across China.** While, in 2020, all Chinese counties are officially no longer considered “poor”, the gap between the developed and less developed regions is large, particularly in terms of the fiscal revenue of the local governments and strength of local banks. The most developed regions consist of a “clustering” of cities, with large fiscal revenues and also the most profitable small banks in China. The opposite is true for less developed provinces.

- **The most developed regions saw a virtuous cycle among MSEs, larger corporates, residents, credit guarantee firms, local banks and governments.** The stronger credit guarantees available in those regions helped banks to provide more supportive financing to MSEs. In turn, the MSEs were able to develop more vibrantly, become stronger financially, and contribute more to growth and employment in the local economy. Banks were hence exposed to less credit risks, and local governments had more fiscal revenues and therefore larger budgets to support the local credit guarantee firms.
- **Most of the counties in less developed regions do not have credit guarantee firms yet,** possibly due to limited local government resources and private sector interest. The banks there also have thinner capital buffers and less sophisticated operational and risk-management know-how. This adverse cycle has been weighing on growth and development. Although the less developed regions benefit from top-down support, including generous fiscal transfers from the central government (which is effectively a subsidy of sorts from the more developed regions), MSEs in less developed regions are often the last in line to benefit from such transfers.

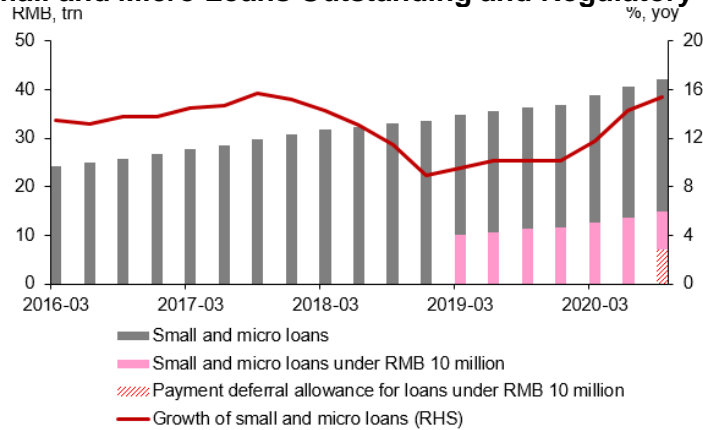
13. **Third, the multiple layers of guarantees and re-guarantees tend to increase costs and slow down decision-making processes, especially during crises.** For example, a local credit guarantee firm would carry out due diligence on the loan that it is guaranteeing. A re-guarantee firm would do another round of due diligence. Each of these institutions has its own internal risk control process. This mechanism inevitably slows down decision-making. As each loan is small, the operational and guarantee cost per loan is high. This challenge was particularly acute at the height of the pandemic, when both MSEs and local banks needed strong support urgently.

#### IV. Policy support: During COVID-19

14. **As many of the aforementioned challenges could not be resolved very quickly, the authorities used a variety of methods in ramping up efforts to help MSEs cope with cash flow strains during the pandemic.** The MOF, the PBC, the China Banking and Insurance Regulatory Commission (CBIRC) and other agencies came together to roll out many key initiatives, as summarized in Table 1 below. Some of the more notable policy measures included MSE loan forbearance, innovative targeted monetary policy measures to support MSEs, and greater availability of credit guarantee to MSEs.

15. **Forbearance and other financial policies have been proactively deployed to support MSEs.** The authorities provided guidance to banks on how to treat loans more flexibly. This included deferring debt service payments until March 2021, particularly for MSEs (Figure 5). In addition, the banking sector was tasked to support the economy by reducing its lending rates and its fees by a total of RMB1.5 trillion (1.5 percent of GDP) in 2020.

**Figure 5. Small and Micro Loans Outstanding and Regulatory Forbearance**



Note: The forbearance on RMB 7 trillion of loans (loan to each entity should be less than RMB 10 million) is automatically granted upon the borrower's application. Forbearance on other loans is dependent on bank-borrower negotiation.  
Sources: Wind

**Table 1. Key Policy Measures to Support MSEs during the Pandemic**

Fiscal Policies	Monetary and Financial Sector Policies
<b>During the Early Stage (end-January to March 2020)</b>	
<p><b>Tax cuts</b> Exempted small taxpayers in Hubei province from value-added tax (VAT), and cut the VAT rate for small taxpayers in other regions from 3% to 1%.</p> <p><b>Fee cuts</b> Lowered the credit guarantee rate charged by government-owned financing guarantee and re-guarantee institutions.</p> <p>Reduced fees related to agricultural credit guarantees, and used the local government's disaster relief fund to support agricultural production.</p> <p>Reduced employers' social security payments.</p> <p>Postponed provident fund payments by enterprises affected by the pandemic.</p>	<p><b>Targeted RRR cuts</b> Reduced the RRR by 0.5%-1% for banks that met the target of granting loans to MSEs.</p> <p><b>Large banks' lending to MSEs</b> Set a target for five large state-owned commercial banks to increase MSE lending by more than 40 percent of their total loans in 2020 (compared to 2019), or RMB1 trillion.</p> <p><b>Supply-chain financing<sup>6</sup> for small and medium enterprises (SMEs)</b> Tasked policy banks to issue RMB300 billion of bonds to support credit to SMEs, and RMB800 billion in supply-chain financing to SMEs (not MSEs).</p> <p><b>Relending and rediscounting loans to support work resumption</b> Increased the capacity of an RMB350 billion relending facility for lending to private, micro, small and medium enterprises at preferential interest rates.</p> <p>Increased the banks' relending and rediscounting quota by RMB500 billion, and reduced the interest rate for relending to agricultural and small businesses by 0.25 percentage points to 2.5 percent.</p> <p>Note: Relending refers to loans provided by the PBC to commercial banks. It can be used to manage market liquidity, and to transmit other monetary policy intentions to commercial banks, encouraging them to carry out commercial activities in accordance with monetary policy objectives. The branches the PBC regularly inspect the relevant operating conditions of commercial banks' usage of money obtained through relending activities. Rediscounting refers to commercial banks giving discounts on outstanding commercial bills to the PBC. It can be viewed as a special type of relending.</p> <p><b>Window guidance for loan forbearance</b> Guided financial institutions to extend and renew MSE loans.</p>

<sup>6</sup> Supply-chain financing helps both suppliers and buyers free up cash trapped in the supply chain process. A bank may offer supply-chain financing programs to help its clients procure supplies (supplier financing) and achieve sales (buyer financing).



<b>During the Later Stage (April 2020 to Present)</b>	
<p><b>Tax and fee cuts</b> Introduced more measures to cut taxes and fees by RMB2.5 trillion in 2020.</p> <p><b>Credit guarantee</b> Actively providing more support to MSEs and the rural economies, and enhancing guarantee coverage for more firms.</p> <p>Promoting corroboration between the NFGF and banks to support banks' MSE lending portfolios, and targeting an RMB400 billion increase in re-guaranteed loans in 2020.</p> <p>Halved the guarantee fees charged to MSEs by local government guarantee and re-guarantee institutions at all levels.</p>	<p><b>New monetary policy tools that would directly reach SMEs:</b> For new SME loans: purchased these SME loans from small banks. For existing SME loans: effectively provided, through interest swap arrangements, a one percent interest subsidy to encourage banks to extend the maturity of their existing SME loans.</p> <p><b>MPA and window guidance</b> Included lending to MSEs and private enterprises as an assessment item in the PBC's MPA exercise.  Targeting to reduce the enterprises-related lending interest and fee revenue paid to financial institutions by RMB1.5 trillion in 2020;  Provided guidance to commercial banks that they should increase the weight of MSE lending, and that the headquarters of the banks should use these indicators in their evaluation of branches.  Persuaded commercial banks to significantly increase lending to MSEs and to renew MSE loans.</p> <p><b>Loan forbearance</b> Encouraging loan forbearance, especially in lending to MSEs in Hubei province.</p> <p><b>Bank capital replenishment</b> Further facilitating bank capital replenishment by using various instruments, especially perpetual bonds, and helping to introduce strategic shareholders to some troubled banks.</p>

Source: MOF, PBC, CBIRC, AMRO

**16. Policymakers have been adjusting their focus toward helping smaller-sized MSEs as their recovery has been lagging behind, with larger banks leading the assistance effort.** As summarized in Table 1, authorities have introduced and implemented the relending, rediscounting and direct MSE financing support policy in a tiered and gradual manner. The effort began by helping larger enterprises that were key pandemic-fighting forces, then moved to MSEs. The lending amount per borrower started at RMB40 million in round 1 (not targeted at MSEs yet), and was then scaled down to RMB830,000 in round 2, and further to RMB20,000 in round 3 (Guo, 2020 a).

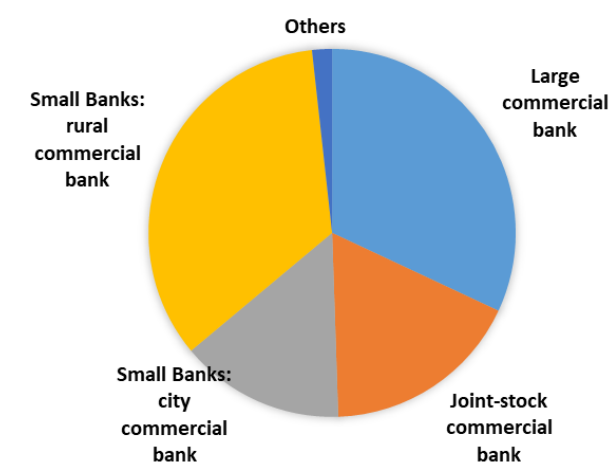
**17. Since June 2020, policy efforts have tilted toward supporting and quickening small banks' lending to MSEs.** As shown in Figure 6, about half of the MSE loans were granted by small banks, namely city commercial banks and rural commercial banks. On June 1, 2020, the PBC introduced the Inclusive MSE Loan Extension Support Tool<sup>7</sup> and the Inclusive MSE Credit Loan Support Program<sup>8</sup>. These tools work directly through small banks, which are mandated to support SMEs and local economies. According to statistics from the Association of Small and Medium Enterprises, out of more than 300 million MSEs in China,

<sup>7</sup> The Inclusive Small and Micro Enterprise Loan Extension Support Tool provided a smaller amount in total, but it has larger multiplier effects. The tool operates on a monthly basis. In Q3 2020, it provided a total of RMB4.7 billion of incentive funds to local banks to support the extension of the inclusive MSE loan principal amount of RMB469.5 billion (100 times the incentive funds), with a weighted average extension period of 12.6 months.

<sup>8</sup> The Inclusive Small and Micro Enterprise Credit Loan Support Program provided a larger total amount. In Q3 2020, it provided a total of RMB93.2 billion of preferential funds to local banks to support their lending to MSEs from March to September 2020, which covered the lending made prior to June 1, 2020, when this program was created. As of Q3 2020, it helped banks to provide RMB264.6 billion in loans to MSEs.

about two-thirds had obtained bank loans as of end-July 2020, and this ratio is expected to increase further with the continued implementation of the policy tools (Guo, August 2020).

**Figure 6. Share of MSE Loan by Bank Type**

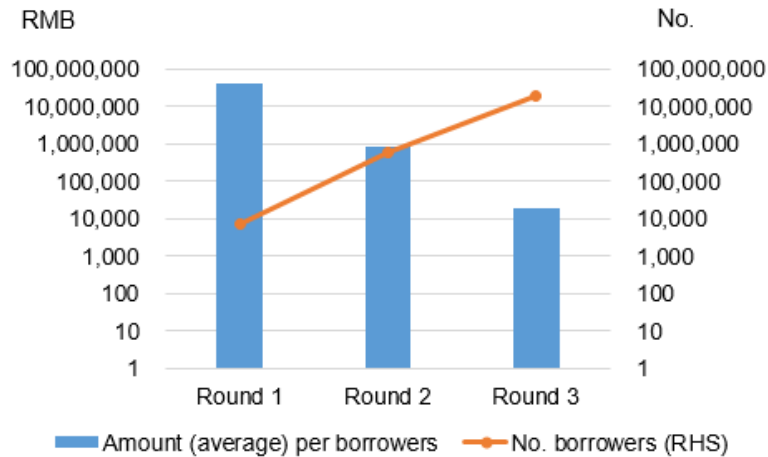


Source: Wind

**Table 2. Developments of Relending and Rediscounting Policies During the Pandemic**

Instruments	Announcement date	Banks	Borrowers	Total amount	Interest rates	Usage	Average amount per borrower
<b>Round 1: Pandemic relief, relending with fiscal subsidies for interest expenses</b>	31 Jan	3 policy banks, 6 large commercial banks and 10 medium-sized banks	Key enterprises <sup>9</sup> (some are large corporates)	RMB300 bn	Loan prime rate (LPR) of 250 bps	RMB280 bn disbursed to 7,000 key enterprises	<b>RMB40 mn</b>
<b>Policy intention:</b> to ensure timely provision of pandemic-related goods and services.							
<b>Round 2: Relending, rediscounting</b>	26 Feb	Small and medium-sized banks	Small and micro enterprises	RMB100 bn for agriculture-related businesses, RMB300 bn for MSEs, RMB100 bn for rediscounting	Relending rate at 2.5%, rediscount rate at 2.25%, banks' lending rate at less than LPR + 50 bps	Related lending by banks, RMB472 bn to 570,000 MSEs	<b>RMB 830,000</b>
<b>Round 2: More relending, rediscounting</b>	3 Apr			RMB1 trn	Relending rate at 2.5%, banks' lending rate at less than 5.5%		
<b>Round 3: Inclusive MSE lending support plan – relending</b>	1 Jun	Local banks (small banks)	About 20 million	RMB932 bn	Relending rate at 0%, no requirements on banks' lending rate	See Footnote 5 and Footnote 6	<b>RMB20,000</b>

<sup>9</sup> These were the key enterprises that provided pandemic relief-related efforts.

**Figure 7. Lending to Enterprises During the Pandemic**

Note:

Round 1 refers to the policy announced on 31 Jan: "Pandemic relief, relending with fiscal subsidies on interest expenses";

Round 2 refers to the policies announced on 26 Feb and 3 Apr: "Relending, rediscounting" and "more relending, rediscounting";

Round 3 refers to the policies announced on 26 Feb and 1 Jun: "Inclusive MSE lending support plan – relending".

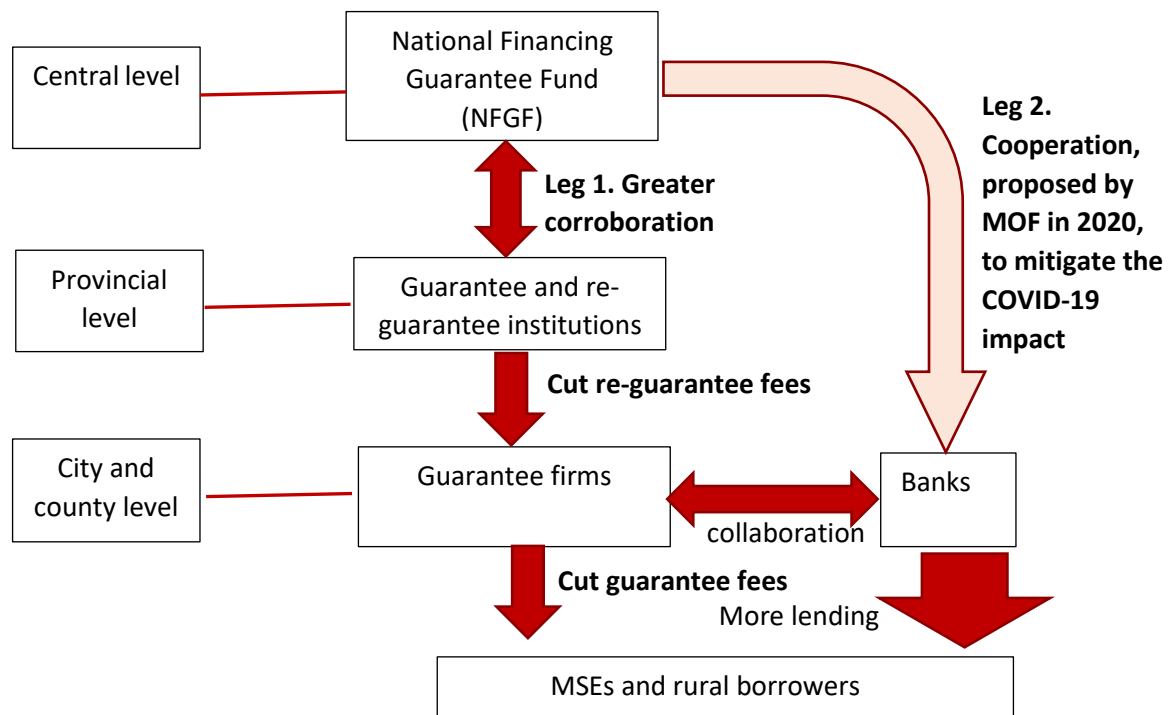
Source: AMRO

#### 18. Authorities also introduced further reforms to the credit guarantee system to better support MSEs:

- **State-owned guarantee institutions were tasked to focus their services on MSEs, and less on large corporates.** In 2020, more than 80 percent of the business at state-owned guarantee institutions is expected to target MSEs only, and of this, more than half will target MSE loans smaller than RMB5 million in notional terms. They are not allowed to make equity investments in non-guarantee institutions, and must not expand the credit guarantee system to local government financing vehicles, as these fall outside the MSE sector.
- **The leading role of the National Financing Guarantee Fund (NFGF) Co. Ltd. was enhanced.** In 2020, the NFGF targeted achieving new re-guarantee business of RMB400 billion in notional terms, and investing in 10 city-level government financing guarantee institutions. The NFGF also waived re-guarantee fees for loans smaller than RMB1 million, and halved re-guarantee fees for those larger than RMB1 million.
- **To overcome the challenges highlighted previously, the NFGF is experimenting with a "headquarters-to-headquarters" bulk guarantee business with seven leading banks (Figure 8).** The NFGF has signed bulk contracts with the headquarters of big banks to benefit from the lending business of their branches nationwide. With this arrangement:
  - a. The NFGF is able to reach MSEs all over the country as it can now leverage the banks' existing networks and edge in local knowledge;
  - b. The NFGF is able to be more cost- and time-efficient, as this model mainly relies on banks' service networks, risk management, and control and technical capabilities. The banks will identify, evaluate and approve the risks in the MSE loans, and the NFGF will only need to review and confirm the procedures and compliance of the MSE loans, without duplicating the banks' work.

- c. The NFGF is then able to scale up the operation more widely and rapidly across the country;
  - d. Banks' risk tolerance has increased immediately, and they can target more MSE clients, and provide more and cheaper financing services.
  - e. Moral hazards are limited, as the NFGF will absorb credit losses only up to three percent of banks' MSE loan portfolio amounts in notional terms.
  - f. While the NFGF is currently working on this scheme with just seven big banks, it is targeting to expand business relations with some smaller local banks in future, after those banks have adjusted their internal procedures to meet the requirements for bulk guarantee business. This expansion is essential in the longer term, as small banks have the most extensive networks and clients in lower-tier cities and counties, advantages that are more pronounced in less developed cities and counties.
- **Guarantee fees across China were halved.** In 2020, local government financing guarantee and re-guarantee agencies at all levels halved their fees for MSEs, and targeted to reduce the overall financing guarantee fee to less than one percent of the national amount of MSE loans.

**Figure 8. Mechanism of Credit Guarantee and Re-guarantee Systems During and After the Pandemic**

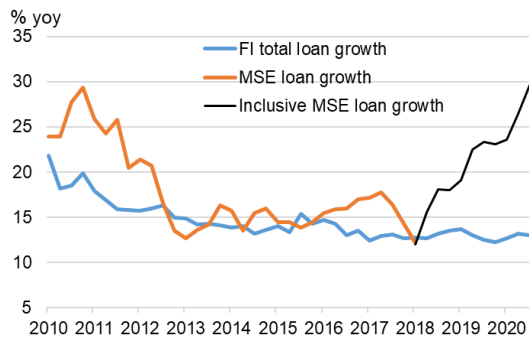


Source: Ministry of Finance, NFGF, AMRO

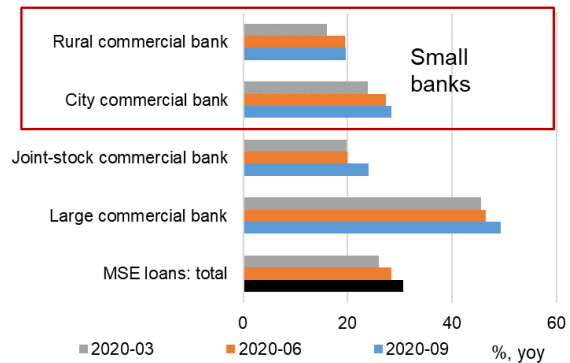
## V. Policy Results

19. **The countercyclical financing policy for MSEs has yielded significant results.** The total outstanding amount of MSE loans stood at RMB14.6 trillion in September 2020, a year-on-year growth of 29.6 percent (Figure 8), which is the highest since statistics became available. The growth rate is also more than twice that of China's total loan growth of 13.2 percent. Overall, the loans granted under the policy supported 31.3 million MSEs, a year-on-year increase of 21.8 percent.

**Figure 9. Growth of MSE Loans**



**Figure 10. Growth of MSE Loans in 2020 by Bank Type**



Note: The PBC no longer publishes data on MSE loans after Q2 2018; it has published data on inclusive MSE loans since Q2 2018.

20. **Small banks have shown improvement in lending to MSEs.** As seen in Figure 10, lending to MSEs at the beginning of the pandemic was driven by large state-owned banks, due to their strong balance sheets and window guidance from the authorities. In Q3, large state-owned banks' lending to MSEs continued to be strong, in part due to the "headquarters-to-headquarters" bulk guarantee business with the NFGF. With policy support, such as the PBC's innovative relending facility rolled out in June 2020, MSE lending by small banks grew faster, albeit still at a more modest pace compared with large banks.

## VI. Policy suggestions

21. **It is crucial to further address the imbalance in the development of credit guarantee institutions between the more developed and less developed regions.** Greater risk-sharing by guarantee institutions at the national level and leveraging of existing infrastructures would be promising directions. The newly established NFGF helps to pool risks on a bigger scale and improve the guarantee system's efficiency. Local governments could consider injecting more capital into the guarantee and re-guarantee institutions regularly. At the central government level, authorities could also consider injecting more capital into the NFGF, with an emphasis on supporting less developed regions, until a markedly wider coverage of MSEs is reached. Central and local authorities could work more intensively with smaller banks to strengthen their operational and risk-management capacities, so that more of these banks can lend more to MSEs and also enter into bulk contracts with the NFGF.

22. **Over time, authorities should also reduce the fragmentation of the system by bringing together public-sector entities and private guarantee institutions to consolidate their businesses.** The sheer scale of providing adequate credit guarantees nationwide in such a large country also means that the central authorities cannot undertake

the task without mobilizing local governments and other players. Yet, many local guarantee firms are small, re-guarantee firms emerge when they see opportunities for contributions and financial gains; and therefore, the market is inevitably fragmented. When the key issue of overall capacity has been addressed meaningfully, to build a more coherent and efficient national credit guarantee system, substantial mergers and acquisitions should be effected. This should be done in such a way that the roles of different players are clear, so that there are no unnecessary duplications or costs.

**23. The credit guarantee coverage ratio could be increased, especially during a severe crisis.** Guarantee coverage ratios for credit loss are typically above 50 percent for other economies. For example, the Korean and Japanese governments offer 50-85 percent. In response to the pandemic, the ratios in Singapore and Hong Kong have been increased, up to 100 in some cases. In China, this ratio is at 80 percent. This likely reflects concerns on moral hazards. As a result, banks in China still have to take a significant share of credit risk. The authorities may consider increasing the guarantee coverage ratio to allow banks to transfer more MSE credit risks to the government, as the pandemic is still exerting a sizable impact on MSEs and their employees.

**24. It is important to consider measures to deal with the inevitable increase in MSE NPLs in the coming quarters.** MSE NPL rates have been high, and will likely keep rising during and after the pandemic. As small banks are the key players in lending to MSEs, and as lending to MSEs is expected to increase substantially in 2020, authorities should consider strengthening the resolution framework for MSE NPLs. This would enable small banks to continue to support MSEs during the phasing-out period of policy support and thereafter.

**25. In the long term, it is essential to keep small banks well-capitalized.** Stress test scenarios should incorporate an explicit element of severe cash crunches for MSEs, and the impact of these cash crunches on banks' asset quality and capital buffers. The stress test results should then prompt strong efforts for small banks to raise capital so that they are able to continue lending to MSEs. In the short term, the authorities may need to facilitate their efforts to raise capital to ensure that they fulfil their role of extending guaranteed credit to MSEs adequately. For the medium- and longer term, there needs to be a stronger effort at boosting the capital base of small banks which do have the necessary expertise and networks but are (much) limited by their financial resources.

**26. Authorities and market players should also make greater use of technologies to improve operational efficiency, credit risk assessment and loan disbursement.** The technologies do not necessarily have to be very advanced but they do have to serve specific purposes well. For example, one of the biggest problems banks face in providing loans to MSEs is that many MSEs do not keep good books, and this makes credit risk assessment more difficult and time-consuming. In Japan, many financial institutions design rigorous methods to analyze the borrowers' financial viability without doing the standard cash-flow analyses. In Hong Kong, the authorities announced in September this year their intention to address what is described as long-standing pain points of SMEs in obtaining bank financing by expanding financial infrastructure so that SMEs can share their data with banks at their discretion, and banks, with access to more comprehensive and timely data, can apply data science to conduct more detailed analysis and assessment of SMEs' financial conditions. The envisaged result is a "win-win outcome", whereby banks can better manage their risks while also helping SMEs to get loans more easily.

27. **China's policymakers have made good progress in building up their capacity and operational readiness to deal with severe shocks, and further efforts on this front should continue.** To provide a lifeline to MSEs in the event of sudden shocks, policy decision-making and implementation need to be swift. The further development of an effective coordination mechanism involving representatives from various public-sector agencies and also between these agencies and the banks and private sector would be very helpful and important.

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