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Thesis

## SME financing in Zhejiang province

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By WANG Jinhua

Supervisors: Prof Alessandra Guariglia and Prof Richard Harris

A Dissertation Submitted for the Degree of Doctor of Philosophy

## **Abstract**

This thesis laid the emphasis on Zhejiang Province which SMEs play a dominant role and is characterized with informal finance. The current financial system provided little opportunity for the SMEs to raise fund; companies in temporary illiquidity or facing solvency crisis obviously could not possibly rely upon internal capital for financing. Then, informal finance should be deeply studied. Guiding the informal finance to alleviate the SMEs financing difficulties could make contribution the financial and social stability at large. Therefore, it is a meaningful topic to be studied, both in theoretical and practical perspective.

In chapter 2, the focus is mainly laid on studying the status quo of the SME financing in Zhejiang Province and exploring the role formal and informal financing play. Through literatures consulting, a tailor made questionnaire has been designed to learn the basic information, business establishment, business growth and funding sources of the firms. The copies of the questionnaire have been disseminated to the sampled entrepreneurs of SMEs across Zhejiang Province. Through the data collected from the valid copies, we could gain a brief understanding of these firms and its financing situation through basic descriptive statistics. With the data collected from the 150 valid copies, we have gained a brief understanding of these firms and their financing situation through basic descriptive statistics.

In chapter 3, we tend to adopt various empirical methods to analyze the relationship of usage of formal (informal) lending and other factors. Correlation analysis, binary regression model and ordered logistic regression model is applied on the collected questionnaire data. With this empirical investigation, we try to further explore what impact these reputation and relationship variables may have on the financing practices they try to employ.

From the empirical results, we find that firms with strong political ties, higher education, larger turnover and having received credit rating are more likely to employ

formal financing practices. No consistent results have been found for informal financing practices. Moreover, we find that more factors work in the case of global financial crisis while only political ties and credit rating status work in the tightened monetary background like the period after year 2010. Combining these results, we conclude that reputation and relationship are vital in obtaining funds from formal financing channels in China. By contrast, all kinds of SMEs' entrepreneurs are likely to tap the informal financing market. The finding is critical: on the one hand, the criteria necessary to obtain formal loans are quite stringent; on the other hand, the informal market seems to set no threshold for financing. In the light of these considerations, informal financing will inevitably play a dominant role within the financial system.

In chapter 4, we firstly consult the extant literatures to learn the SMEs practice around the world. We then hold interviews with five managers from a commercial bank to learn their mindset towards SMEs business. Then, through the combination of what we find from the literature and the interviews, as well as the empirical results from the previous chapters, we propose specific policy suggestions. Policy suggestions are proposed from three different dimensions: the supply side of funds for SMEs financing (including both the formal and informal financial institutions); and the demand side. Such grand view will offer more insightful understanding in SMEs financing. The policy suggestions proposed are explicit, specific and practical.

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## **Chapter 1 Introduction**

### **1.1. Small- and medium-sized enterprises in China and Zhejiang Province**

Small- and medium-sized enterprises (SMEs) play a vitally important role in economic development worldwide. SMEs dominate the number of business enterprises in both developed and developing countries. Their importance is not only exhibited by their turnover percentage, but also by the strong support they offer to economic growth and employment. Ayyagari, Beck, and Demirgüç-Kunt (2003) found that the contribution of SMEs to employment has grown increasingly significant with increasing income, with a range from 17.5% (contribution ratio) in low-income countries to 57.24% in high-income countries. Similarly, their contribution to GDP is also impressive and ranges from 15.56% (contribution ratio) in low-income countries to 51.45% in high-income countries.

In China, SMEs play a very important role in the national economy. Since the reform and opening up policy in 1978, the state-owned enterprises (SOEs) have been busy unloading the historical burden by, for example, restructuring and laying off staff. The rapid development of the Chinese economy can to a large extent be attributed to the rise in the number of SMEs. According to the McKinsey report (Farrell, Lund, Rosenfeld, Morin, Gupta, and Greenberg, 2006), private enterprises' turnover—of which a large proportion refers to SMEs—has grown faster than GDP growth. The share of production of the wholly SOEs have shrunk to one-quarter of GDP. SMEs with rapid, healthy, and sustainable growth help boost the economy, absorb the labor force, and promote innovation. According to the data from the Report of the SMEs Development in China (2007–2008), SMEs cover 99.8% of the number of enterprises, 58% of the GDP, 59% of the social sale revenue, 50.2% of the tax revenue, and 63% of the export output. They also offer 75% of jobs, greatly alleviating unemployment.

In Zhejiang Province, which is characterized by abundant SMEs, the figure is even more impressive. According to the Development Report 2015 of SMEs, Zhejiang Province (Zhang, 2016), there were 40,243 SMEs in Zhejiang Province in 2014, which included 98.54% of all enterprises. SMEs, as a whole, have made vital and irreplaceable contributions to the economic aggregate, employment, tax revenue, and export earnings.

### **Economic aggregate**

In 2014, the industrial value that was created by SMEs amounted to 5101.8 billion Yuan, which is equivalent to 76.1% of the total industrial value in Zhejiang. As for industrial value added, the contribution of SMEs amounts to 923.58 billion Yuan, which is equivalent to 73.6% of the total industrial value added in Zhejiang.

### **Employment**

Rapid development in SMEs has made a vital contribution to job creation in Zhejiang Province. SMEs are the main channel for absorbing labor forces. In 2014, there were 5.92 million people employed within SMEs, and the employment contribution ratio was 91.10%.

### **Tax revenue**

Despite the downward pressure in the economy, SMEs are still a reliable source of tax revenue in Zhejiang. In 2014, SMEs in Zhejiang paid 196.0 billion Yuan taxes, which is equivalent to 64.98% of the total tax revenue in that year.

### **Export earnings**

Zhejiang Province is highly developed in foreign trade. SMEs have always been the main force pushing high export earnings. In 2014, SMEs recorded 861.9 billion Yuan export delivery value, which is equivalent to 72.3% of the total export delivery value.

One of the important reasons why SMEs in Zhejiang makes such a great contribution is that it has a vibrant market-oriented private economy. As the 2015 China Zhejiang Investment Report shows, the vast majority of foreign investors have considerable insight into the Chinese economy, and 32% of foreign investors believe that Zhejiang is synonymous with China's private economy.

Despite the fact that SMEs play a dominant role in China and Zhejiang Province, they still face tough hurdles in survival and further development, of which financing is one of the most severe and complicated factors.

## **1.2. SME financing constraints caused by the malfunction of the financial system in China**

By their nature, SMEs are relatively small, lack resources and collateral, operate in an opaque manner, and are perceived by lenders to be more risky as they have a more volatile pattern of growth, profitability, cash flow, and earnings, which enhances default risk and business insolvency compared to larger firms (Petersen and Rajan, 1994; Berger and Udell, 1998; Hyttinen and Pajarinen, 2008). This is compounded by a lack of credit history and credit rating if the business has not borrowed in the past. A limited bank–client relationship makes it difficult for a bank to assess the viability and track record of the company’s finances, resulting in a high loan processing time and cost for loan approvals. SMEs may also lack the necessary information and skills to access external finance, including the compilation of a bankable business plan.

The characteristics of the banking system in developing and emerging markets frequently inhibit SME lending (Harvie, Narjoko, and Oum, 2013). Many banks are state-owned and they allocate credit on the basis of government guarantees or in line with government targeting to specific sectors. Banks are often subject to ceilings on the interest rates they can charge, making it difficult to price credit in a way that

reflects the risk of lending to SMEs. In other cases, banks may have ownership and other ties to industrial interests and tend to favor affiliated companies. In a market where banks can earn acceptable returns on other lending, the banks cannot develop the skills needed to deal with and lend to SMEs. Furthermore, financial markets in developing or emerging markets may not contain the necessary range of products and services to meet the needs of SMEs.

Here, we briefly introduce the formal financial market in China. The core identifying characteristic of the formal market is that its function relies on the anonymous interaction between a client and a formal financial institution (Allen, Qian, and Qian, 2005). The formal financial system is mainly composed of commercial banks and capital markets.

The Chinese financial system is characterized by a dominant banking sector that is predominantly state owned (Ayyagari, Demirgüç-Kunt, and Maksimovic, 2008). As a consequence, a large share of bank funding flows into state-controlled companies, regardless of their profitability. Moreover, due to the inadequate information on other borrowers' credit histories and financial performance, together with weak credit-rating skills and personnel, banks tend to lend to SOEs. The SOEs are a seemingly low-risk option because the SOEs' debts have implicit government backing, which leaves the more productive private sector (most of which are SMEs) seriously credit constrained. According to Tian (2013), the total amount of loans made to SMEs was 1.08 trillion RMB, which is 19.6% of all the loans made in 2011. In spite of recent policy reform that encourages commercial banks to provide loans to SMEs, only 62.2% of SMEs reported that their funding requests could be met up to 80% of the credit required.

While China's banking system is large, its equity and bond markets are smaller than most of developed countries, both in terms of market capitalization and total value traded as a percentage of GDP. The equity markets are, to a large extent, a vehicle for privatization by the government rather than a market for capital raising by firms with

growth opportunities (Wang, Xu, and Zhu, 2004). Durnev, Kan, Randall, and Bernard (2004) show that compared to other transition economies, China has one of the poorest functioning stock markets with highly synchronous stock returns, which may be linked to weak property rights, corporate opacity, and political rent-seeking. The corporate bond market in China is crippled by excessive government regulation (Ayyagari, Demirgüç-Kunt, and Maksimovic, 2008). The approval and issuance process is so cumbersome that it takes 14–17 months to issue a corporate bond. Furthermore, the lack of institutional investors and credit-rating agencies make it quite difficult to price the debt accurately, and the threshold is set so high that almost no SMEs could tap that market.

From the introduction above, we can conclude that the current framework leaves SMEs in a quite disadvantaged position. They have little access to the formal financial market. The extant studies have revealed that one critical pillar to support their momentous growth is their internal fund. A study (Tenev, Zhang, and Brefort, 2002) conducted by International Finance Corporation (IFC) showed that the owners' capital and unallocated capital cover 30% and 26% of the SMEs' capital, respectively. Due to the stringent criteria and license barrier, SMEs rarely raise capital in the public capital market, covering less than 1% of the SMEs' capital.

In accordance with the survey conducted by the Chinese Enterprise Evaluation Association, 48.41% of the sample enterprises choose to use their internal fund to expand the production while 38.39% of the sample enterprises choose to obtain a bank loan. Other channels constitute less than 13% of the total and only 2.38% of the firms choose to raise capital by issuing stocks and bonds. For bank loans, the SMEs mainly do business with the four state-owned banks (69.05%), while other commercial banks (4.76%) and local banks (5.56%) are used less often. This implies that the four state-owned banks play a dominant role in supporting the SME financing.

The Global Financial Crisis, which began in 2008, has worsened the financing problems for many SMEs in China. They suffered huge losses or even went bankrupt because of shrinking demand in overseas markets, increasing labor and raw material costs in local markets, and most importantly, a shortage of liquidity. The financial difficulty of SMEs has been widely recognized. According to Ayyagari, Demirguc-Kunt, and Maksimovic (2010), firms with bank financing grow faster than firms without external financing support. Schoar (2010) showed that the majority of funding for SMEs is provided through banks in developing countries.

### **1.3. Informal finance in China and Zhejiang Province**

Since it is hard for the SMEs to raise external capital from the formal financial market (including the commercial banks and capital markets), they resort to the informal financial market. Sun (2008) proposed the concept of informal financing (civilian lending) from the perspective of institutional economics. Informal financing is defined as the direct financing activities between individuals and individuals, individuals and firms, firms and firms, and indirect financing activities that are aimed at making a profit, which are conducted by non-official financial institutions (and thus are excluded from the formal finance framework) and cannot be protected and supervised by the government rules and regulations. The informal financial market can be categorized into three types based on their forms and purpose (Bai and Chen, 2004). Activities or transactions with neither legal forms nor justifiable purposes are referred to as black finance (the typical example is money laundering); activities or transactions with legal forms but no justifiable purposes are referred to as grey finance (the typical example is mutual guarantees among listed companies); activities or transactions without legal forms but justifiable purposes refers to civilian lending.

For those businessmen who are eager to develop the firm while having no access to the formal financial market, informal finance becomes an attractive alternative. In

particular, they mainly rely on capital from friends, relatives, colleagues, and other individuals to finance various stages along the firm's life-cycle. Apart from individual lending, other commonly seen forms of informal finance include Rotating Savings and Credit Association (mainly in Fuzhou, Wenzhou, and Guangzhou), money-lenders, pawn shops, and cooperatives. Sun (2008) also included private equity as one form of the civilian lending.

This thesis focuses on Zhejiang Province where SMEs play a dominant role and where informal finance is well developed. The case in Zhejiang Province is representative for China as it shares a long history of a dominant private economy and informal finance (Zhou and Tao, 2007).

We aim to understand the status quo of the SME financing situation in Zhejiang Province. Specifically, we determine what type of SMEs could obtain funding from formal channels and what features they have, such as firm size, political connection, business experience, credit-rating status, etc. Furthermore, we determine the role that informal finance plays in SME financing and whether it is widely used or if only certain types of SME resort to it. The answer to this question is critical. If informal finance is only used by certain type of SME, pertinent micro-policies could be made accordingly. In contrast, if informal finance is used universally, the implication is that micro-policies will be ineffective, and only systematic solutions could work.

With a full understanding of the SME financing status quo, we can determine where the problems lie. Pertinent policy recommendations could then be proposed, which are not only vital to the development of the SMEs themselves but also to the entire national economy. Moreover, guiding the informal finance to effectively alleviate the SMEs' financing difficulties could contribute to the financial and social stability at large. Therefore, it is a meaningful topic to be studied, both from a theoretical and practical perspective.



In this thesis, we gain a comprehensive view of the status quo of SME financing in Zhejiang Province through a questionnaire and interview. Data and material are first-hand and original. The research could make a contribution both in theory and practice.

In theory, we have empirically proved that variables like political ties, credit rating, size, and education play a key role in formal financing in Zhejiang Province. Variables like credit rating and political ties always work in obtaining formal financing while some variables could only work in specified period, such as the Global Financial Crisis and the subsequently tightened monetary period (e.g., 2010–2013). Meanwhile, we find that relationship variables like business experience could not play an important role as we expect. More importantly, no consistent results have been found for informal financing practices. In other words, none of these factors have a vital impact on obtaining informal financing, which could explain why informal financing is extensive and universal.

In practice, policy suggestions have been proposed for both formal and informal financing from three dimensions: the fund providers for SMEs, the SMEs who need the funding, and the background that underpins them. These policy suggestions are systematic, specific, and practical.

The rest of the thesis is arranged as follows:

In Chapter 2, the focus is mainly on studying the status quo of the SME financing in Zhejiang Province and exploring the role that formal and informal financing play. By consulting the literature, a tailor-made questionnaire (the full copy of the questionnaire is presented in Appendix 1) has been designed to determine the basic information, business establishment, business growth, and funding sources of the firms. The copies of the questionnaire were disseminated to the sampled entrepreneurs of SMEs across Zhejiang Province. With the data collected from the 150 valid copies,

gain a brief understanding of these firms and their financing situation through basic descriptive statistics.

In Chapter 3, we adopt various empirical methods to analyze the relationship between usage of formal (informal) lending and other factors. Correlation analysis, a binary regression model, and an ordered logistic regression model are applied on the collected questionnaire data. By this empirical investigation, we further explore what impact these reputation and relationship variables may have on the financing practices SMEs try to employ.

From the empirical results, we find that firms with strong political ties, higher education, larger turnover, and having received a credit rating are more likely to employ formal financing practices. No consistent results are found for informal financing practices. Moreover, we find that more factors work in the case of the Global Financial Crisis while only political ties and credit-rating status work during the tightened monetary background, such as the period after 2010. Combining these results, we conclude that reputation and relationship are vital in obtaining funds from formal financing channels in China. By contrast, all kinds of SME entrepreneurs are likely to tap into the informal financing market. This finding is critical: on the one hand, the criteria necessary to obtain formal loans are quite stringent, while on the other hand, the informal market seem to set no threshold for financing. In the light of these considerations, informal financing will inevitably play a dominant role in the financial system.

In Chapter 4, we first consult the extant literature to define the SME financing practice around the world. We then hold interviews with five managers from a commercial bank to understand their mindset towards SME business. Then, through the combination of what we find from the literature and the interviews, as well as the empirical results from the previous chapters, we propose specific policy suggestions. Policy suggestions are proposed from three different dimensions: the supply side of

funds for SME financing (including both the formal and informal financial institutions), and the demand side. Such a wide view will offer more insightful understanding of SME financing. The policy suggestions proposed are explicit, specific, and practical.

Chapter 5 concludes the thesis.

## **Chapter 2 Investigation of the status quo of SME financing in Zhejiang**

### **2.1 Introduction**

As the first part of the research, this chapter focuses on the status quo of the SME financing in Zhejiang Province and exploring the role that informal finance plays. Through consulting the literatures, a tailor-made questionnaire has been designed to determine the basic information, business establishment, business growth, and funding sources of the firms. The copies of the questionnaire were disseminated to the sampled entrepreneurs of SMEs across Zhejiang Province. With the data collected from 150 valid copies, a brief understanding of these firms and its financing situation could be gained through basic descriptive statistics.

### **2.2 Literature review**

The purpose of This thesis is to gain a wide view of the financing practices of SMEs in Zhejiang Province. The financing patterns of SMEs in China's costal region are determined by social and political considerations as much as economic factors. Scholars have attempted to study the factors pertinent to private entrepreneur financing. Tsai (2002) proposes a number of factors that affect the institutionalization of private entrepreneurs' financing, including: strength of political ties, residential origin, years in business, and gross annual income. Zhang (2008) blends Tsai's original thoughts with the factors of the entrepreneur's educational level and the firm's credit-rating status to gain further insight. Based on their research, this section reviews the competing explanations regarding the SMEs' choice of financing practices, provides a footing to derive testable hypotheses, and proposes a systematic set of independent variables as explanatory factors for the research to be conducted in chapter 3.

#### **2.2.1 Political connection of the SMEs**

In the study of the transitional economy, the role played by non-market power, including social capital and political capital, has not received due attention (Fisman, 2001; Appleton, Song, and Xia, 2005). In economics, there is no consensus on the

definition of the political capital, and scholars have given various explanations. Birner and Witter (2003) defined political capital as the resources that an actor can use to influence policy formation processes and achieve outcomes that serve the actor's perceived interests. Such resources include being trusted by a political organization/network and political connections obtained through affiliation with a political organization/network. Political capital, however, comes from not only affiliation with the political organization/network, but also the activities associated with this affiliation or membership. Li, Meng, and Zhou (2008) think a member of the ruling party or having experience of serving in the army constitutes political capital. Fisman (2001) and Faccio, Masulis, and McConnell (2006) argue that if shareholders or members of the board with ownership of more than 10% of the company shares are also a member of parliament, or has a close relationship with the top leaders, then this counts as political capital. Chen, Lu, and He (2008) state that in China, whether the entrepreneur is a member of the People's Congress (PC) or Committee of Political Consultative Conference denotes the strength of his/her political power.

Zhou (2009) discussed some important characteristics of political capital. First, like financial capital, political capital can be gained through investment. For example, membership in the Chinese Communist Party (CCP) is considered political capital in China, and investment in such political capital involves making an effort to join the party and, in the process, subjecting oneself to a greater degree of political scrutiny and responsibility (Liu, 2003). Secondly, as a special type of social capital, political capital must be spent to be useful. Some forms of political capital, such as political connections, may even fragment and disorganize if left unused. Thirdly, political capital needs to be invested continuously. If left alone without further investment after obtaining membership, the value of political capital may decrease rapidly, and as one exits the political organization/network, political capital will generally expire.

### **2.2.1.1 Research in foreign countries**

By analyzing data from Hungary in 1992, Rona-Tas (1994) suggests that political power is converted into economic advantage when planned economies start to transform themselves into market economy systems. His research finds that the party bureaucrats in the previous communist regimes maintain their advantageous position when they become entrepreneurs and do extremely well in the business sector with dynamism. Wank (1995, 1999) elaborates in detail on the political dependency of private entrepreneurs in China.

Khwaja and Mian (2005) have argued that banks politically favor connected firms in less-developed economies. Using a loan-level data set containing all corporate loans in Pakistan between 1996 and 2002, they investigate political corruption in banking. By classifying a firm as “political” if its director participates in an election, they examined the extent, nature, and economic costs of political rent seeking. They find that political firms borrow 40% more and have 50% higher default rates than other firms. Such preferential treatment occurs exclusively in government banks while private banks provide no political favors. Based on these studies, it is reasonable to suppose that access to political and bureaucratic networks may be reflected in the private entrepreneurs' choice of financing strategies.

### **2.2.1.2 Research in China**

Choi and Zhou (2001) analyze nationwide survey data from 1993 that was collected by the All China Federation of Industry and Commerce on 1440 sample entrepreneurs throughout China. They demonstrate empirically that being a cadre member has a positive effect on profits. They also argued that the importance of political connections for Chinese entrepreneurs increases as the scale of the business grows. In particular, state patronage is needed to help Chinese firms overcome the uncertainty that frequently surrounds their legal status.

Vicziany and Zhang (2004, 2005a) apply case studies of private enterprises in western China to show that political connections have been helpful for the most successful private entrepreneurs. The effect is especially prominent if they begin businesses as green-field private enterprises. Basing their work on three case studies, including two of Xinjiang's leading entrepreneurs, they argue that party connections help in developing local markets, provide clients for fledgling businesses, and facilitate access to credit.

Xin and Pearce (1996) find that the SMEs in China place greater emphasis on the political capital than the SOEs and collective enterprises do. The political capital available to the SMEs has a dramatic influence on how much resource is accessed. The resource accessed includes the amelioration of the financing environment, entry into the highly regulated industries, and the subsidies from the state.

The impact of an entrepreneur's political capital on the financing environment is channeled through two channels: the replacement mechanism and the signal mechanism. Due to the fact that a large portion of the credit goes to the state firms, the political capital of the entrepreneur works as a replacement for the official support, and it is easier to obtain the credit in a normal situation or a bridging loan when in difficulty. Such replacement mechanisms are well recorded in different countries (Faccio, Masilis, and Mcconnell, 2006; Yu and Pan, 2008). The signal mechanism works because the political capital helps to alleviate the information asymmetry and so banks are willing to lend to these firms. If the entrepreneurs become a member of the People's Congress or Committee of Political Consultative Conference, it conveys the signal that the firm has been widely accepted by society and the government. Accordingly, the bank feels more confident and grants the loan (Shao, 2011).

Jiang (1999) and Zhang and Ming (2000) suggest that more and more private entrepreneurs have acquired membership of the People's Congress or the Committee of Political Consultative Conference (CPCC). The PC is China's legislative body and

the CPCC is similar to the upper house in Great Britain, but its functions are limited to consultation (Zhou, 2009). Although a significant proportion of the positions in both the PC and CPCC are preserved for current or semi-retired party/government officials, people from other social strata are also represented at all levels of the two political organs. While there were almost no private entrepreneurs in the two organs before the reform in 1978 because of the elimination of the whole stratum, entrepreneurs have been increasingly represented in both the PC and CPCC since the reform. By the late 1990s, around 10% of private entrepreneurs with at least eight employees were already members of either the PC or CPCC nationwide (Zhang and Ming, 1999).

Zhou (2009) argued that high political capital can bring political legitimacy, thus helping solve the resource acquisition problem. A legislative membership signals the recognition of the entrepreneur's contribution to the economy and sociopolitical order by the state. Therefore, entrepreneurs with legislative membership have generally been treated differently from other entrepreneurs when the state allocates resources. Thus, they may obtain government-mandated loans from the local branches of state-owned banks. Many private entrepreneurs in Fuyang (a county in Zhejiang Province), for example, have reported that they enjoyed "the freedom of doing business," such as easy access to bank loans, protection from unfair competition, and positive media coverage only after being coopted into the PC or CPCC (He, 1999).

Prominent barriers exist in many industries, such as energy and finance, and so the SMEs rarely have opportunities to enter these industries. Using the data of 1604 listed companies from 50 industries, Yuan and Shao (2010) find that the number of state firms increases with the level of the industry barrier and the extent of monopoly. In industries with a market concentration of less than 50%, private firms dominated while in industries with a market concentration of more than 50%, state-owned firms (SOEs) prevail. Using the top 100 entrepreneurs in Zhejiang Province, Hu (2006) finds that membership of the PC or Committee of Political Consultative Conference



enabled the entrepreneur to enter the highly regulated finance industry and to obtain the license required for financial services.

The political capital could also help the SMEs to gain tax credit and various types of subsidies (Schleifer and Vishny, 1994; Bertrand, Kramarz, Schoar, and Thesmar, 2004; Faccio, Masulis, and McConnell, 2006). Chen, Li, and Yu (2009) find that the local government in China maintains a strong power in taxation and subsidies. Only the state-owned firms and those SMEs with close political relationships with the local government are treated favorably regarding tax and subsidies.

Political capital gained from legislative membership can also help mobilize resources through enhancing the institutionalized social networks of the entrepreneurs. Sociologists have argued that social networks are often based on social similarity (Burt, 1992). Therefore, enjoying high-status can increase the probability of having other high-status people in one's personal networks (Suchman, 1995). According to Zhou (2009), legislative membership, which indicates high political status, can increase the probability that entrepreneurs will have other politically important people, such as politicians, bureaucrats, bankers, or other political elites in the PC or CPCC, in their personal networks. These high-status contacts can provide assistance in solving the resource acquisition problems. Zhou (2009) explained how these contacts might help entrepreneurs get access to bank loans as follows:

First, high-status contacts can facilitate relationship lending. The information asymmetry problem is especially severe in China due to the weak protection of private property rights. To deal with the information asymmetry problem, one important contracting method often used by banks is relationship lending (Berger and Udell, 1998; IFC, 2000). However, as discussed previously, Chinese banks have not usually had incentives to establish relationships with private entrepreneurs because of the uncertainty of the future of private businesses under the legal and regulatory constraints (IFC, 2000; Tsai, 2002). With legislative membership, an entrepreneur can

use associated high-status contacts to help establish relationships with bank officials. Given that direct and indirect ties between the entrepreneur and the bank officials may create social obligations between the two parties, which may cause them to behave generously toward each other (Gulati, 1995; Shane and Cable, 2002), such high-status contacts may facilitate access to bank financing. It could be seen that such a channel is similar to the signal mechanism described by Shao (2011).

Secondly, some high-status contacts can even directly intervene on behalf of the entrepreneur in the credit decisions of banks. During most of the reform period, bank officials have not generally been able to make independent credit decisions, as local governments have had strong control over local branches of state-owned banks and have often intervened in their credit decisions (Naughton, 1995). In the late 1990s, although the central government reorganized the provincial network of the People's Bank of China (the central bank) and eliminated the credit quota system in order to break the links between local governments and state-owned banks, local governments were still finding new ways to preserve some role in the allocation of financial resources through the banking system (IFC, 2000). With legislative membership, therefore, an entrepreneur can secure bank loans by using some of his/her high-status contacts to intervene in the credit decisions of banks on behalf of him/her. In other words, we could regard it as a decision-making intervention mechanism.

From the literature consulted above, it could be concluded that political capital could function effectively in China via the following channels:

- 1) As a signal of social acceptance
- 2) As a replacement for official support
- 3) As a direct intervention in credit decisions.

We also know that communist party membership may not help matters while PC or CPCC membership can function as effective political capital. As a matter of fact, from the top, we have PC and CPCC from national, provincial, city and county level. We could expect that PC and CPCC of different layer may carry different weight.

### **2.2.2 Locality of the entrepreneur**

Zhang (2008) argues that having local social networks depends on the household registration status of the entrepreneurs and their length of residence in particular cities. Hence, it is important to differentiate between private entrepreneurs who are indigenous to a place and those who are migrants from other places, including other cities in Zhejiang Province. Discrimination against migrants in China is reasonably well documented. Some scholars like Day and Ma (1994) and Solinger (1999) have examined the nature of this discrimination with respect to the social networks of outsiders, as well as their employment prospects and access to political support. These studies both conclude that migrant entrepreneurs face more problems compared with their native counterparts (Solinger, 1999). In addition, residents in rural areas who have flocked to China's cities in recent years are generally viewed with discrimination. They suffer from discrimination in both the job-seeking and home-rental markets, and their children even have difficulty in accessing local schools (Nielsen, Smyth, and Zhang, 2006). Therefore, Chen (2004) argues that it is a reasonable assumption that the grassroots entrepreneur amongst the migrant population also suffers from relative marginalization. This in turn may be reflected in the choice they make about their financing strategies, as new migrants are probably more likely to be excluded from community-based financial institutions and may reluctantly try the informal financing channel.

### **2.2.3 Education level of the entrepreneur**

Given that private entrepreneurs are more able to create and manage viable enterprises with increased human capital (Astebro and Bernhardt, 2003), it is reasonable to include human capital indicators in the following analysis. There are numerous definitions of human capital that are cited in the literature, which cover a broad contextual spectrum. There are, however, several recurring factors that are cited as relevant determinants of human capital. These include, for example, educational level, skill level, personal aptitude, experience, attitude, and behavior (Davenport, 1999). Of

these, the factor that serves as the best indicator of human capital is the level of education. Boshoff and Schutte (1998) argue that education level is one of the main predictors of entrepreneurial success in a developing country. Van-de-Ven, Hudson, and Schroeder (1984) and Jo and Lee (1996) find a direct and linear relationship between educational level and entrepreneurial performance. Moreover, Bates (1990), using an analysis of a nationwide random sample of 7743 small firms in the US, shows that entrepreneurs with higher educational qualifications are likely to raise funds from capital markets more easily and survive longer in the market than those without such qualifications. Access to formal financial sources requires more than just literacy for a number of specific tasks: maintaining and analyzing accounts, understanding the rules and procedures for bank credit, and the capacity to manage the accounts and books of a wide variety of financial sources in order to diversify the range of access to business capital. In the case of micro-credit, Li, Rozelle, and Zhang (2004) find that minimal educational competence is essential for reading bank passbooks, understanding the length and conditions of loans, and being able to monitor loan repayments in order to prevent fraud by the lending agency.

#### **2.2.4 Business experience of the entrepreneurs**

There is a vast literature on the impact of business experience on entrepreneurial performance. Financial growth-cycle theory suggests that entrepreneurs without sophisticated experience often started as individual entrepreneurs who could not get access to formal financial channels because their credit status was very low (Berger and Udell, 1998). As these small, private firms became better established, their creditworthiness and reputation improved and they developed characteristics that enabled formal funding institutions to better monitor loans in a manner that was not possible for the infant companies. More specific research has also been done to establish the relationship between business experience and entrepreneurial performance. Stuart and Abetti (1990) find a strong positive correlation between business experience and entrepreneurial performance, and other studies have found similar results (e.g., Vesper, 1980; Sandberg and Hofer, 1987).

### **2.2.5 Firm's credit-rating status**

Many studies have examined the effect of credit scoring on small-business lending. In their study of large US banking organizations, Frame, Srinivasan, and Woosley (2001) find that credit scoring was associated with an 8.4% increase in the amount of credit extended to small businesses. Frame, Padhi, and Woosley (2004) add two more dimensions to their study of the characteristics of credit-scored loan recipients: income levels and the location of a firm. Their results suggest that regardless of income level and location, credit scoring increases the average size of loans. Approaching the question from a different angle, Berger, Espinosa-Vega, Frame, and Miller (2004) examine how credit scoring reduced uncertainty about borrowers (they called it informational opacity) and made it possible for lenders to receive loans with longer repayment periods (i.e., extended loan maturity). The authors found that debt maturity is significantly longer for borrowers when they borrow from banks that use credit-scoring methods.

## **2.3 Research design**

### **2.3.1 The questionnaire**

The questionnaire used in this chapter is composed of four parts, and a detailed introduction is presented in this section.

The first part refers to basic information. It asks the respondents their personal information, as well as their firm's status. Personal information includes age, gender, educational level, and origin (whether he/she is a local resident or not). A firm's status mainly consists of the size (measured by the number of employees) and turnover (measured by the revenue earned last year). In order to judge to what extent the political factors impact the business and financing, we ask the respondents about their relationship with the government or SOEs. Questions were designed to ask whether

they themselves, or their relatives or employees, have ever worked in such institutions or enterprises.

Yu and Pan (2008) argue the political capital of the entrepreneur functions as a replacement for the official support and it is easier to obtain the credit in the normal situation, as well as to be granted a bridging loan when in financial difficulty. Shao (2011) claims that if the entrepreneurs become members of the PC or CPCC, it conveys the signal that the firm has been widely accepted by the society and the government. Accordingly, the bank feels more confident and grants the loan to the firm. Specifically, questions like whether they are members of the PC or Committee of Political Consulting Conference are asked since such membership indicates political capital of the entrepreneur.

In the second section—business establishment—the respondents are required to show how they started their business. Their business initiation information is determined from three aspects: when they start; why they choose Zhejiang Province to start (due to the fact that all of the respondents are entrepreneurs in Zhejiang Province); and through which financing channel they obtained the funds to start. The business experience of the entrepreneur could be extracted from the first aspect. Though no exact relationship exists between the age of firm and the financing channels, it is generally agreed that informal finance is more likely to be associated with infant or premature firms (Berger and Udell, 1998). To determine the reasons for choosing Zhejiang for the business start-up, we offer some probable explanations: better policy, bigger market, family bonds, and a better financing environment. Various formal and informal channels are also listed to check how the entrepreneurs access the capital.

The third section refers to business growth. In this section, the respondents are required to explain how their businesses developed. We need to determine the capital source of the firm, including whether the capital comes from the participation of state and whether foreign capital has a stake in their firm. In addition, it is necessary to

define the industry the firm belongs to (ten industries are listed as options: food and beverage, textile, intermediary, paper and printing, medicine, architecture, machinery, artifact, electronic appliances, and furniture) and the major market they serve (domestic or overseas). Moreover, we asked questions regarding their operating conditions, which asked in a comparative manner: whether the firm's turnover increased compared with that of last year and whether they have plans for further business expansion. Furthermore, we asked their opinions about the financing issues, including how they finance their business after the initial period and whether it is difficult for them to access further funds when needed. Similar to the arrangement in the second section, the financing channel used in the growth stage has also been included here.

The last section explores the firms funding status in detail. Due to the fact that the banking industry dominates in China's finance system, we begin this section by asking for information about the bank account of the respondents: whether they have a bank account and which type of bank it is. Here, we offer them four tiers of bank: the first tier refers to the Big-5 (Industrial and Commercial Bank of China, Bank of China, China Construction Bank, Agriculture Bank of China, and Bank of Communications); the second tier is the stock-listed commercial banks; the third tier refers to the urban commercial banks; the fourth tier refers to the rural cooperatives. Then we ask whether a line of credit is applied to their business. Two types of questions have been designed to learn the financing environment. The respondents are required to answer the frequency with which they receive financing support from the banking institutions and non-banking sources. Secondly, the respondents are guided to answer their feelings regarding the financing difficulty from both banking institutions and non-banking sources. The same questions are applied in three different scenarios: in the past several years, during the Global Financial Crisis, and now. The answers to both types of question are measured on a Likert five-point scale. Here, we choose a Likert five-point scale since its range could offer sufficient information, while a Likert seven-point scale is redundant.

The respondents are provided with a wide range of financing channels in this section, from the most formal channel of financial institutions, like the Big-5 state-owned commercial banks, to the most informal channel, like the civilian lending. Unlike the previous two sections, the channels listed in this section have been categorized into two types.. Type 1 refers to the channels linked to formal financial institutions while type 2 is labeled as “informal finance” due to its wide coverage of informal financing mechanisms. Such categorization enables us to explore further in later stages of the research. The respondents could then pick an option and tell us why they choose one over another and whether there are constraints and what exactly prevents them from using the formal channels, or what special motives prompt them to use the informal channels. As well as learning about the financing from the demand side, we also attempt to learn it from the other way round: whether the firm has ever lent money informally and on what grounds they have the confidence to lend. Last, but not least, credit-rating status is also determined in this section. Through setting this question, we aim to find the proportion of firms that have a credit rating.

### **2.3.2 The data**

The data for This thesis are collected from the results of a survey that was undertaken in Zhejiang Province from November 2010 to August 2011. One hundred and eighty questionnaires were distributed and 150 valid questionnaires were returned (feedback ratio: 83%). These 180 copies were randomly distributed mainly through one channel: the sub-branches of the commercial banks. The Zhejiang Province Private Entrepreneur’s Association provided us with instrumental guidance in the process.

The designed questionnaires were mainly disseminated with the help of three commercial banks. We explained our academic purposes to the managers, and the staff from the loan division provided with a list of potential respondents. The candidates chosen are mainly clients or potential clients of these banks in Hangzhou. This arrangement ensures that the candidate could answer the questions in a



collaborative and honest way due to consideration upon their relationship with banks. However, concentration in region and industry remains a problem. In order to diversify the client range, we contacted with Zhejiang Province Private Entrepreneur's Association to seek advice. According to their proposal, the region for the survey was enlarged so that both geographical and industrial concentration could be alleviated. We then negotiated with the banks to provide us with the information for the whole of Zhejiang Province. From the data collected, the industry diversification is acceptable.

## **2.4 Descriptive statistics based on the data from the feedback of the questionnaires**

### **2.4.1 Basic information**

As introduced above, the basic information was to learn the respondents' personal information, as well as their firm's status. Specifically, personal information involves age, gender, educational level, and origin (whether he or she is a local resident or not). The firm's status mainly consists of the size (the number of employees) and turnover (the revenue earned last year). Table 2.1 to 2.6 illustrates the detailed distribution of these six factors.

The descriptive statistics briefly present the features of these sample SMEs and entrepreneurs. From Table 2.1, we learn that the entrepreneurs are mainly in the range of 20–39 years old. Seven respondents are in the range of below 20 years old; a probable explanation for candidates so young is that they may be the children or grandchildren of older entrepreneurs of a family business. In Zhejiang Province, there are many family businesses, and whether the firm should be run by the family members or external managers is a topic that attracts public attention.

**Table 2.1: Descriptive statistics of the respondents' age.**

Age	Number of respondents	Percentage of the whole sample
<20	7	4.67%
20–29	58	38.67%
30–39	32	21.33%
40–49	23	15.33%
>50	30	20.00%
Total	150	100%

From Table 2.2, in our sample, respondents' gender is basically balanced, with more than 40% of the respondents being female. An explanation for this is that Zhejiang is characterized by a long history of private business, and discrimination against females is not part of the local tradition. Indeed, succession of family businesses in Zhejiang Province or choosing entrepreneurs mainly focuses on the candidate's management skills and inner quality rather than merely their gender.

**Table 2.2: Descriptive statistics of the respondents' gender.**

Gender	Number of respondents	Percentage of the whole sample
Male	87	58.0%
Female	63	42.0%
Total	150	100%

From Table 2.3, we see that more than 80% of the respondents have received education to at least the level of senior high-school. Over 45% have studied in universities while only 18% of the respondents received relatively only a lower level of education.

**Table 2.3: Descriptive statistics of the respondents' education level.**

Education level	Number of respondents	Percentage of the whole sample
Primary school	12	8.0%
Junior middle-school	15	10.0%
Senior high-school	30	20.0%
Vocational training	25	16.7%
College	45	30.0%
Graduate school	23	15.3%
Total	150	100%

From Table 2.4, 43% of the entrepreneurs are indigenous to Zhejiang Province. As the sample was chosen randomly, to some extent it could be seen as evidence to prove that Zhejiang Province is inclusive and friendly to outsiders.

**Table 2.4: Descriptive statistics of the respondents' origin.**

Local or not	Number of respondents	Percentage of the whole sample
Local	65	43.3%
Not local	85	56.7%
Total	150	100%

From Table 2.5, most of the firms (93.33%) have more than 10 employees. Due to the very rare cases of *getihu*, we tend not to categorize the sample into the two types: *getihu*<sup>1</sup> and *siyingqiyejia*<sup>2</sup> (firms with more than eight employees) as Zhang (2008) did. About 28% and 29% of firms have employees in the range 10–50 and 100–499, respectively. From Table 2.6, more than 70% of the sample firms have earned revenue

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<sup>1</sup> GETIHU refers to the entrepreneur whose firm has fewer than eight employees.

<sup>2</sup> SIYINGQIYEJIA refers to the entrepreneur whose firm has more than eight employees).

of more than 1 million Chinese Yuan, of which about 37% reached 10 million Chinese Yuan.

**Table 2.5 Descriptive statistics of the number of respondents' employees.**

Number of firm's respondents' employees	Number of respondents	Percentage of the whole sample
0–10	10	6.7%
10–50	42	28.0%
50–100	30	20.0%
100–499	43	28.7%
500–999	20	13.3%
>1000	5	3.3%
Total	150	100%

**Table 2.6 Descriptive statistics of the respondents' firm's turnover.**

Range	Number	Percentage
<100,000	12	8.0%
100,000–999,999	30	20.0%
1,000,000–9,999,999	53	35.3%
>10,000,000	55	36.7%
Total	150	100%

Table 2.7 presents the political connection of the entrepreneurs. From Part A, we find that only 10% of the respondents have served in SOE or government institutions. Of these 15, 11 chose to continue answering the following questions. Among them, 10 once worked in institutions; all were managerial staff and 8 of them worked with the post of chief leader. Three of the 11 even are members of PC or CPCC member.

**Table 2.7: Descriptive statistics of the respondents' political connections.**

**Part A**

**Experience of the respondents or any other member of senior management serving in a government working unit or SOEs**

a. Having served in SOE or government institutions	Number	Percentage
Yes	15	10.0%
No	135	90.0%

**Part B**

**The type of government working unit the respondents or any other member of senior management served**

b. Type of government unit or SOE	Number	Percentage
Government bureau/department/committee/institution	10	6.7%
State-owned enterprise	0	0.0%

**Part C**

**Level of the position the respondents or any other member of senior management in the government working unit**

c. Level of the position	Number	Percentage
Chief leader/CEO	8	5.33%
Department chief/manager	3	2.00%
Ordinary staff	0	0.00%

**Part D**

**Whether relatives or friends that have a relationship with the government unit or stated-owned enterprises**

d. Relatives of friends	Number	Percentage
Yes	3	2.00%
No	8	5.33%

### Part E

**Whether the respondents or any other member of senior management has been elected as a congressman (PC or CPCC member).**

e. PC or CPCC	Number	Percentage
Yes	3	2.00%
No	8	5.33%

### Part F. Employees that have relationships with government units or SOEs

f. Employees that have relationships with government units or SOEs	Number	Percentage
Yes	3	2.00%
No	8	5.33%

#### 2.4.2 Business establishment

Due to the fact the respondents could make multiple choices to the problem “Why they chose Zhejiang to start their business,” the sum of the number may not necessarily add to 150, i.e., the sample size. From the results listed in Table 2.8, about 60 people chose the reason “bigger market” while 50 made the choice because of being indigenous to Zhejiang Province. The number 50 is smaller than 65 (the number who are indigenous) indicating that not all of the local people feel it is more convenient and meaningful to do business in their hometown. It is worth mentioning that only eight people chose the reason “better financing opportunities,” indicating that the financing environment is far from satisfactory despite the existence of a developed and active informal lending market.

Looking further into the financing channels, we see that 60 people rely on internal financing rather than seeking funds from outside. Only 48 firms have successfully obtained loans from the banks, and a rather small proportion (only 8 firms) of firms have been granted subsidies from the government. Meanwhile, 17 firms go to the most informal financing channels: pawn shops.

**Table 2.8 Descriptive statistics of reasons for choosing Zhejiang Province to start the business.**

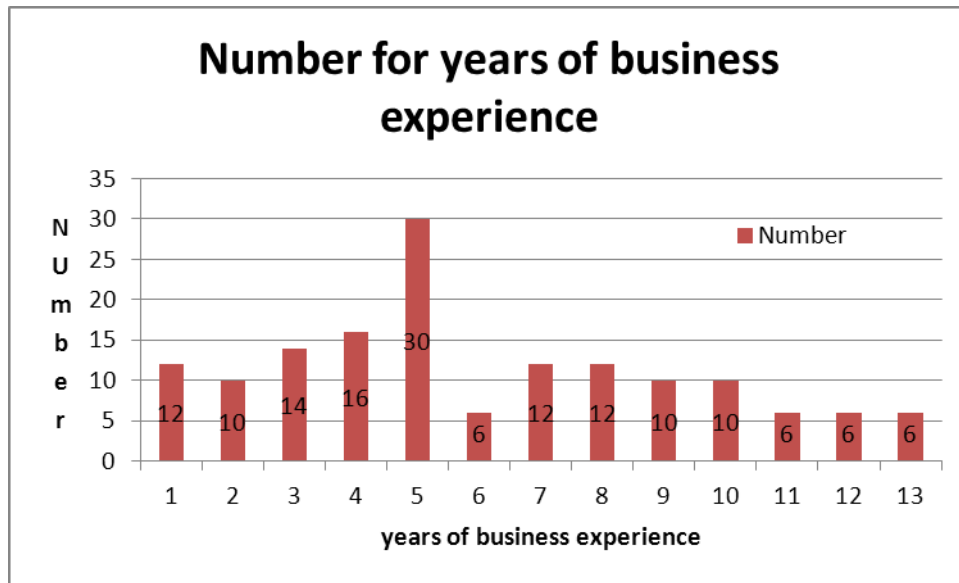
Reasons for choosing Zhejiang Province to start the business	Number of respondents	Percentage of the whole sample
Better policy environment	20	13.33%
Bigger market	60	40.00%
Easier access to supply materials	25	16.67%
I'm a native of Zhejiang	50	33.33%
Better financing opportunities	8	5.33%

**Table 2.9 Descriptive statistics of financing channels chosen by the respondents.**

Financing channels	Number of respondents	Percentage of the whole sample
Internal finance (including family member contribution)	60	40.00%
Pawn shop	17	11.33%
Cooperative	25	16.67%
Bank loans	48	32.00%
Government institutions	8	5.33%

Figure 2.1 shows the distribution of entrepreneur's business experience in the sample. The pattern is skewed to the right, which indicates that a large proportion of the entrepreneurs have fewer years of business experience. Entrepreneurs having six years of experience recorded the highest percentage. Experienced entrepreneurs are rare in our sample since the proportion of those having more than 13 years is quite low. Table 2.10 shows that the mean value of the respondent's business experience is about 6 years.

**Figure 2.1 Description of business experience.**



**Table 2.10 Descriptive statistics of the respondents' business experience.**

Business experience (Years)	Minimum	Maximum	Mean	Standard Deviation
	1	21	7.36	2.71

### 2.4.3 Business growth

From Table 2.11, we can see that the sample is quite diversified in terms of industry distribution and that there is no evident industry concentration. The sum of industries respondents are part of for all the samples indicates that some firms may do business across industries. After initial success in the industry that they were familiar with, many SMEs chose to diversify their business. They started to enter into industries that seem to be lucrative but which they are quite unfamiliar with. In some cases, that might just be the beginning of the final collapse and bankruptcy of the firms.



**Table 2.11 Descriptive statistics of the distribution of the industries of the respondents were part of.**

Industry of respondents	Number of respondents	Percentage of the whole sample
Food and beverage	10	6.67%
Textile	22	14.67%
Intermediary	28	18.67%
Paper and printing	7	4.67%
Medicine	8	5.33%
Architecture	15	10.00%
Machinery	15	10.00%
Artifact	10	6.67%
Electronic appliances	22	14.67%
Furniture	18	12.00%

**Table 2.12 Descriptive statistics of market served by the respondents**

Market served	Number of respondents	Percentage of the whole sample
Domestic market	105	70%
Foreign market	48	32%

As for the markets served, over two-thirds of the sample firms are home-market oriented while less than one third serve the foreign market. A simple arithmetic calculation tells us that three forms of the whole sample served both the domestic markets and overseas. A probable explanation is that these three firms have a wider range of products that could serve the need of both domestic and overseas customers' needs.

**Table 2.13 Descriptive statistics of respondents' revenue growth in the past year.**

Revenue growth	Number of respondents	Percentage of the whole sample
Increased by 0–20%	58	38.67%
Increased by 20–50%	30	20.00%
Increased by 50–100%	13	8.67%
Increased by more than 100%	23	15.33%
About the same	3	2.00%
Decline	23	15.33%

From Table 2.13, we see that more than 80% of the enterprises recorded growth in the past year, and of these, about 40% of the enterprises have reaped modest growth while 44% have achieved a promising performance. A strong performance may indicate that

the firms are financially healthy, and it is reasonable to deduce that they could withstand relatively high financing costs.

When asked whether they regard financing as a constraint for their business expansion, more than half of the sample firms answered “yes.” The figures for the answers presented in Table 2.14 are exactly the same when they were asked whether they had difficulty in obtaining funds during the Global Financial Crisis.

Table 2.15 presents the choice of the financing channel of the sample firms when they expand their business. A first look at the table shows that no firms have answered beyond the 5-year range, probably because the entrepreneurs may not share a vivid memory about how they financed their growth in the remote past.

Looking further into the available information, we find that it is likely that firms tend to use multiple channels rather than maintaining just one. Using more than one channel could ensure the liquidity and safety of the firms under most situations. Among the channels used, trade credit is used most frequently, followed by informal channels and retained earnings. Financing through formal financing institutions, like banks and credit unions, is rather scarce. The usage of direct financing channels is rarely recorded (10 firms obtained funds through issuing debt instruments while no firms accessed equity funds).

**Table 2.14 Descriptive statistics of respondents’ perception of financing difficulty.**

Perception of financing difficulty	Number of respondents	Percentage of the whole sample
Financing is difficult	80	53.33%
Financing is not difficult	70	46.67%

**Table 2.15 Descriptive statistics of respondents' usage of financing channels for business expansion.**

Usage of financing channels for business expansion with the contract terms set between 0–5 years	Number of respondents	Percentage of the whole sample
Retained earnings	43	28.67%
Trade credit	88	58.67%
Bank loans	12	8.00%
Credit union loans	13	8.67%
Corporate bonds	10	6.67%
External equity	0	0.00%
Informal channels	50	33.33%

From the data collected through the questionnaires, we found quite limited information about firms' ownership. None of the respondents answered whether any stakes are owned by the state. Only 12 people chose to reply that their firms are joint ventures. From such feedback, it seems that ownership may remain something that the entrepreneurs avoid answering questions about directly.

#### **2.4.4 Funding source**

From Table 2.16, we see that all of the sample firms owned a bank account. However, fewer firms (merely 6.67%) have used a line of credit. The information retrieved from the questionnaire also showed that most of the accounts are in the Big-5 state-owned banks and large stock-listed commercial banks.

**Table 2.16 Descriptive statistics of respondents' usage of bank accounts and credit lines.**

	Number of respondents using source	Percentage of the whole sample	Number of respondents not using source	Percentage of the whole sample
Bank account	150	100%	0	0%
Line of credit	10	6.67%	140	93.33%

**Table 2.17 Descriptive statistics of reasons for obtaining loans from the banking institutions.**

Probable reasons for obtaining loan from the banking institutions	Number of respondents	Percentage of the whole sample
Start-up capital requirement	0	0.00%
Fixed asset investment	13	8.67%
Current asset needs	50	33.33%
Research and development	30	20.00%
Personnel training	30	20.00%
Other	0	0.00%

**Table 2.18 Descriptive statistics of reasons for failure to obtain loan from the banking institutions.**

Probable reasons for failure to obtain loan from the banking institutions	Number of respondents	Percentage of the whole sample
Small scale of the business	18	12.00%
Not state owned	13	8.67%
No credit guarantee	28	18.67%
No qualified collateral	12	8.00%
Policy constraints	27	18.00%
Lack of creditworthiness and government connections	2	1.33%
Lack of business influence	3	2.00%
Other	8	5.33%

Table 2.17 and Table 2.18 present various reasons for the success or failure to obtain loan from the banking institutions. Current asset needs, research and development expenditures, and personnel training are the main reasons accepted by the commercial banks. It is worth noting that the success in obtaining loans for research and development expenditure and personnel training could imply that there is policy inclination toward some industries, but this needs to be proved with further empirical studies in the future.

Meanwhile, a lack of credit guarantee, policy constraints, and scale of the business are the main obstacles for firms to be granted loans. The implication is that sufficient credit risk mitigation schemes, such as providing collateral or third-party guarantees, carries much weight for SME financing. In addition, more should be done to alleviate policy bottlenecks and prejudice against SMEs. Another implicit reason that is not listed in the items is location discrimination.

Similar to the results of the banking institutions, current asset needs and research and development are the main reasons for obtaining funds from non-banking institutions. The reasons for failure to access such funds from these channels include a lack of creditworthiness, no credit guarantee, and the small scale of the business. The only difference is that social networking and personal relationships are much more important in informal financing, which agrees with Allen, Qian, and Qian (2005).

**Table 2.19 Descriptive statistics of reasons for obtaining loans from non-banking institutions.**

Probable reasons for obtaining loans from non-banking institutions	Number of respondents	Percentage of the whole sample
Start-up capital requirement	3	2.00%
Fixed asset investment	8	5.33%
Current asset needs	40	26.67%
Research and development	30	20.00%
Personnel training	3	2.00%
Other	13	8.67%

**Table 2.20 Descriptive statistics of reasons for failure to obtain loans from non-banking institutions.**

Probable reasons for failure to obtain loans from non-banking institutions	Number of respondents	Percentage of the whole sample
Small scale of the business	15	10.00%
No credit guarantee	25	16.67%
Lack of creditworthiness	28	18.67%
No good project	10	6.67%
Lack of social network	3	2.00%
Other	15	10.00%

In the fourth section, we have provided a variety of financing channels for the respondents to choose from. These financing channels are categorized into two types: type 1 channels are mainly formal institutions, including the Big 5 commercial banks, stock-listed commercial banks, and rural credit cooperatives while the type 2 channels are mainly informal channels, including seeking funds from friends, relatives, colleagues, upstream suppliers, downstream merchants, loan-sharks, and pawn shops. Type 2 channels could be seen as informal lending. Table 2.21 shows that 43.33% of the sample firms have used the more formal channels while 38% have used informal lending. One probable drawback of the demarcation is that there are other channels, such as internal financing, which are not included in these two types.

**Table 2.21 Descriptive statistics of use of formal and informal financing**

Use of formal and informal financing	Number of respondents having used	Percentage of the whole sample	Number of respondents not having used	Percentage of the whole sample
Type 1 channels	65	43.33%	85	56.67%
Type 2 channels	57	38.00%	93	62.00%

According to Table 2.22, about one-fourth of the firms have a credit rating. Firms that have completed such a procedure are more inclined to approach formal financing channels since their financial health and strength have been monitored by a third party, and thus the information asymmetry could be alleviated to some extent. Empirical tests are conducted in the next chapter to show whether such deduction holds.



**Table 2.22 Descriptive statistics of firm’s credit rating status.**

Credit rating status	Number of respondents	Percentage of the whole sample
Have a credit rating	38	25.33%
Do not have a credit rating	112	74.67%

## **2.5 Conclusion**

In this chapter, we focused on the status quo of SME financing in Zhejiang Province and explored the role played by formal and informal financing. By consulting the literature, we designed a tailor-made questionnaire to learn basic information, such as business establishment, business growth, and funding sources of the firms. Our data enable us to gain an understanding of these firms and their financing situation. In next chapter, we further explore the data to determine the respondents’ characteristics that enable them to obtain funds from the formal and informal funding markets.

## **Appendix 1: The questionnaire**

**This questionnaire is only for academic application. If you feel uncomfortable with any of the questions, you do not need to answer them.**

### **I. Basic information**

#### **1. Please indicate your age**

- Under 20
- 20–29
- 30–39
- 40–49
- Over 50

#### **2. Gender**

- Male
- Female

#### **3. Education level**

- Primary school
- Junior middle-school
- Senior high-school
- Vocational training
- College
- Graduate school

#### **4. Are you a native of Zhejiang?**

- Yes
- No

**5. Size of your business/firm (number of employees)**

- 0–10
- 10–50
- 50–100
- 100–499
- 500–999
- More than 1000

**6. Annual business turnover (RMB) in the last 12 months**

- Less than 100,000
- 100,000–999,999
- 1,000,000–9,999,999
- 10,000,000 or more

**7. Connection with government or state-owned enterprises**

**7a. Do you or any other member of senior management work in a government working unit or state-owned enterprise?**

- Yes (if yes, please continue to answer the following questions)
- No (if no, please continue with question 8)

**7b. Could you please specify the type of government working unit?**

- Government bureau/department/committee/institution
- State-owned enterprise

**7c. What level is the position in the government working unit?**

- Chief leader/CEO
- Section chief/manager
- Ordinary staff

**7d. Do you have any relatives or friends that have a relationship with a government working unit or stated-owned enterprise?**

- Yes
- No

**7e. Have you or any other member of senior management been elected as a congressman (PC or CPCC member)?**

- Yes
- No

**7f. Do you have any employees that have a relationship with a government working unit or stated owned enterprise?**

- Yes
- No

## **II. Business establishment**

**8. Why did you choose Zhejiang to start your business?**

- Better policy environment
- Bigger market
- Easier access to supply materials
- I'm a native of Zhejiang
- Better financing opportunities
- Other (please specify)

**9. In which year did you/your firm commence business activities?**

**10. Where did you get your start-up financing?**

- Self-financed (including family member contribution)
- Pawn shop
- Cooperative
- Bank loans
- Government institutions
- Other (please specify)

**11. Does the state have any ownership of your firm? If so, what is the proportion?**

**12. Is your company a joint venture? If so, what is the proportion of foreign ownership?**

**III. Business growth**

**13. Which industry is your company in? If your company is involved in more than one industry, please specify the main business**

- Food and beverage
- Textile
- Intermediary
- Paper and printing
- Medicine
- Architecture
- Machinery
- Artifact
- Electronic appliance
- Furniture

**14. Does your company mainly serve the domestic market, the foreign market, or both?**

- Domestic market
- Foreign market
- Both

**15. What is the annual turnover of your business compared with last year?**

- Increased by 0–20%
- Increased by 20–50%
- Increased by 50–100%
- Increased by >100%
- About the same

- Decreased

**16. a. Do you regard financing difficulties as a constraint for the growth of your business?**

- Yes
- No

**b. What other serious constraints did you face in the start?**

- No new project
- No access to local market
- Lack of skilled personnel
- Heavy tax burden
- Competition from other firms
- Other (please specify)

**c. Did you have difficulty in obtaining finance during the Global Financial Crisis?**

- Yes
- No

**17. Have you ever thought of issuing stock to expand your business?**

- Yes
- No

**18. When and where did you obtain additional finance for expansion? (Please tick when the option applied)**

	First 5 years	Second 5 years	Last 5 years
Retained earnings			
Suppliers			
Bank loans			
Credit Union loans			
Corporate Bonds			
External Equity			
Informal Channels			

**IV. Funding source**

**19. a. Does your business have a bank account?**

- Yes
- No

**b. If so, where? (Please tick which option applied)**

- Industrial and Commercial Bank of China
- Bank of China
- China Construction Bank
- Agriculture Bank of China
- Bank of Communications
- China Ever-Bright Bank
- CITIC Industrial Bank
- China Minsheng Bank
- China Merchants Bank
- Huaxia Bank
- Zheshang Bank
- Rural Credit Cooperatives
- Other (please specify)

**c. Has your firm ever used a line of credit?**

**20. a. How often have you used the following channels for financial support in the last 12 months?**

No of times	Never	Once	Less than 5	More than 10	More than 20
Local Banks					
Non-bank source					

**b. How often have you used the following channels for financial support in the first year of your business?**

No of times	Never	Once	Less than 5	More than 10	More than 20
Local Banks					
Non-bank source					

**c. How easy has it been for you in the past to obtain financial support from the following sources in Zhejiang? Please tick number from 1 to 5 as appropriate to each factor.**

	Very easy		Neutral		Very hard
Access from local banks	1	2	3	4	5
Access from Non-bank source	1	2	3	4	5

**d. How easy has it been for you during the Global Financial Crisis to obtain financial support from the following sources in Zhejiang? Please tick number from 1 to 5 as appropriate to each factor.**

	Very easy		Neutral		Very hard
Access from local banks	1	2	3	4	5
Access from Non-bank source	1	2	3	4	5

**e. How easy is it for you NOW to obtain financial support from the following sources in Zhejiang? Please tick number from 1 to 5 as appropriate to each factor.**

	Very easy		Neutral		Very hard
Access from local banks	1	2	3	4	5
Access from Non-bank source	1	2	3	4	5

**21. a. What are the main reasons for you requiring a banking loan?**

- Start-up capital requirement



- Fixed asset investment
- Current asset needs
- Research and development
- Personnel training
- Other (please specify)

**b. What are the main reasons for you accessing non-banking finance?**

- Start-up capital requirement
- Fixed asset investment
- Current asset needs
- Research and development
- Personnel training
- Other (please specify)

**c. If you were unable to obtain bank finance, what are the main reasons for this?**

**Pick up to three options.**

- Small scale of the business
- Not state owned
- No credit guarantee
- No qualified collateral
- Policy constraints
- Lack of creditworthiness
- Lack of government connections
- Lack of business influence
- Other (please specify)

**d. What are the main reasons for not being able to obtain non-banking finance?**

- Small scale of the business
- No credit guarantee
- Lack of creditworthiness

- No good project
- Lack of social network
- Other (please specify)

**22. Has your business ever borrowed money from the following lending institutions?**

- Yes
- No

**If yes, please fill in the following table**

	When	Amount	length	Collateral(Y/N)	Purpose loan	Satisfaction (Y/N)	Interest Rate
Industrial and Commercial Bank of China							
Bank of China							
China Construction Bank							
Agriculture Bank of China							
Bank of Communications							
China Ever-bright Bank							
CITIC Industrial Bank							
China Minsheng Bank							
China Merchants Bank							
Huaxia Bank							
Zheshang Bank							
Rural Credit Cooperatives							
Others (Please specify)							

**23. Has your business ever borrowed money from the following?**

- Yes
- No

**If yes, please fill in the following table**

	When	Amount	length	Collateral(Y/N)	Purpose loan	Satisfaction (Y/N)	Interest Rate
Friend							
Relative							
Colleague							
Upstream Suppliers							
Downstream merchants							
Loan shark							
Pawn shop							
Cooperatives							
Others (Please specify)							

**24. Has your business ever issued any stock shares to the public?**

- Yes
- No

If yes, please fill in the following table

	When	Amount	Purpose of stock issue	Satisfaction (Y/N)
Shanghai Stock Exchange				
Shenzhen Stock Exchange				

**25. Have you ever lent money to a friend's or relative's business?**

- Yes
- No

**If so, what are the reasons?**

- Friend/relative has qualified collateral
- Friend has capability
- Friend is trustworthy
- Friend has good feasibility study for his/her plan
- Purely friendship

**26. Has your business have a credit rating?**

- Yes
- No

**27. Other issues**

If there are other important aspects to the growth of your business that the previous questions did not identify, please feel free to write them in the space provided below.

## **Chapter 3 Gaining further insight into SME financing in Zhejiang**

### **3.1 Introduction**

In chapter 2, we mainly focus on the status quo of SME financing in Zhejiang Province and exploring the role played by formal and informal financing. Through consulting the literature, we have designed a tailor-made questionnaire to learn the basic information, such as business establishment, business growth, and funding sources, of the firms. With the data collected from the 150 valid copies of the questionnaire, a brief understanding of these firms and their financing situation has been gained. In this chapter, we adopt various empirical methods to analyze the relationship between the use of formal (informal) lending and other factors. Correlation analysis, a binary regression model, and an ordered logistic regression model are applied to the collected questionnaire data. With this empirical investigation, we further explore what impact these reputation and relationship variables may have on the financing practices these firms employ. The investigation of the status of the SMEs' financing situation in this chapter will provide a vital footing for policy suggestions to be proposed in the next chapter.

### **3.2 Literature review**

In this section, we propose six hypotheses based on the relevant literature.

Rona-Tas (1994) suggests that political power is converted into economic advantage when planned economies start to transform themselves into market systems. In his paper, he found that the ex-communist cadres or party bureaucrats maintain their advantageous position when they become entrepreneurs and that these entrepreneurs do extremely well in the dynamic business sector. Vicziany and Zhang (2004, 2005a) conducted case studies of private enterprises in western China and showed that political connections are helpful for the most successful private entrepreneurs, especially if they begin business as green-field private enterprises. Based on three case studies, including two of Xinjiang's leading millionaire entrepreneurs, they show

that party connections help in developing local markets, provide clients for fledgling businesses, and facilitate access to credit.

Zhou (2009) conducted regression analysis and suggested that legislative membership is associated with a lower self-reported degree of difficulty in obtaining bank loans and a higher probability of access to bank loans for private entrepreneurs, that higher-level legislative membership is more useful in solving bank financing obstacles, and that such memberships in general are more helpful for SMEs.

Choi and Zhou (2001) also argued that the importance of political connections for Chinese entrepreneurs increased as the scale of the business grows. State patronage, in particular, was needed to help Chinese firms overcome the uncertainty that frequently surrounded their legal status. Khwaja and Mian (2005) argue that banks favor politically connected firms in less developed economies. Zhang (2008) argues that access to political and bureaucratic networks may be reflected in the private entrepreneurs' choice of financing strategies.

Nofsinger and Wang (2011) find that the legal environment is important for access to external financing. The amount and diversity of sources of external financing are associated with high levels of property rights, contract enforcement, and corruption protection.

Ruziev and Midmore (2015) investigate the effects of interpersonal links with bureaucrats on SME access to formal finance. A survey of 502 SMEs in post-communist Uzbekistan showed that fewer SMEs with government connections express a need for external finance and that the success rates of applications for loans are higher for SMEs with connections compared to those without connections. Econometric models show that government-connected SMEs receive more formal credit than their counterparts. The small share of SME credit available is thus distributed to those capitalizing on bureaucratic links, which leads to resource

misallocation. These findings imply that greater SME credit flow require an improvement in bank transparency and efficiency.

Hence, we formulate the following hypothesis:

**Hypothesis 1:** Firms with close political or bureaucratic ties are more likely to use formal financing than those with fewer political connections.

Solinger (1999) concludes that migrant entrepreneurs face more problems compared with their native counterparts in employment prospects and access to political support. Zhao (2003) found that migrant networks play an important role in the survival of new migrants and that experienced migrants have a positive and significant effect on subsequent migration. In some cases, the migration of people is driven by entrepreneurial ambition, as in the case of the minority Uyghur who have migrated from Xinjiang to Beijing and Shanghai (Vicziány and Zhang, 2005b). Zhang (2008) found that even migrants who are able to develop their own financial responses to capital scarcity face more political, bureaucratic, and community obstacles in accessing local capital sources beyond their immediate family, relatives, and migrant community.

Chen (2004) argues that it would be a reasonable assumption that the raw entrepreneurs amongst the migrant population also suffer from relative marginalization. Since they could not obtain the funds from the community, they may have to tap into the informal channel. Vos, Yeh, and Carter (2007) find that social networks and connections are important for accessing finance. Zhang (2008) showed that a native of Chengdu is more likely to employ formal financing practices than immigrants by empirical investigation.

Hence, we propose the following hypothesis:

**Hypothesis 2:** Native entrepreneurs are more likely to use formal financing than immigrant entrepreneurs.

Boshoff and Schutte (1998) argue that education level is one of the main predictors of entrepreneurial success in a developing country. Li, Rozelle, and Zhang (2004) found that minimal educational competence is essential for reading bank passbooks, understanding the length and conditions of loans, and being able to monitor loan repayments in order to prevent fraud by the lending agency. In a study by Vos, Yeh, and Carter (2007) using UK and US data, they find that younger and less educated SME owners are more likely to actively seek external financing than older and more educated SME owners. Nofsinger and Wang (2011) studied the determinants of external financing in initial firm start-ups in 27 countries and found that entrepreneurial experience is helpful in obtaining financing from institutional investors.

Hence, we formulate the following hypothesis:

**Hypothesis 3:** Entrepreneurs with a higher education level are more likely to use formal financing than those with a lower education level.

Stuart and Abetti (1990) established the relationship between business experience and entrepreneurial performance and found a strong positive correlation, and other studies have found similar results. (e.g. Sandberg & Hofer, 1987; Vesper, 1980).

Hence, we propose the following hypothesis:

**Hypothesis 4:** Entrepreneurs with longer-term business experience are more likely to use formal financing than those with shorter-term business experience.

Frame, Srinivasan, and Woosley (2001) find that credit scoring is associated with an 8.4% increase in the amount of credit extended to small businesses. Frame, Padhi, and Woosley (2004) used two additional dimensions in their study of the characteristics of credit-scored loan recipients: income levels and the location of a firm. Frame, Padhi, and Woosley (2004) use the US case to examine how credit scoring reduced

uncertainty about borrowers (known as informational opacity) and made it possible for lenders to provide loans with longer repayment periods (namely, extended loan maturity).

Hence, we formulate the following hypothesis:

**Hypothesis 5:** Firms that have received a credit rating are more likely to use formal financing than those that have not.

Petersen and Rajan (1994) argued that the amount of information banks can acquire is usually much less in the case of smaller firms due to limited information about their investment opportunities and managerial capabilities. In addition, the extent of credit rationing applied to small firms might occur simply because they are not well collateralized. De la Torre, Soledad, Per á, and Schmukler (2010) also attribute difficult in SME access to finance to opaqueness that makes it difficult to ascertain whether firms have the capacity (by investing in viable projects) and the willingness (moral hazard factors) to pay. This opaqueness particularly undermines credit access from institutions that engage in more impersonal or arms-length financing, which requires hard, objective, and transparent information. Gertler and Gilchrist (1994) also argue that firm size itself is a critical determinant in accessing external finance. The International Finance Corporation (2000) argues that smaller businesses are less able to provide appropriate information (financial statements) when applying for credit through formal financial institutions, and hence, they tend to employ informal financing practices due to the low requirements for information. Beck, Demirgüç-Kunt, and Maksimovic (2008) find that small firms and firms in countries with poor institutions use less external finance, especially bank finance, leasing, or trade finance, compared with larger firms. They also find that larger firms can more easily expand their external financing when they are financially constrained than can small firms, and they find suggestive evidence supporting the pecking order hypothesis across countries.



Hence, we propose the following hypothesis:

**Hypothesis 6:** Firms with a larger turnover are more likely to use formal financing than those with a smaller turnover.

### 3.3 Research design

In Chapter 2, we have collected data from 150 valid questionnaires, and basic descriptive analysis was also conducted. In this chapter, we further reveal the relationship between the usage of formal (informal) financing channels and firm characteristics with correlation and regression analyses.

The main equations to be tested are as follows:

Binary regression:

$$UFM = C (1)*POL + C (2)*NAT + C (3)*EDU + C (4)*BEX + C (5)*CRE + C (6)*SIZE + C + \varepsilon ; \quad [1]$$

$$UIFM = C (1)*POL + C (2)*NAT + C (3)*EDU + C (4)*BEX + C (5)*CRE + C (6)*SIZE + C + \varepsilon ; \quad [2]$$

Ordered regression:

$$FDC = C (1)*POL + C (2)*NAT + C (3)*EDU + C (4)*BEX + C (5)*CRE + C (6)*SIZE + C + \varepsilon ; \quad [3]$$

$$FDP = C (1)*POL + C (2)*NAT + C (3)*EDU + C (4)*BEX + C (5)*CRE + C (6)*SIZE + C + \varepsilon ; \quad [4]$$

$$FDN = C (1)*POL + C (2)*NAT + C (3)*EDU + C (4)*BEX + C (5)*CRE + C (6)*SIZE + C + \varepsilon ; \quad [5]$$

Here, we give the definition of the dependent and independent variables in advance.

#### **Dependent variables:**

*UFM* stands for the respondent's use of formal financing channels; the value is from question 22. *UFM* with value "1" means that the respondent has used the formal financing channels while *UFM* with value "0" means the opposite. By definition, it is a dichotomous variable.

*UIFM* stands for the respondent's use of informal financing channels; the value is from question 23. *UIFM* with value "1" means that the respondent has used the informal financing channels while *UIFM* with value "0" means the opposite. By definition, it is a dichotomous variable.

*FDC* stands for the respondent's feeling of difficulty in obtaining funds from formal financing channels during the recent international financial crisis; the value is from question 20. *FDC* ranges from 1 to 5 (1 = very easy, 5 = very difficult). By definition, it is an ordered variable.

*FDP* stands for the respondent's feeling of difficulty in obtaining funds from formal financing channels in the past; the value is from question 20. *FDP* ranges from 1 to 5 (1 = very easy, 5 = very difficult). By definition, it is an ordered variable.

*FDN* stands for the respondent's feeling of difficulty in obtaining funds from formal financing channels now; the value is from question 20. *FDN* ranges from 1 to 5 (1 = very easy, 5 = very difficult). By definition, it is an ordered variable.

Due to the fact that in questions 20a, 20b, and 20c, the respondents chose to answer the question in the first line but neglected to answer the second line, we have collected the full sample from the first line. Therefore, *FDC*, *FDP*, and *FDN* are also retrieved from the first line from 20d, 20c, and 20e (namely, the formal financing channels).

**Independent variables:**

*POL* stands for political or bureaucratic connections of the respondents; the value is from question 7a. *POL* with value "1" means that there are political or bureaucratic connections while *POL* with value "0" means the opposite. The reason for the selection is that all the respondents answered question 7a while questions 7b to 7g were rarely answered. By definition, it is a dichotomous variable. According to Choi

and Zhou (2001) and Zhang (2008), entrepreneurs with strong political ties in China can easily obtain funds from the formal channels. Hence, we predict that a positive relationship exists between *POL* and *UFM*. Similarly, firms without such political ties may have to tap the informal financing markets to obtain funds. As for *FDC*, *FDP*, and *FDN*, we predict that closer political ties will enable the entrepreneur to access the funds more easily from the formal financing channel. In China, firms with strong political connections are likely to obtain funds while merely having such funds is not helpful in building or strengthening political connections. Hence, the variable *POL* cannot be endogenous.

*NAT* stands for respondents' origin, the value that is retrieved from question 4. *NAT* with value "1" means that the respondent is a native of Zhejiang Province while *NAT* with value "0" means the opposite. By definition, it is a dichotomous variable. From the business practice, local people may find it easier to obtain funds from formal channels especially in urban and rural cooperatives. Moreover, due to their residence in Zhejiang Province, it is also highly likely that they shall have access to the "local civilian lending." Hence, it is likely that a positive relationship exists between *NAT* and *UFM* (*UIFM*). As for *FDC*, *FDP*, and *FDN*, we predict that native entrepreneurs will find it easier to access funds from the formal financing channel. In Zhejiang Province, local entrepreneurs are likely to obtain funds while there is no relationship between having obtained funds and being local people. Hence, the variable *NAT* cannot be endogenous.

*EDU* stands for the education level of the respondent; the value is from question 3. *EDU* with value "1" means that the education level is primary school; *EDU* with value "2" means that the education level is junior middle-school; *EDU* with value "3" means that the education level is senior high-school; *EDU* with value "4" means that the education level is vocational training; *EDU* with value "5" means that the education level is college; *EDU* with value "6" means that the education level is graduate school. As study (Li, Rozelle, and Zhang, 2004) have suggested, a strong

relationship exists between the education level and the access to formal financing channels. Hence, we predict that the sign of the coefficient between *EDU* and *UFM* should be negative (the higher the number, the higher likelihood that the *UFM* is 1.) In China, it is usually the case that entrepreneurs with higher education levels seek funds from formal channels. Hence, we predict that the sign of the coefficient between *EDU* and *UIFM* should be positive. As for *FDC*, *FDP*, and *FDN*, we predict that entrepreneur with a high level of education will find it easier to access the funds from the formal financing channel. However, these elites may tap the informal funding markets to speculate. They borrow money from the informal markets, use it as collateral to get a loan from the banks (this works as leverage), and then lend it out in informal markets with a higher rate. Sometimes, the margin may be wide and almost risk-free when the informal financing market remains tranquil and stabilized. In Zhejiang Province, entrepreneurs having received higher education are likely to obtain funds; however, we cannot conclude that obtaining funds is related to a higher level of education. Hence, the variable *EDU* cannot be endogenous.

*BEX* variable stands for the business experience of the respondent; the value is from question 9. The respondents answered this question with the year, and then we get the number by subtracting 2009 (e.g., if the answer is 2010, then the number of years of business experience is one year). According to financial growth-cycle theory, long-term business experience could bring entrepreneurs easier access to formal funding while early entrepreneurs may have to tap into the informal funding markets. Hence, we predict that a positive relationship exists between *BEX* and *UFM* while a negative relationship exists between *BEX* and *UIFM*. As for *FDC*, *FDP*, and *FDN*, we predict that sophisticated entrepreneurs will find it easier to access the funds from the formal financing channel. In Zhejiang Province, entrepreneurs with sophisticated business experience are likely to obtain funds while we cannot reach the conclusion that obtaining funds is related to sophisticated business experience. Hence, the variable *AGE* cannot be endogenous.

*CRE* variable stands for the credit rating status of the respondent; the value is from question 26. *CRE* with value “1” means that the respondent has received a credit rating while *CRE* with value “0” means the opposite. By definition, it is a dichotomous variable. It is highly likely that firms having received a credit rating may have already been approved for a loan application. Intuitively, these firms may not need to tap the informal funding market. Hence, a positive relationship exists between *CRE* and *UFM* while a negative relationship exists between *CRE* and *UIFM*. As for *FDC*, *FDP*, and *FDN*, we predict that firms with a credit rating will find it easier to access funds from the formal financing channel. In Zhejiang Province, firms that have received a credit rating are likely to obtain funds while we cannot conclude that obtaining funds is related to having received a credit rating. The common practice is that when firms have obtained funds from formal institutions like banks, banks have already conducted a credit rating on the firm. The firms may resort to other institutions for further funds or to diversify their financing channels. Other institutions might also assign them a rating. However, it must be clarified that the ratings assigned by other institutions are based on the extant financing practice, or in other words, the credit rating assigned by the finance providers. Hence, the variable *CRE* cannot be endogenous.

*SIZE* stands for the turnover of the respondent; the value is from question 6. *SIZE* with value “1” means that the annual business turnover is less than 100,000 Chinese Yuan; *SIZE* with value “2” means that the annual business turnover is in the range 100,000–999,999 Chinese Yuan; *SIZE* with value “3” means that the annual business turnover is in the range 1,000,000–9,999,999 Chinese Yuan; *SIZE* with value “4” means that the annual business turnover is more than 10,000,000 Chinese Yuan. Usually, firms with a large turnover have better access to the formal funding market while applications from small- and medium-sized firm are rejected. Hence, we predict that a negative relationship exists between *SIZE* and *UFM* while a positive relationship exists between *SIZE* and *UIFM*. As for *FDC*, *FDP*, and *FDN*, we predict that firms with a larger turnover will find it easier to access the funds from the formal

financing channel. In Zhejiang Province, firms of larger size are likely to obtain funds while we cannot conclude that obtaining funds is related to larger size. Hence, the variable *SIZE* cannot be endogenous.

*AGE* stands for the age of the respondent; the value is from question 1. *AGE* with value “1” means that the respondent’s age is 0–20 years; *AGE* with value “2” means that the respondent’s age is 20–29 years; *AGE* with value “3” means that the respondent’s age is 30–39 years; *AGE* with value “4” means that the respondent’s age is 40–49 years; *AGE* with value “5” means that the respondent’s age is over 50 years. In Zhejiang Province, older entrepreneurs are likely to obtain funds while we cannot conclude that obtaining funds is related to the entrepreneurs being elder. Hence, the variable *BEX* cannot be endogenous.

Based on the introduction of the dependent and independent variables, we conduct regression analysis of two types, binary regression and ordered regression.

### **3.4 Descriptive statistics and correlation analysis**

Before proceeding to the regression analysis, we present the descriptive statistics and conduct correlation analyses to roughly test the correlation among variables.

In panel 1, we present the descriptive statistics for all the variables.

We have five binary variables: *NAT*, *CRE*, and *POL* as independent variables and *UFM* and *UIFM* as dependent variables. The mean and median values show that they are all inclined to value 0, indicating that more people are not native, have not been credit rated, have no political connections, and have used neither the formal nor informal financing channels. Among them, *POL* has the lowest standard deviation.

*BEX* is the only continuous variable. Its mean value is 6. The relatively low value shows that most of the respondents are not quite sophisticated in business experience.

The rest are all ordered variables. The respondents on average have received vocational training, were aged between 30 and 39, and had an annual turnover ranging from 1 to 10 million. Dependent variables *FDP*, *FDC*, and *FDN* share similar mean and median values, which shows that the feeling about financing constraints changes little over time. The higher mean and median values of *FDC* show that the financing crisis had some additional negative impact on respondents' financing availability.

### 3.4.1 Descriptive statistics<sup>3</sup>

Panel 1: the descriptive statistics of all the variables

	<i>AGE</i>	<i>BEX</i>	<i>CRE</i>	<i>EDU</i>	<i>FDN</i>	<i>FDC</i>	<i>FDP</i>	<i>NAT</i>	<i>POL</i>	<i>SIZE</i>	<i>UFM</i>	<i>UFIM</i>
Mean	3.26	6.07	0.26	3.99	3.59	4.04	3.64	0.44	0.10	3.01	0.44	0.38
Median	3.00	5.00	0.00	4.00	4.00	4.00	4.00	0.00	0.00	3.00	0.00	0.00
Maximum	5.00	13.00	1.00	6.00	5.00	5.00	5.00	1.00	1.00	4.00	1.00	1.00
Minimum	1.00	1.00	0.00	1.00	1.00	1.00	1.00	0.00	0.00	1.00	0.00	0.00
Std. Dev.	1.19	3.34	0.44	1.48	1.09	1.03	0.97	0.50	0.30	0.95	0.50	0.49
Skewness	0.04	0.38	1.12	-0.42	-0.23	-0.72	-0.52	0.26	2.65	-0.59	0.26	0.51
Kurtosis	1.85	2.21	2.26	2.19	1.99	2.61	2.80	1.07	8.05	2.35	1.07	1.26

Note: *POL* = political or bureaucratic connections of the respondents; *NAT* = whether the respondent is a native of Zhejiang Province; *EDU* = education level of the respondent; *BEX* = business experience of the respondent; *CRE* = credit rating status of the respondent; *SIZE* = turnover of the respondent; *AGE* = age of the respondent; *UFM* = respondent's use of formal financing channels; *UFIM* = respondent's use of informal financing channels; *FDC* = respondent's feeling of difficulty in obtaining funds from formal financing channels during the recent international financial crisis; *FDP* = respondent's feeling of difficulty in obtaining funds from formal financing

<sup>3</sup> All of the empirical results in this project were obtained by using software SPSS version 13.0.

channels in the past; *FDN* = respondent's feeling of difficulty in obtaining funds from formal financing channels now.

### 3.4.2 Correlation analysis

#### 3.4.2.1 Correlation between various independent variables

In this section, we detect the existence of potential multicollinearity between the independent variables. The correlation matrix of all variables is presented in Table 3.1.

**Table 3.1: Correlation matrix of all variables**

	<i>EDU</i>	<i>NAT</i>	<i>BEX</i>	<i>AGE</i>	<i>CRE</i>	<i>SIZE</i>	<i>POL</i>	<i>UFM</i>	<i>UIFM</i>	<i>FDP</i>	<i>FDC</i>	<i>FDN</i>
<i>EDU</i>	1.00	-0.12	-0.11	-0.37**	0.14	-0.09	-0.07	-0.61**	0.06	-0.08	-0.12	-0.10
<i>NAT</i>		1.00	0.18*	-0.11	0.02	-0.11	0.29**	0.05	0.01	0.15	0.01	0.11
<i>BEX</i>			1.00	0.11	-0.06	0.11	-0.05	0.01	0.14	-0.17*	-0.17*	-0.06
<i>AGE</i>				1.00	-0.26	0.43**	-0.21	0.11	0.03	0.07	0.12	0.09
<i>CRE</i>					1.00	-0.29**	0.01	0.02	0.08	-0.17*	-0.23**	-0.28**
<i>SIZE</i>						1.00	-0.12	0.02	0.05	-0.01	0.17	0.08
<i>POL</i>							1.00	0.11	0.06	0.45**	0.47**	0.32

\*\* Correlation is significant at the 0.01 level (two-tailed).

\* Correlation is significant at the 0.05 level (two-tailed).

Note: *POL* = political or bureaucratic connections of the respondents; *NAT* = whether the respondent is a native of Zhejiang Province; *EDU* = the education level of the respondent; *BEX* = business experience of the respondent; *CRE* = credit rating status of the respondent; *SIZE* = turnover of the respondent; *AGE* = age of the respondent; *UFM* = respondent's use of formal financing channels; *UIFM* = respondent's use of informal financing channels; *FDC* = respondent's feeling of difficulty in obtaining funds from formal financing channels during the recent international financial crisis;



*FDP* = respondent's feeling of difficulty in obtaining funds from formal financing channels in the past; *FDN* = respondent's feeling of difficulty in obtaining funds from formal financing channels now.

Using a rule-of-thumb (Zhang, 2008), a correlation coefficient of more than 0.6 suggests potential multicollinearity. As shown in Table 3.1, the correlation coefficients between each pair of independent variables are less than 0.6. Thus, there should not be any potential multicollinearity between the independent variables. Therefore, all of the independent variables discussed above could be included in the regression models.

#### **3.4.2.2 Correlation between independent variables and dependent variables**

In this part, we roughly explore the relationship between the independent and dependent variables. The correlation matrix of independent variables is presented in Table 3.1.

As shown in Table 3.1, the correlation coefficient between education and use of formal financing channels is more than 0.6, indicating that significant correlation exists between these two variables. However, no significant correlation is detected between any dependent variable and independent variable.

#### **3.4.2.3 Correlation between various dependent variables**

From Table 3.1, we also find that *FDC*, *FDN*, and *FDP* are highly correlated with each other, indicating that the feeling of difficulty in obtaining funds from formal financing channels changed little with time.

### 3.5 Regression analysis

#### 3.5.1 Binary logistic regression analysis

When the dependent variable is dichotomous, binary logistic regression should be used. Hence, binary regression analysis is used here for the variables *UFM* and *UIFM*. Table 3.2 and 3.3 show the regression results for the variables *UFM* and *UIFM*, respectively.

From Table 3.2, we find that the regression model could reliably distinguish the respondents who chose the formal financing channels or not (the log-likelihood value is 130.87). A further look at the results tells us that the signs of the coefficients of the statistically significant independent variables, such as the education level and credit rating, are just as predicted.

From Table 3.2, the odd ratios for the variables *CRE*, *BEX*, *SIZE*, and *POL* are 2.41, 0.98, 0.96, and 2.1, respectively. In particular, the odds ratio indicates that the likelihood of obtaining funds from formal channels is 2.41 times higher for the respondents with closer political connections than those without. Similarly, the likelihood is 2.1 times higher for the respondents with a credit rating than those without.

These results show that in our sample, hypotheses 1, 3, and 5 can be justified. Respondents with strong political connections are more inclined to use the formal financing channel than those without (consistent with Choi and Zhou, 2001). Entrepreneurs with a higher education level are more inclined to use more formal financing than those with a lower education level (consistent with Li, Rozelle, and Zhang, 2004). Firms having received a credit rating are more inclined to use more formal financing than those without (consistent with Padhi, and Woosley's (2004) findings in US cases).

However, the coefficient for the variables *NAT* and *BEX* is not statistically significant; the odds ratio for *SIZE* is also insignificant. In other words, hypotheses 2, 4, and 6 cannot be justified. Here, we explain these inconsistencies.

For the variable *NAT*, we argue that the nativeness may have an effect if urban and rural cooperatives are the major formal financing channels in the respondents' jurisdiction. However, in our sample, there are only 12 cases for these two types of financial institution, and hence, the role of nativeness could not be brought fully into play.

For the variable *BEX*, the results seem to be counter to what the theory claims. A probable reason is that Chinese entrepreneurs with long-term business experience may not have the advantage of being shielded against the power of economic cycle and firms' own life-cycle. On one hand, the life-cycles of the private enterprises tend to be short in China. Even people with long-term business experience tend to be vulnerable when economic crisis occur. On the other hand, the legal framework in China is not sound enough to protect private property. People with long-term business experience may still have a strong memory about the era prior to the reform and opening-up period. They may have other concerns when they resort to formal institutions for financing.

Similar to the explanation given for the variable *BEX*, turnover may not directly lead to easier access to formal financing. In China, turnover is a plus for obtaining loans from financial institutions but it cannot ensure that banks would lend to a firm just based on their size. Firms belonging to encouraged industries, such as high-tech industries and the internet, may be able to get financing with their intellectual property rights as collateral despite being quite small in size. However, firms belonging to discouraged industries, such as iron and shipping, are prohibited from having access to funds no matter how big they are.

**Table 3.2: The binary logistic regression results for the variable *UFM*.**

3.2.1 Model summary

-2 Log likelihood	Cox and Snell R-Square	Nagelkerke R-Square
130.869	0.391	0.525

3.2.2 Parameter estimation

Variable	B	S.E.	Wald	Sig.	Odds ratio
<i>EDU</i>	1.402	0.23	37.1	<0.001	0.246
<i>NAT</i>	-0.298	0.471	0.399	0.528	0.743
<i>BEX</i>	-0.017	0.071	0.055	0.815	0.984
<i>CRE</i>	0.881	0.55	2.57	0.099	2.414
<i>SIZE</i>	0.037	0.25	0.021	0.883	0.964
<i>POL</i>	0.737	0.785	0.883	0.347	2.091
Constant	3.68	1.049	12.297	<0.001	39.636

Note: *UFM* = respondent's use of formal financing channels; *POL* = political or bureaucratic connections of the respondents; *NAT* = whether the respondent is a native of Zhejiang Province; *EDU* = education level of the respondent; *BEX* = business experience of the respondent; *CRE* = credit rating status of the respondent; *SIZE* = turnover of the respondent's firm.

**Table 3.3: The binary logistic regression results for *UIFM***

3.3.1 Model summary

-2 Log likelihood	Cox and Snell R-Square	Nagelkerke R-Square
192.422	0.044	0.06

### 3.3.2 Parameter estimation

Variable	B	S.E.	Wald	Sig.	Odds ratio
<i>EDU</i>	0.099	0.118	0.699	0.403	1.104
<i>NAT</i>	-0.135	0.374	0.131	0.717	0.873
<i>BEX</i>	0.106	0.056	3.643	0.056	1.112
<i>CRE</i>	0.508	0.412	1.519	0.218	1.661
<i>SIZE</i>	0.174	0.194	0.804	0.37	1.19
<i>POL</i>	0.64	0.589	1.178	0.278	1.896
Constant	-2.138	0.792	7.295	0.007	0.118

Note: *UIFM* = respondent's use of informal financing channels; *POL* = political or bureaucratic connections of the respondents; *NAT* = whether the respondent is a native of Zhejiang Province; *EDU* = education level of the respondent; *BEX* = business experience of the respondent; *CRE* = credit rating status of the respondent; *SIZE* = turnover of the respondent's firm.

As for the *UIFM* binary logistic regression model, few of the coefficients are statistically significant. The coefficient for *BEX* is statistically significant, with the sign unexpected. The coefficient is positive when we expect it to be negative. The odds ratio of variable *BEX* is also relatively low. Thus, no hypothesis proposed could be proved by this model. The implication is that people of different age, educational background, nativeness, and business experience might resort to the informal channels. This finding coincides with what we observe from daily life: the practice of informal financing in Zhejiang Province is universal and widespread.

For the variable age, young entrepreneurs may have to tap into the informal funding market due to the fact that the firm is still in its infancy. However, it is also likely that the older entrepreneur may also go to the informal funding market for help when their firm faces temporary financial difficulties. For the variable education background, a probable reason for the unexpected sign may be that when the monetary policy tightens in China, firms may have no credit at all, and in this case, entrepreneurs—regardless of their education—may resort to the informal funding market.

For the variable nativeness, the result implies that the informal funding market does not distinguish the client based on their origin and so the entrepreneurs from different regions may all have the chance to employ the informal funding practices. For the variable business experience, the explanation for the unexpected sign is similar to that for the variable age. Early entrepreneurs may have to tap into the informal funding market due to the fact that the firm is still in its infancy; however, it is likely that the sophisticated entrepreneur may also go to the informal funding market for help when in financial difficulty.

### **3.5.2 Ordered logistic regression analysis**

In this section, ordinal regression is adopted in which the dependent variable is an ordered one. The ordered logistic regression analysis is based on the assumption that the dependent variable can be ordered in terms of the degree of difficulty in obtaining funds from the formal financing channel. The results of these three regression equations reflect the probability that a given independent variable has an effect on each ordered degree of the dependent variable. Tables 3.4–3.6 show the regression results for the variables *FDC*, *FDP*, and *FDN*, respectively. Here, we analyze the results separately.

From Table 3.4, we see that the coefficients of *POL* and *CRE* are statistically significant at the 1% threshold level while the coefficients of *BEX* and *SIZE* are statistically significant at the 5% threshold level. The coefficient of *EDU* and *NAT* are not statistically significant. The results show that during financial crises, political patronage, sophisticated business experience, larger turnover, and credit rating status can help the entrepreneur obtain funds. However, the effect of locality and level of education seem to be negligible. An explanation for these findings is as follows: when a crisis hits, formal institutions like commercial banks tend to be risk averse and unwilling to lend to SMEs that they are not familiar with. Political patronage,

sophisticated business experience, larger turnover, and credit rating status are effective indicators to ensure the banks that the firm is safe while indicators like locality and higher education are not effective in this regard.

From Table 3.5, we see that the coefficients of *POL* and *CRE* are still statistically significant at the 1% threshold level and the coefficient of *BEX* is still statistically significant at the 5% threshold level. The coefficients of *EDU*, *NAT*, and *SIZE* are not statistically significant. These results show that political patronage, sophisticated business experience, and having a credit rating helped the firm obtain funds in the past. An explanation of these findings is as follows: unlike during the crisis period, during the relatively tranquil period (no credit rationing or credit control), immigrant entrepreneurs or entrepreneurs with a lower education level, as well as smaller firms, could all fetch the funds.

From Table 3.6, we see that the coefficients of *POL* and *CRE* are statistically significant at the 1% threshold level. The coefficients of *EDU*, *NAT*, *SIZE*, and *BEX* are not statistically significant. These results show that political patronage and having received a credit rating help the firm to obtain funds now. However, business experience seems to be ineffective for the firm to successfully obtain funds from normal institutions. A probable reason for this result is that the second generation of the officials or successful businessman may enter into the business. They have strong political ties but no “sophisticated business experience” themselves.

Combining these results, we see that political ties and having received a credit rating are quite robust in helping the entrepreneurs to obtain funds in different periods while other factors may only work at specified times.

**Table 3.4: The ordered logistic regression results for *FDC*.**

Model fitting information

Model	-2 Log likelihood	Chi-Square	Significance.
Intercept only	373.484		
Final	313.617	59.687	<0.001

Parameter estimation

	a	Estimate	S.E.	Wald	Sig.
Threshold	<i>FDC</i> =1	-0.819	0.678	1.459	0.227
	<i>FDC</i> =2	0.586	0.676	0.751	0.386
	<i>FDC</i> =3	3.109	0.783	15.766	<0.001
	<i>FDC</i> =4	5.079	1.035	24.102	<0.001
Location	<i>EDU</i>	-0.084	0.108	0.598	0.439
	<i>NAT</i>	-0.394	0.347	1.291	0.256
	<i>BEX</i>	-0.113	0.050	5.107	0.024
	<i>CRE</i>	-1.124	0.414	7.361	0.007
	<i>SIZE</i>	0.436	0.177	6.058	0.014
	<i>POL</i>	3.685	0.653	31.811	<0.001

Note: *FDC* = respondent's feeling of difficulty in obtaining funds from the formal financing channels during the recent international financial crisis; *POL* = political or bureaucratic connections of the respondents; *NAT* = whether the respondent is a native of Zhejiang Province; *EDU* = education level of the respondent; *BEX* = business experience of the respondent; *CRE* = credit rating status of the respondent; *SIZE* = turnover of the respondent's firm.



**Table 3.5: The ordered logistic regression results for *FDP*.**

Model fitting information

Model	-2 Log likelihood	Chi-Square	Sig.
Intercept only	390.151		
Final	344.414	45.737	<0.001

Parameter estimation

	a	Estimate	S.E.	Wald	Sig.
Threshold	<i>FDP=1</i>	-2.640	0.706	13.980	<0.001
	<i>FDP=2</i>	-0.305	0.665	0.211	0.646
	<i>FDP=3</i>	1.545	0.700	4.868	0.027
	<i>FDP=4</i>	3.955	0.928	18.165	<0.001
Location	<i>EDU</i>	-0.049	0.105	0.218	0.641
	<i>NAT</i>	0.306	0.335	0.835	0.361
	<i>BEX</i>	-0.115	0.049	5.556	0.018
	<i>CRE</i>	-1.104	0.383	7.008	0.008
	<i>SIZE</i>	0.021	0.173	0.015	0.904
	<i>POL</i>	2.937	0.605	23.566	<0.001

Note: *FDP* = respondent's feeling of difficulty in obtaining funds from the formal financing channels in the past; *POL* = political or bureaucratic connections of the respondents; *NAT* = whether the respondent is a native of Zhejiang Province; *EDU* = the education level of the respondent; *BEX* = business experience of the respondent; *CRE* = credit rating status of the respondent; *SIZE* = turnover of the respondent's firm.

**Table 3.6: The ordered logistic regression results for *FDN*.**

## Model fitting information

Model	-2 Log likelihood	Chi-Square	Sig.
Intercept Only	411.393		
Final	380.223	31.17	<0.001

## Parameter estimation

	a	Estimate	S.E.	Wald	Sig.
Threshold	<i>FDN=1</i>	-1.579	0.660	5.713	0.017
	<i>FDN=2</i>	-0.056	0.645	0.008	0.931
	<i>FDN=3</i>	1.399	0.660	4.491	0.034
	<i>FDN=4</i>	4.437	0.962	21.280	<0.001
Location	<i>EDU</i>	-0.043	0.102	0.177	0.674
	<i>NAT</i>	0.251	0.324	0.600	0.438
	<i>BEX</i>	-0.048	0.047	1.060	0.303
	<i>CRE</i>	-1.200	0.374	10.283	0.001
	<i>SIZE</i>	0.125	0.168	0.552	0.458
	<i>POL</i>	1.917	0.557	11.822	0.001

Note: *FDN* = respondent's feeling of difficulty in obtaining funds from the formal financing channels now; *POL* = political or bureaucratic connections of the respondents; *NAT* = whether the respondent is a native of Zhejiang Province; *EDU* = education level of the respondent; *BEX* = business experience of the respondent; *CRE* = credit rating status of the respondent; *SIZE* = turnover of the respondent's firm.

A review of the explanatory variables reveals that these are actually good indicators of reputation and relationships in the informal financing literature. Political connections, nativeness, and education level can be used to measure the respondents' social relationships, and even reputation while credit rating could be seen as scale for creditworthiness, and business experience can also be considered as a measure of reputation. The empirical results show that these factors—especially political connection and credit rating status—have a significant impact on formal financing of

the small private firms. It could be concluded that relationship and reputation also play important roles in formal financing in China although they are conventionally labeled as the main characteristics of informal mechanisms.

However, no significant factors could be found in regards to obtaining funds from informal channels. Irrespective of whether people had political connections, were local, had received higher or lower level of education, had sophisticated business experience, or had a credit rating, the respondents could all tap into the informal markets. Such a finding is crucial since the informal financing practice is universal and widespread. Pertinent micro-policies might not take effect and strategic macro-policies have to be made to ensure the stability of the whole financial system.

It could be questioned why, if the formal financial system does not play an important role in supporting SMEs, are SMEs hurt most when the formal financial system is in trouble. This situation could be elaborated from the following aspects:

- 1) The decisive factors for SMEs to develop and prosper are multifaceted. Both external and internal factors could exert vital impact. External factors include government factors, industry environment, market environment and regional environment; internal factors include enterprise resources, organizational structure, corporate culture, financing capacity, strategic management, innovative awareness and the quality of entrepreneurs. (Zhang, 2007; Chen, 2009). Financing is only one of the important factors.
- 2) Although informal financing is one of the most important factors, it does not rule out the use of formal finance channels. Our investigation showed that 43% of respondents have used formal financing despite the difficulty in obtaining it. As we learnt from the interviews, the situation of SMEs' formal financing has improved.
- 3) Informal financing is rather complex, and we have learnt that part of the formal funding channel has flown to the informal market through various channels. This finding implies that the formal market and the informal market are intertwined. When

the formal market is tightened, the informal market will also be dampened, thus pushing the cost of funding up.

4) The reason why the informal market could effectively fill the financing is that these funds can satisfy a higher return. When the economy slows down, the return from industry is lower and the funds will go elsewhere like speculative asset markets. Meanwhile, with the economy slowdown, internal funds also shrink, and thus SMEs will face financing pressure from both internal and external channels.

### **3.6 Conclusion**

In this chapter, we gain further insight to SME financing in Zhejiang. From the empirical results, we find that firms with strong political ties, higher education, larger turnover, and having received a credit rating are more likely to employ formal financing practices. No consistent results are found for informal financing practices. Moreover, we find that more factors were important during the Global Financial Crisis while only political ties and credit rating status were important in the tightened monetary background of the period after 2010. Combining these results, we conclude that reputation and relationships are vital in obtaining funds from formal financing channels in China, while people tapping into informal financing do not show any dominant characteristics. This finding is critical because on one hand, the criteria necessary to obtain formal finance seem to be quite stringent while, on the other hand, almost any SME can obtain informal finance. In these circumstances, informal financing will inevitably play a dominant role within the financial system. In Chapter 4, we will explore specific policy implications based on what we have observed in the previous two chapters and other findings.

## **Chapter 4 Policy suggestions on SME financing in Zhejiang**

### **4.1 Introduction**

In Chapter 2, we mainly focus on studying the status quo of the SME financing in Zhejiang Province and exploring the role formal and informal financing play. With the data collected from the 150 valid copies of designed questionnaires, a brief understanding of these firms and their financing situation has been gained through basic descriptive statistics. In Chapter 3, we have gained further insight of SME financing in Zhejiang. From the empirical results conducted, we find that firms with strong political ties, higher education of managers, larger turnover and having received credit rating are more likely to employ formal financing practices. Meanwhile, we find that other factors only take effect in certain periods. Combining these results, we conclude that reputation and relationship is vital in obtaining funding from formal financing channels in China. As obtaining formal financing is difficult, this could give informal financing a role. Moreover, we find that practice of informal financing is universal and widespread. In Chapter 4, we firstly consult the extant literature to determine SME practice around the world, and then we interview five managers from a commercial bank to learn their mindset toward SME businesses. Through a combination of the literature and the interviews with the empirical results from the previous two chapters, we propose specific policy suggestions.

### **4.2 Literature review**

SME financing could be seen as a system with the following parts: the SMEs who need the capital to survive, develop, and prosper; the formal and informal financial institutions who may (or may not) lend funds to SMEs; and the background that encourages or discourages the various financial institutions to lend to SMEs. In order to solve the SMEs' financing difficulties comprehensively, we propose the following:

Step 1: Learn what good practices there are around the world

Step 2: Learn the status quo of SME financing in Zhejiang Province comprehensively

Step 3: Propose advice accordingly to meet the gap between steps 1 and 2

The second step has been done in the previous two chapters while in this chapter, we address the remaining two steps.

In this section, the extant literature concerning SME financing is consulted from three dimensions: the providers of funds to SMEs—the supply side; the SMEs—the demand side; and the background. The literature is mainly compiled according to the authors' (of the literatures) advice or conclusions.

#### **4.2.1 The providers of funds to SMEs—The supply side**

In this section, we introduce the literature regarding the fund suppliers for SMEs, the various financial institutions. Specifically, we focus on the following four dimensions: the characteristics of banks, banks' internal decision-making, banks' products and service to SMEs, and the role of guarantee societies.

##### **4.2.1.1 The characteristics of banks—Size and ownership**

Ahunov Muzaffa, Van, and Jegers (2011) investigated foreign banks' interest in financing small- and medium-sized enterprises in Ukraine, a country where massive foreign bank entry took place during a late stage of transition. The study uses unique, self-collected bank-level data on banks' involvement with SMEs in the years 2004, 2006, 2009, and 2010. Initially, foreign banks were neither less nor more interested in financing SMEs than domestic banks. However, with the surge in the presence of foreign bank in the years 2005–2006, acquired foreign banks started demonstrating a higher involvement with SMEs relative to not only domestic banks, but also to green-field foreign banks. The mode of entry of foreign banks thus clearly matters, and so does their country of origin: acquired banks from long-standing market economies are more inclined to offer SME-specific products in general, whereas their counterparts from post-socialist countries are more likely to provide loans to SMEs and run SME promotion activities. Overall, the findings are consistent with the recent

literature that challenges the conventional wisdom that foreign banks are not interested in lending to SMEs.

Using unique panel data constructed from the Ecological Environment Survey conducted in 2005, Shen, Shen, Xu, and Bai (2009) evaluate how bank size affects SME lending. They find that measured by total asset, bank size is an insignificant factor for SME lending. On the other hand, if banks are defined with a more hierarchical level as big and rural credit cooperatives as being small, the data provide evidence that smaller banks can lend more funds to SMEs. This should not discourage the establishment of small- and medium-sized banks even though total bank assets are not a significant factor. In fact, more small- and medium-sized banks can lead to greater SME lending by generating more intense competition in local markets.

#### **4.2.1.2 Bank's internal decision-making**

Kooli (2011) argues that deregulation and progress in information and communication technologies have increased the geographical expansion of banking structures and instruments. The trend implies that banks are operationally closer to the borrowers. Meanwhile, consolidation in the banking industry has induced a geographical concentration of decision-centers and strategic functions, leading to an increase in the functional distance that separates the decision center of a bank from its operational branches (Kooli, 2011). Kooli evaluates the impact of these two trends on SME lending and the empirical findings suggest that:

- 1) Increased functional distance induces an increase in the investment cash flow sensitivity, which is considered as a measure of financing constraints.
- 2) The relationship between operational proximity and financing constraints is nonlinear with an investment–cash flow relationship that is increasing for low levels of operational proximity below a certain threshold and decreasing for high levels of

operational proximity. The adverse effect of functional distance on financing constraints is particularly acute for small firms. (Kooli, 2011)

With the empirical findings, two policy-oriented implications have been proposed by Kooli:

1) Increase in the functional distance led by the consolidation of the French banking industry may aggravate financing problems of small local firms, especially in peripheral departments. As Alessandrini, Presbitero, and Zazzaro (2009) and Berger and Udell (2002) have pointed out, these negative externalities of market deregulation could be reduced by favoring a change in emphasis in bank organization from the search of economies of scale by standardized, arm's-length lending technologies, to economies of scope by making specialized credit instruments available to local firms.

2) Their findings regarding operational proximity and its impact on SME financing suggest that the French banking system should be more operationally proximate to local firms to better fit their funding needs and to promote the entry and creation of new banks and non-bank competitors struggling to offer financing to local firms. Despite commendable efforts made by certain banking groups since the early 2000s to reinforce the French banking system's supply by opening new branches, much remains to be done in this field.(Kooli, 2011)

De la Torre, Soledad, Peria, and Schmukler (2008) studied the factors that banks perceive as drivers and obstacles to financing SMEs. De la Torre et al. focused on the role of competition and the institutional framework. They used a survey of banks in Argentina and Chile and showed that, despite alleged differences in the countries' environments regarding rules, regulations, and ease of doing business, SMEs have become a strategic segment for most banks in both countries. In particular, banks have begun to target SMEs due to the significant competition in the corporate and retail sectors. They perceive the SME market as highly profitable, large, and with good prospects. Moreover, banks are developing coping mechanisms to overcome the particular institutional obstacles present in each country and to compete for SMEs.



Banks' interest in SMEs is not based on government programs, yet policy action might help reduce the cost of providing financing, especially long-term lending. (De la Torre, Soledad, Peria, and Schmukler, 2008)

Shen, Shen, Xu, and Bai (2009) used unique panel data constructed from the Ecological Environment Survey (conducted in 2005) and show the effect of lending authority (self-loan approval rights), incentives of loan officers (profit weights in performance evaluation, and the payment scheme), bank competition, and institutional arrangements on SME lending. Shen et al. find that lending to SMEs would be higher if an institution has been authorized with more self-loan approval right, competition is fiercer, and if the loan manager's wage is linked with loan quality. From the institutional point of view, they find that weak law enforcement would lead to less SME lending. Their dataset also indicates that in most cases, soft information is an important consideration when banks make decisions about SME loans, only if wages are linked with loan quality and cost control measures are undertaken. The literature supporting the concept that small banks tend to provide greater SME lending narrates the story that if a bank is small, then the bank can collect more soft information; SMEs are at a comparative advantage in providing soft information, and thus small- and medium-sized banks are more willing to lend to SMEs. Their study therefore indicates that in China, even if a bank has the advantage of collecting soft information, whether it has an incentive to fully utilize such information is critical for the success of the above story. If a local bank has higher self-loan approval rights, if the upper branch provides greater pressure in making profit through increasing the weight of profit in performance evaluation, and if wages are linked with loan quality and cost control measures are undertaken, then the local bank tends to work hard on collecting and using soft information to find high-quality customers. The above discussion indicates that it is necessary to be granted the authority to control its funds, and incentive schemes for loan managers need to be worked out carefully so that small and medium sized bank can grow in a sustainable fashion. In the process, the government can still play an active role, not through directly interfering in loan

decisions but through fostering a good institutional environment such as stronger law enforcement. (Shen, Shen, Xu, and Bai, 2009)

#### **4.2.1.3 Banks' products and services to SMEs**

Rahman and Khatun (2012) ascertained the underlying factors that influence the financing of SMEs from formal channels in Bangladesh. A survey was carried out among the SME entrepreneurs in order to identify the presence and importance of both the finance-related and service-related factors. The results of the principal component analysis identified five factors:

1) Service delivery factors—four factors are retrieved due to their relationship with this factor, including:

- Convenient locations of financial institutions
- Quality of service of financial institution's staff
- Availability of other financial services from the same provider
- Similarity and correctness of information

2) Service responsiveness factor—four factors are retrieved due to their relationship with this factor, including:

- Spontaneity of loan delivery (time, amount)
- Need special connections with banks
- Processing and consulting fee
- An effective secured transactions system

3) Fund availability factor—two factors are retrieved due to their relationship with this factor, including:

- Cheaper than other source of financing
- Scope for future fund availability

4) Fund delivery factor—three factors are retrieved due to their relationship with this factor, including:

- Interest rate
- Repayment process

➤ Relaxation of collateral requirements

5) Implicit cost factor—two factors are retrieved due to their relationship with this factor, including:

➤ Low direct and indirect cost

➤ Bank paperwork or bureaucracy

Among these five principal factors identified, service delivery factor has been found to be the most significant factor with the highest variance. The empirical results have several implications for the financial institutions as the formal sources of funds for the SME. The providers of funds can concentrate on several strategic issues to deal with the aspects of SME financing. The first issue is to reduce or eliminate implicit costs that SMEs might incur in the process of collecting required funds. This would assist the fund-providing organizations (e.g., banks) to ensure the easy access to capital for the SME, which would further enhance the quality of the service-delivery process since it would reduce needless bureaucratic stages of the fund disbursement. Another key issue is that the study would help the fund-providing organizations to bring simplicity in their loan collection and repayment processes if they can ensure relaxed collateral requirements as well as easy repayment processes. Still, one broad strategic benefit of the study for the fund providers would be the development and alignment of the service-delivery and responsiveness issues within the fund-providing organizations (such as banks). This means that the fund providers from the formal channels need to consider service aspects of the loans and advances in addition to the core fund-related issues (such as availability). The quality of the SME financing can be improved further if the formal channel members commit themselves to ensure these broad issues while extending loan facilities to the SME entrepreneurs. (Rahman and Khatun, 2012)

Liu (2009) studies the impact of the Global Financial Crisis on small and medium enterprises in mainland China. The author states that comprehensive policy suggestions have been proposed from various dimensions including the most important formal financial institutions. Banks should be given incentives to lend to

SMEs first, then innovative products should be developed to serve and the ideology towards SMEs should be transformed accordingly.

Commercial banks can make use of financial product innovation based on mortgage guarantees to help SMEs obtain bank loans (Li, 2001). Proceeding from the scope of the entire industrial chain, banks can issue credit based on the comprehensive business chain and effectively inject funds into relevant enterprises according to the business's transactional relationships. This can enable banks to provide flexible financial products and services. In terms of modalities for financing the supply chain, the strength of creditability of core large enterprises can be utilized to help SMEs obtain financing from banks. It would lower bank exposure to loan risks to some extent.(Liu, 2009)

Liu (2009) also argued that Commercial banks should improve services for SMEs. First of all, the banks should have a department dedicated to the management of financing services for SMEs in light of SMEs' unique characteristics. Center of operation for SME credit business should be set up with dedicated client managers to serve SME clients. Secondly, banks should streamline the approval procedure; for example, the establishment of SMEs loan relationships, credit ratings, credit approval, and mortgage pricing could be combined into one service. The efficiency of loan approval could then be enhanced.

#### **4.2.1.4 The role of guarantee societies**

Cabrero, Sánchez, and Molinero (2013) analyze how Spanish Reciprocal Guarantee Societies (RGSs) have developed and the problems they face resulting from an increase in bad debts in the 2008 global economic crisis. Facing current difficulties, the RGS have become all the more significant as they facilitate credit access for SMEs. However, as other financial institutions, these societies are also affected by the

increase in bad debts and they also need to keep required solvency ratios. Cabrero et al. analyze the role of re-warranty packages for covering the credit risk of RGS, the solvency of these societies and their level of activity over these years. It is clear that the latest introduced mechanisms have been important. Practical examples include: taking into account Spanish Re-warranty Company, S.A. (CERSA) re-warranty when calculating the capital compliance ratio and the introduction of different autonomous re-financing models. These measures allow the RGSs to assume greater risk and reinforce their solvency. (Cabrero, S á nchez, and Molinero, 2013)

In summary, we can conclude that banks' characteristics like size and ownership seem not to be significant factors. However, internal decision-making carries much weight, as it directly affects the products and services banks provide to its clients, including SMEs. Therefore, more policy suggestions should be proposed in this regard. Moreover, the practice of guarantee societies in Spain implies the possibility of setting up similar institutions in China.

#### **4.2.2 The SMEs—The demand side**

In this section, we focus on the SMEs themselves, that is, the demand side of the funding. Specifically, we discuss the following three dimensions: firm financing demand, firm financing channel selection, and corporate governance.

##### **4.2.2.1 Firms' financing demand**

Hertland and Mjls (2012) show that investments of ex ante financially unconstrained firms are more affected by exogenous changes in credit availability than investments of financially constrained firms. Using a survey of Norwegian, primarily non-listed, firms with questions about how they were affected by the financial crisis of 2008–2009, they combine the answers to these survey questions with information about the firms' financial and bank accounts. They investigate whether changes in credit

availability affect investment after controlling for firm output demand. They find that this is the case, even though the effect of changes in credit availability is substantially reduced when including firm output demand control variables. In their second research question, they find that changes in credit availability affect investments the most for the least financially constrained firms. A potential reason for this is that the unconstrained firms have the easiest access before the crisis, and are therefore likely to experience the largest changes in a situation where banks reduce access to credit for all firms. They present a basic theory model to illustrate the mechanism behind this. The findings suggest that purely looking at the correlation between credit availability and firm investments of the most financially constrained firms during economic downturns is unlikely to capture the full dynamics of the credit channel on the business cycle. Financially constrained firms' tendency to use cash holdings and other means to hedge against future cash flow shortfalls, and potentially also against future credit market disruptions, means that the dynamics of financial constraints and their effects on real investments are more complex than has generally been assumed in the prior literature. (Hertland and Mjøs, 2012)

#### **4.2.2.2 Firms' financing channel selection**

Carbó-Valverde, Rodríguez-Fernández and Udell (2013) argue that firms, SMEs in particular, suffered from a significant credit crunch during the 2008 financial crisis. Due to a lack of data in the US and elsewhere, little research exists on how SMEs coped with this problem. Carbó-Valverde et al. analyze for the first time whether trade credit provided an alternative source of external finance to SMEs during the crisis. Using firm-level Spanish data, they find that credit constrained SMEs depend on trade credit, but not bank loans, and that the intensity of this dependence increased during the financial crisis. Unconstrained firms, in contrast, are dependent on bank loans not trade credit. (Carbó-Valverde, Rodríguez-Fernández and Udell, 2013)

#### **4.2.2.3 Corporate governance and self-construction**

According to the definition of the Organization for Economic Co-operation and Development (OECD) Corporate Governance Committee, corporate governance is a system by which corporations are directed and controlled. In addition, corporate governance is defined as relationships among the top management, board of directors, shareholders, and other stakeholders. In this regard, corporate governance is a structure that determines objectives of corporations and performance evaluation methods to reach these objectives. (Tunal, 2009).

There are two main corporate governance models in the world. These models are stockholder governance and stakeholder governance (Prabhaker, 1998; Wheeler and Sillanpää 1998; Gamble and Kelly, 2001; Vinten, 2001; Friedman and Miles, 2002; Letza, Sun, and Kirkbride, 2004). The stockholder governance model emphasizes the importance of shareholders in the governance of corporations. On the other hand, all stakeholders (e.g., shareholders, employees, customers, suppliers, society in general, government, financial institutions, etc.) are equally important in the stakeholder governance model (Günay, 2008). In today's business world, the stakeholder governance model is more rational than the stockholder governance model because of complex network of relationships among corporate stakeholders. (Günay, 2008).

Traditionally, it is thought that corporate governance is related to large-sized companies and agency problems. Agency problem arises as the result of the relationships between shareholders and managers. It may be thought that there is no need for corporate governance in SMEs because the owner and manager is the same person and agency problem is irrelevant in these firms. Besides, it may be thought that there is no need for accountability for the firms that do not use external funds. However, a firm needs its stakeholders for its existence and growth. In other words, it does not mean that there is no need for corporate governance if the owner and manager is the same person and a firm does not use any external funds (Abor and

Adjasi, 2007). In this regard, it is important that SMEs form good relationships with their customers, suppliers, employees, and society in general.

Abor and Adjasi (2007) examined the impact of corporate governance in SMEs in Ghana and argued that having independent board members brings forth a new strategic aspect and increase firms' competitiveness. Independent board members help firms have creativity and innovation and achieve fast growth. In this regard, it is reported in a study conducted in Japan that SMEs with high growth rates have more independent board members compared to large-sized firms (Liang and Meng, 2010). Having a board without independent board members in SMEs makes it ineffective in terms of monitoring daily operations of management (Huse, 2000; Brunninge and Nordqvist, 2004). On the other hand, the existence of independent board members allows boards to be used as strategy development instruments (Fiegener, 2005). Therefore, independent board members play an important role in the strategic growth of SMEs.

Ramakrishnan (2013) argue that good governance is vital for the development of a healthy and competitive corporate sector. For SMEs, corporate governance is about the respective roles of the shareholders as owners and the managers. It is about establishing rules and procedures to manage and run the enterprise. It has been empirically tested that good governance practices of a company gives a positive signal to investors. With the globalization of markets, international capital flows have become extremely valuable sources of external financing. Good corporate governance leads to the development of a framework that provides adequate protection to the interests of stakeholders and reinforces the fiduciary responsibilities of those vested with the authority to act on behalf of the stakeholders. ( Ramakrishnan, 2013)

Mahzan and Yan (2013) argues that it is imperative for SME to strengthen its governance, risk, and control (GRC) system that is recommended by Corporate Governance (CG) code to support strong business performance. The internal auditor is the right party to provide assurance and consultancy on GRC for a firm to stay



competitive. There is generally a lack of awareness among these enterprises regarding significance of internal audit and if there is awareness and there is a general aversion to adopting these practices because of the cost of implementation. Their paper is carried out solely through analysis of the extant literature. Mahzan and Yan identify from reports and previous studies that SME failures are due to several factors including low productivity and lack of financing, as well as inadequate skills and capabilities. The corporate governance literature posits that companies may achieve strategic, tactical, and operational efficiency by embracing good CG principles, which include risk management and control mechanisms. Further, internal audit enhances CG through assurance and consultancy work on GRC. Based on the findings from the review of the extant literature, the current status of CG in SMEs is not impressive at all, mainly because of lack of awareness, as well as the high cost of implementation involved. However, good governance is still deemed important, and hence, the authors may argue that a separate set of corporate governance frameworks may work better for SMEs, similar to the adoption of a separate set of International Financial Reporting Standards( IFRS) for SMEs. (Mahzan and Yan, 2013)

Liu (2009) studied the impact of the Global Financial Crisis on small- and medium-sized enterprises in mainland China. The author advised that SMEs' ability for self-construction should be strengthened as well. This can be done in the following four ways:

- Strengthening capability in technological innovation
- Strengthening financial management, improving financial systems, and enhancing credit rating
- Building brand awareness to enhance competitiveness. The Global Financial Crisis is a good opportunity for corporate upgrading. SMEs must be responsive to updating products, developing new products, and building their own brands on an active and constant basis
- Boosting the construction of SME credit systems for further market development

(Liu, 2009)

Although corporate governance has many advantages for the SMEs, there are also costs. For instance, having an external audit and independent board members are costly, especially for SMEs. Advantages of corporate governance are received in the middle term while costs are assumed in the short term. This cost makes the implementation of corporate governance principles difficult for SMEs. Calculating the dollar cost of corporate governance is difficult for firms of all sizes (Chittenden, Kauser, and Poutziouris, 2002). Clarke and Klettner (2009) examined corporate governance applications of 19 SMEs quoted in the Australian stock market. They argue in their study that implementation of corporate governance principles have a significant dollar-cost for firms of all sizes. Furthermore, they argue that there is 25% more time-cost for the large-sized firms. For SMEs, the time-cost is even more than 25%, and hence, utility-cost analyses must be made by SMEs to implement corporate governance principles in their firms.

In summary, we find that self-construction, such as enhancing corporate governance, is also important according to the global practice.

### **4.2.3 Infrastructure for SMEs to obtain financing**

In this section, we introduce the background that encourages or discourages the various financial institutions to lend to SMEs. Specifically, we focus on the following three dimensions: taking advantage of capital markets, macro-policy encouraging banks to lend to SMEs, and banking industry supervision and competition.

#### **4.2.3.1 Taking advantage of capital markets**

Jafarov (2013) proposes policy suggestions to engage in promoting SME development in Azerbaijan with reference to infrastructure building:

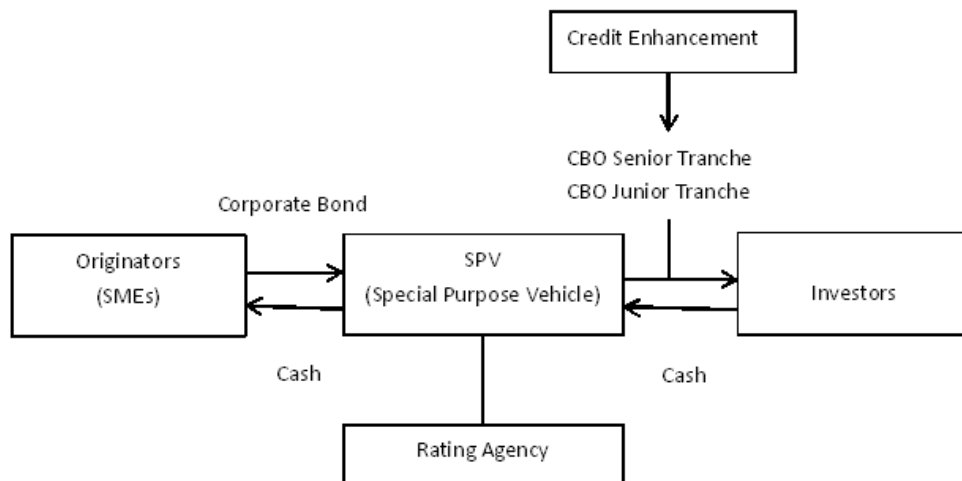
**Credit Registration:** Coordinate dissemination of financial literacy assistance programs. Instead of a centralized registry, several credit bureaus could be licensed to operate under commercial incentives, compete with each other devoted specifically to small and medium enterprises, for extensive and accurate information, and ultimately be regulated by a designated authority. Countries with heavy SME presence, underscoring the quality of business relationship and mutual trust, went further and established even credit bureaus.

**Loan or bond issuance:** To catalyze financing for start-up SMEs that are too small to issue debt, secure a loan or otherwise be accommodated by traditional financial intermediaries, developing support vehicles for tailor-made venture capital or private equity funds may be considered among the long-term objectives.

**Securitization mechanisms:** To mitigate the adverse impact of mismatch in bond issuance, devising various securitization mechanisms has also been affirmed to be a particularly powerful technique in underdeveloped markets. Conceptually, securitization means repackaging regular and classifiable cash flows from a diversified portfolio of illiquid present or future receivables of varying maturity and quality into negotiable capital market paper (“tranches”) issued by either the originator of the securitized assets/receivables or a non-recourse, single-asset finance company (“special-purpose vehicle,” Park, 2008). Debt issuance by SMEs with low credit ratings can also be collectively repackaged by special-purpose vehicles with solid creditworthiness and sold to the investors with diverse risk preferences. Individual SME bonds are perceived to be risky, but pooling them altogether significantly reduces the overall risk of default. Related to this, the primary collateralized bond obligations (P-CBOs) used in Korea are an example of such a mechanism. Following the Asian Financial Crisis, the Korean government launched a P-CBO program in order to diversify financing options for failing SMEs and reduce their dependence on bank loans. The P-CBO is an asset-backed security issued by the special-purpose vehicles, usually bankruptcy remote corporations, trusts, partnerships, or limited liability companies, with bonds issued by many SMEs as an underlying security. Credit enhancement is also provided through banks and credit guarantee

funds, while their quality is assessed via local credit-rating agencies. The basic structure of P-CBO issuance is provided below:

**Figure 4.1 Structure of P-CBO mechanism:**



Source: Developing the Capital Market to Widen and Diversify SMEs Financing: The Korean Experience, 2008

Liu (2009) argues that SMEs must receive assistance to make them more credit ready. A multi-faceted approach must be employed, training SMEs to cover marketing, product development, efficiency, etc. This will positively impact their growth and development. Financing channels for SMEs through the capital market must also be developed. It is necessary to expand the scale of the SME board at the Shenzhen Securities Exchange, accelerate and boost the Growth Enterprise Market, improve the fostering mechanism for the listing of SMEs, and encourage various business start-up institutions to strengthen investment for SMEs, especially innovative SMEs. It is important to encourage local governments to issue collective bonds to SMEs so as to effectively expand their direct financing channels. The SMEs Development Fund and the SMEs Innovation and Investment Fund must also be established.

#### **4.2.3.2 Macro-policy encouraging banks to lend to SMEs**

In a Joint Survey of the Union of Arab Bank and the World Bank, Rocha, Farazi, Khouri, and Pearce (2011) study the status of bank lending to SMEs in the Middle East and North Africa (MENA) region. Among the principal constraints for SME lending is the lack of SME transparency, poor credit information from credit registries and bureaus, and weak creditor rights. If constraints can be addressed, lending can potentially reach bank targets of 21%. State banks still play an important role in financing SMEs in the MENA region, but they use less sophisticated risk-management systems than private banks. On the other hand, credit guarantee schemes are a popular form of support to SME finance in the region, and are associated with higher levels of SME lending. The paper concluded that MENA policy-makers should prioritize improvements in financial infrastructure, including greater coverage and depth of credit bureaus, improvements in the collateral regime (especially for movable assets), and increased competition between banks and also non-banks. Weaknesses in insolvency regimes and credit-reporting systems should also be alleviated. Direct policy interventions through public banks, guarantee schemes, lower reserve requirements, and subsidized lending, as well as other measures, have played a role in compensating for MENA's weak financial infrastructure, but more sustainable structural solutions are needed. (Rocha, Farazi, Khouri, and Pearce, 2011)

Liu (2009) studied the impact of the Global Financial Crisis on small and medium enterprises in mainland China and advises that the government must also initiate capacity-building support services for both banks and the SME sector. Banks must be capacitated to lend not merely on the basis of collateral, but rather, on the basis of SME risk using several indicators.

For the main formal funding providers, the commercial banks should be mandated to lend to the SMEs or be provided with good incentives to lend to SMEs willingly.

Then, hopefully, the bank loans to SMEs could reach a higher target. In this light, financial institution (especially banks) issuing loans to SMEs could be exempted from business tax. Relevant organizations and individuals transferring or leasing patents to SMEs can also be exempted from, or have a deduction of, business taxes (Gao, 2008).

Furthermore, Liu (2009) argues that a benign business environment is usually a key determinant for the development of SMEs. Evaluation of this environment includes barriers to entry and exit, property rights protection, contract enforcement, and the functioning of the public service system.

Credit-guarantee schemes have been one of the most important policy tools in many countries. According to Green (2003), Today over 2,250 schemes exist in almost 100 countries. An economic rationale for such public intervention is that it can enhance efficiency by providing additional funds for SMEs that are in fact healthy but unable to borrow sufficient loans because of the informational gap between lenders and borrowers.

Extant empirical studies provide evidence that could justify such intervention. Riding and Haines Jr. (2001) and Riding, Madill, and Haines (2007) analyzed data from Canada and observed that a credit-guarantee program enhanced SMEs' loan availability. In the UK, Cowling (2010) shows that the loan-guarantee program alleviated credit constraints of small firms by promoting access to debt finance. Using a firm-level panel data from Italy for the period 1999–2004, Zecchini and Ventura (2009) demonstrate that credit guarantees reduced the cost of finance by 16–20% and the median value of total debt increased 9.64%. Using a dataset from Japan during the financial crisis in the late 1990s, Uesugi, Sakai, and Yamashiro (2010) also find that the special credit-guarantee program improved credit availability for small businesses.

Using a micro-dataset, Kang and Heshmati (2008) and Oh, Lee, Heshmati, and Choi (2009) find that the Korean credit guarantee program initiated after the Asian currency

crisis had a significantly positive impact on employment, sales, and wages, although it had no significant impact on productivity and investment. In the US, Hancock, Peek, and Wilcox (2007) used state-level data for 1990–2000 and observed that disbursements of bank loans guaranteed by the Small Business Administration (SBA) are associated not only with more output, employment, and dollar payrolls, but also with fewer business failures and bankruptcies. Craig, Craig, Jackson, and Thomson (2007) also find a positive correlation between the relative levels of SBA-guaranteed bank loans in a local market and the future per capita income growth. Using data of the emergency credit-guarantee program during the Lehman shock episode in Japan, Ono, Uesugi, and Yasuda (2013) demonstrate that the program eased credit availability, but the ex-post performance of small businesses after receiving credit guarantee deteriorated compared with those not receiving such guarantees.

The effectiveness of credit-guarantee schemes has been fully evaluated, while its cost has been scarcely studied. One important source of the cost of providing credit guarantee is adverse selection and moral hazard. Since credit guarantee insures banks from incurring losses from default, banks are enticed to ask seemingly risky borrowers to apply for credit guarantee. Due to the fact that credit-guarantee corporations cannot distinguish low-risk borrowers from risky ones, credit-guarantee schemes attract a sizable portion of risky borrowers, which results in inefficient resource allocation. Kuniyoshi and Daisuke (2014) argued that this potential problem could be especially grim in Japan where the proportion of 100% credit guarantee is more than 50%. They used data on city, regional, and shinkin<sup>4</sup> banks and their findings are consistent with the adverse selection and moral hazard predicament. They found statistically significant positive correlations between credit risk (subrogation rate) and the amount of guaranteed loans, indicating that a public credit-guarantee program is influenced by asymmetric information. Further investigation also

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<sup>4</sup> Shinkin banks are cooperative regional financial institutions for SMEs. See the website of Shinkin Central Bank for details about shinkin banks: [http://www.shinkin-central-bank.jp/index\\_fin\\_e.html](http://www.shinkin-central-bank.jp/index_fin_e.html).

suggested that the association between the subrogation rate and the ratio of guaranteed loans to total loan is stronger for 100% credit guarantee than for 80% credit guarantees, implying that the “20% self-payment” criteria is working as an effective mechanism for alleviating the problem, but is not enough to eliminate it.

#### **4.2.3.3 Banking industry supervision and competition**

Agostino and Trivieri (2008) investigated whether local differences in banking competition impact on the amount of bank debt used by Italian small- and medium-sized manufacturing firms. Sample selection and Double Hurdle models are adopted as the process, which results in the choice of bank financing may differ from that determining its amount. Their main finding is that more competitive banking markets seem to be associated with relatively higher usage of bank debt by less transparent firms. On the other hand, a higher banking competition seems to have no effect on the probability of receiving bank loans. (Agostino and Trivieri, 2008)

Using a survey on the financing of enterprises in China, combined with detailed bank branch information, Chong and Lu (2012) investigated how concentration in the local banking market affects the availability of credit. They find that a lower market concentration alleviates financing constraints. The widespread presence of joint-stock banks has a larger effect on alleviating these constraints than the presence of city commercial banks, while the presence of state-owned banks has a smaller effect.

Ryan, Conor, and Fergal (2014) investigate the impact of bank market power on investment financing constraints experienced by SMEs. By using a large sample of approximately 118,000 SMEs across 20 European countries over the period 2005–2008, their sample extends the coverage of both countries and firms relative to existing research. Ryan et al test the degree to which firms are financially constrained and investigate how such financial constraints vary by the degree of market



competition between domestic banks. They also explore whether this relationship is heterogeneous across firm size categories. (Ryan, Conor, and Fergal, 2014)

Ryan et al. find that firms' investment is sensitive to the availability of internal funds and interpret this as being indicative of a wedge between the cost of internal and external financing. Furthermore, they find that market power of a bank is associated with lower levels of SME investment. Moreover, the adverse impact of bank market power on investment is driven by the adverse effect of market power on financing constraints. In fact, much of the variation in cash-investment sensitivity is captured by the bank's market power effect. Separately, they estimate the empirical model to test for heterogeneous effects of bank market power on financing constraints across different categories of firm size. They find that the adverse effect of bank market power on financing constraints is reduced for the smallest subset of firms—defined as “microenterprises”—and argue that this is evidence of an information hypothesis-type effect that dampens, but is ultimately outweighed by, the direct market power effect. (Ryan, Conor, and Fergal, 2014)

The research of Ryan, Conor, and Fergal (2014) provides a number of important insights for SME credit policy in the context of Europe's economic recovery and financial stability. In many cases, the very heterogeneous impact of the financial crisis on domestic banking sectors in Europe has led to a retrenchment towards domestic activity (Barrell Fie, Fitz, Orazgani and Whitworth, 2011). It is a result of the extensive, but necessary, state intervention to provide banking sector support and restructuring (Petrovic and Tutsch, 2009). Ryan et al.'s findings suggest that SMEs will face increasing financing constraints if such restructuring significantly lessens competition between financial institutions. Such credit constraints would inevitably lead to lower investment and potential output, if binding in the medium term. Policy actions that ensure financial stability but provide for additional (or just restore) competition in the European lending market for SMEs would be a necessary condition for future SME growth and it would support economic development. Additionally, as

they find that the effect of bank market power on financing constraints is stronger in financial systems that are more bank-dependent, the implication is that developing more alternative liquid financing sources for SMEs in Europe would be helpful to create a more stable financing environment. This would provide firms with a number of financing channels and the possibility of following a more diversified financial structure. (Ryan, Conor, and Fergal, 2014)

In summary, various measures have been applied to the SMEs financing environment such as taking good advantage of capital markets, adopting more favorite policies for banks to lend to SMEs, etc. We may wonder whether these policies could possibly fit the context in China. In order to find out, in the next section, we determine the current practice in China through the interviews.

### **4.3 Understanding the status quo of SME financing in Zhejiang Province—A comprehensive perspective**

In this section, we adopt a comprehensive perspective to analyze the SME financing in Zhejiang Province. In the previous two chapters, we have applied questionnaire survey approach to study Zhejiang's SMEs and their financing situation. Through the efforts made, we could learn the demand side of the funding. From the empirical results conducted, we find that firms with strong political ties, higher education of managers, larger turnover and having received credit rating are more likely to employ formal financing practices. Moreover, we find that more factors work in the case of the Global Financial Crisis while only political ties and credit rating status work in the tightened monetary background like the period after 2010. Combining these results, we could conclude that reputation and relationship is vital in obtaining funding from formal financing channels in China. Furthermore, the practice of informal financing is found to be universal and widespread.

In order to propose specific and insightful advice, it is also necessary for us to learn the supply side of the funding, i.e., to find out how the formal and informal financial

institutions regard financing the SMEs. There are mainly two types of fund providers to SMEs: namely, the formal and informal financial institutions. The former type mainly refers to the commercial banks while the latter includes pawnshops, warranty companies, micro-loan companies, etc. Both types of institutions play an active role in SME lending in Zhejiang, a province characterized by developed informal finance.

Here, we try to learn the SMEs financing from supply side through interviews. We invited five managers from different departments of one commercial bank (the departments belong to the bank's headquarters) to attend. Specifically, the managers from the corporate banking department, SME business management and operation center, and asset liability management department can offer deep insight into the commercial bank's daily operation and management practice in SME lending. The manager from the investment-banking department can inform us on the situation of SME products in the capital market. The practice of the informal financial institutions can be learnt from the manager of the financial institution department. The interview sample covers the different angles needed to understand the practice of the two types of financing institutions we discussed earlier.

Specific questions were asked about how managers treat SME financing strategically, how they put the strategy into practice, what difficulties they face in real business, and what advice they propose to solve the difficulties. Due to the concern that it is hard to define an accurate boundary of formal/informal finance, as well as the fact that banks' SME lending business is intertwined with those informal financing institutions, we tried to obtain the information from these bank managers. Questions have been asked about their opinion toward the role of informal financial institutions in SME financing, how they can meet the need of SME financing, and what the potential problems of informal financing are. The specific questions are presented in Appendix 2.

Through the interview, we learn the basic logic of banks' SME lending. It could be explained from the following three aspects:

1) The incentives for banks to lend to SMEs

It was once thought that Chinese banks mainly lent to SOEs and neglected the SME business. Through the introduction of the managers from both the SME business management and operation center and the asset liability management department, we find that significant changes have happened in recent years driven by the rapid pace of interest rate liberalization. On one hand, more and more SOEs have tapped into the capital markets to get funding. The comprehensive funding cost of issuing corporate bonds is 85–90% of the corresponding benchmark loan rate of the banks. The funding efficiency (the filing process, waiting period to obtain the funds, the opportunity of choosing the timing of issue, etc.) of issuing bonds is also higher. On the other hand, banks can barely profit from SOE lending. SOEs not only require a low funding cost, but also require that the funds that they put into the banks account should be deposited with the highest rate available (10% above the corresponding benchmark rate, the ceiling of the official deposit rate in China). The bank now has stringent requirements for SOE lending: unless the comprehensive return can reach a specified target, the branches are forbidden to lend to SOEs.

In contrast, banks lay more emphasis on SME lending. This can be shown from the following dimensions. Firstly, banks have to be more engaged in SME business in order to fulfill their profit since the once-lucrative SOE business can no longer bring benefits. Secondly, more favorable policies have been put forward at the national level, such as granting more credit quota to commercial banks if their SME lending growth rate can surpass the overall lending growth rate, tolerance for higher non-performing loan rate, and permission for banks to issue SME-specific bonds to lend to SMEs. Moreover, SMEs can bring a satisfactory comprehensive return for the banks. The rate banks charge to SMEs is 10–30% higher than the corresponding loan benchmark rate. Furthermore, banks have built internal incentives to lend to SMEs, such as

independent SME centers have been set up, and the branches can get more compensation from fulfilling the given target (including the loan growth, daily average deposit target, non-performing loan target, etc.).

To sum up, banks now put more strategic emphasis on lending to SMEs.

## 2) The constraints banks face to lend to SMEs

The banking industry is heavily regulated in China. Commercial banks face three statutory and regulatory constraints in lending as laid down by managers from the assets liability management department.

- Statutory loan/deposit ratio

It is written in commercial banking law that the loan/deposit ratio must not surpass 75%. The deposit level directly limits the loan growth.

- Regulated capital adequacy ratio

There is a two-level capital adequacy ratio: the capital adequacy ratio and the core capital adequacy ratio. Such a ratio directly constrains the growth of risk-weighted assets with a loan covering a large part.

- Given quarterly loan quota

The quarterly loan quota available to banks is given directly from the Peoples' Bank of China, the central bank, according to a set of indicators including: the banks' performance in SME lending, the management of loan growth, the situation of the loan/deposit ratio and the capital adequacy ratio, and liquidity management. Severe punishments are handed out if banks choose to lend more than the given quota.

These three constraints directly constrain the upper limit of loans available. Apart from that, banks still face internal constraints in SME lending.

- Untimely response

The SME financing need is fast, urgent, and frequent. The loan period is scarcely longer than one year. SMEs hope that they can use the funding when needed. In

practice, however, the banks usually take more than two weeks to decide whether the loan can be granted. Most of the time is wasted on specifying the collaterals due to the fact that the collaterals SME provides are usually in niche markets and hard to evaluate. Furthermore, the loan product provided is not flexible enough.

- Inaccurate pricing mechanism

One of the potential hazards of SME lending is a higher non-performing loan rate. The common practice is that SMEs have to provide credible collaterals to ensure that the loan lent remains safe even if SME could not fulfill the obligation on its own, and hence, the riskiness of the loan can be lowered. As for how much the banks can charge for each loan, it mainly relies on subjective judgment. In other words, banks can set a given profit margin target; however, banks cannot calculate different types of cost accurately, especially the operation cost. Such pricing inaccuracy leads to more requirements and more reliance on collateral. More dangerously, it may lead to insufficient compensation for potential risk.

- Unsatisfactory human resources and IT resources

SME lending is human extensive, the size of each loan is rather small but involves multiple loans. Currently, banks rely on branches but the geographical distribution of branches cannot effectively cover the SME businesses. Meanwhile, the number of people that can be devoted to SMEs is quite limited in banks. Usually, banks' SME client managers are also in charge of larger businesses. Therefore, they may not pay too much attention to SME clients. Moreover, the development of tailor-made system cannot catch up with the development of SMEs lending business.

To sum up, although banks have strategically paid attention to SME lending, there are still many tactical problems to be solved.

### 3) The role of capital market products in SME lending

In recent years, the bond markets have enjoyed rapid growth in China. Diversified products have been developed, including bonds issued for SME financing. However, according to the description of the bank's investment banking manager, these products were created merely for innovation. After the "boom" in early stage, investors' passion soon evaporated. The benefit the undertakers could obtain is negligible compared with other bonds and most of the investors hope to find firms that will one day be listed on the stock market. With the door of initial public offering (IPO) constantly being shut, the investors' patience withers. It seems that institutional investors would not take a more active role in SME bond products unless a stock option is already present, and only then could the tradeoff between risk and return be achieved.

Through the interview, we also determined the role of informal financial institutions in SME lending, which are revealed by the following two aspects:

#### 1) Informal financial institutions in SME lending

These informal institutions take an active role in SME lending. Compared with banks, they can better meet the "fast, urgent, and frequent" need of SME financing. They have fewer requirements in terms of collateral and are more reliant on relationships and soft information as we observed in the empirical results. The process is more flexible and risk management is mainly reflected in the much higher rate that informal institutions charge. Although they may require collateral, less time or even no time has to be spent on evaluation.

#### 2) Regulation of informal financial institutions

Unlike banks, the informal financial institutions face fewer direct regulations. The last two decades have witnessed several rounds of boom and bust in these informal financial institutions, and thus, their development is characterized by high cyclicity. It seems necessary that a counter-cyclicity mechanism should be set up.

#### **4.4 Policy suggestions**

In this section, we try to propose eight policy suggestions through a combination of the literature consulted with the empirical results and the contents of the interviews.

The policy suggestions are developed from three dimensions: the fund providers for SMEs, the SMEs, and the background of SME lending. For the fund providers, we mainly focus on the formal financing institutions since micro-policy suggestions could be proposed accordingly, while macro-policy suggestions should be proposed to cope with informal financing since we found that that nearly all kinds of SME entrepreneurs can obtain informal financing.

##### **4.4.1 Policies suggestions for SME fund providers**

Through the interviews, we know that commercial banks nowadays have strategic incentives to do business with SMEs, and symbolic measures have been taken, such as setting up independent SME centers. Internal incentives have also been built. However, we know from the questionnaire that more than half of the respondents still could not get funding from the banks. Just as one of the bank managers said, service efficiency should be further enhanced. Accordingly, we put forward four policy proposals. Moreover, the development of rural banks should also be paid due attention.

###### **4.4.1.1 Setting up community banks to serve SMEs**

From the questionnaire investigation, we learn that relationships count more in SME lending. However, such relationships cannot easily be built. In order to relieve the information asymmetry, banks require more collateral, as we observed from the interview. As Kooli (2011) claims, community banks should be set up to serve SMEs. Due to the shortened distance between the banks and the firms/entrepreneurs, banks



could have better access to their dynamics. To some extent, they could learn more about firms through frequent observation rather than reading infrequent financial statements. The banks, therefore, could discover the SMEs with potential and evaluate their properties in advance so that the period of loan granting could be shortened.

Community banks are known for their focus on traditional banking activities, and they mainly conduct lending- and deposit-gathering activities within a fairly limited market area (Adler, 2012). Community banks provide a range of products and services to meet the needs of local consumers and SMEs, including electronic banking services, free ATM services, credit cards, debit cards, billing, savings and investment products, mortgages, consumer loans, small and micro business loans, and agricultural loans. They are said to be relationship lenders, which rely to a significant degree on specialized knowledge gained through long-term business relationships.

Community banks of this pattern are an independent legal entity, similar to China's rural credit cooperatives and other financial institutions. At the beginning of the interest rates' marketization in the US during an environment of higher interest rates, development of a monetary fund and the direct financing market, as well as financial product innovation, all oppressed the development space of the traditional community banks. Lots of community banks went bankrupt and were acquired by other financial institutions.

ING Direct, known as the model of internet banking (Fei and Dou, 2013), is the direct bank under the ING Group. Their ideology is to make things simple. First, customers and products are simple. The targeted customers are 30- to 50-year-old educated people. The products are also simple since their line of the products is strictly limited to savings deposit accounts, real-estate mortgages, and money-market funds. Secondly, they aim to control the cost and to benefit customers. The benefit of lower costs in direct banking operations will be returned to the products' revenues. Moreover, they make an effort to enhance the customers' experience. The offline site is mainly in the

form of coffee bars. There is no counter or cash business. After accumulating customers' resources, they try to transform the community bank into a universal bank.

Xin and Zhang (2012) noted that Wells Fargo Community Bank focuses on providing financial products and services (including financing, savings, and intermediate business) to small-business owners whose sales are less than US\$10 million a year. The physical outlets of Wells Fargo Community Bank are mainly distributed in dense residential communities with an open layout, a separate business area, and rest areas. The interior decoration is simple and warm.

In addition to investment in the physical network, Wells Fargo also invest a lot in their information system and staff training to have a better understanding of customer needs. With long-term accumulation, a breakthrough has been made in cross-selling. Wells Fargo's experience can be summarized into the following two aspects:

- 1) They increase physical outlets to guide the adjustment of asset structure. Wells Fargo has made much more investment in physical network construction and human resources than other banks. The purpose is to tap customer resources, improve relationship business, enhance customer experience, and lay solid foundation in cross selling. As a result, the physical outlets of Wells Fargo's Community Bank have played a decisive role in its retail business, especially in the housing loan and retail loan market.
- 2) The physical outlets are arranged with strategic consideration. The main considerations of Wells Fargo in establishing physical outlets include four aspects: density, cross-selling, efficiency, investment quantity and quality. Specifically, density measures how many local residents a single physical outlet can cover; cross-selling measures the number of products and services a single household or family will buy and, accordingly, how much income it could earn; efficiency mainly refers to the operation cost, including transaction costs, marketing costs,

rental cost, etc. The area and cost of Wells Fargo Community Bank have been declining in the long run. Investment quantity and quality refers to learning how to optimize network construction to improve the customer experience and to increase the number of customers and cross-selling. Wells Fargo Bank has established a quantitative evaluation system to cover the four aspects mentioned above.

As the experience of Wells Fargo shows, as introduced by Xin and Zhang (2012), community banks in Zhejiang should focus on their loan business since it could bring long-term benefit although it maybe not be attractive in the short term. Through mass, intensive, and standardized management, especially in risk management, loan products could produce a stable profit. On one hand, with the credit risk controlled, credit spread is generally higher than that of deposit products; on the other hand, loan products are more powerful in strengthening customer relationships than deposit products. They could bring more cross-selling opportunities and bring more benefits.

In practice, the community banks could be in two styles: set up within a neighborhood or a shopping mall (or Science and Techonology Park). The community banks located in neighborhoods are usually smaller in size than those located in shop malls. Community banks of both types could provide financing services. Those located in neighborhoods could provide loan products to inhabitants or merchants while those located in shopping malls could provide loan products to firms within it.

#### **4.4.1.2 Simplifying the SME financing procedure**

Simplification could be achieved through a more flexible way of paying back loans and more accurate loan pricing. From the interviews, we learned that the informal financial institutions offer a more flexible style of financing. The banks could learn a lesson from that. They could design the products as follows: specify a maximum term; the interest is computed daily with the rate increasing as the term increases; specify a

comprehensive amount so that SMEs could use the funding when necessary as long as the ceiling is not surpassed.

Mybank, an internet bank that was set up in Zhejiang Province in 2015, provide tailor-made financing products to SMEs. The key feature of Mybank is that it grants credit loans based on big-data technology to conduct a credit rating rather than setting up rigid requirements for collateral. Till the end of February 2016, Mybank has served 800 thousand SMEs and provided loans worth 45 billion Yuan. Nowadays, the mindset of banks is that the risk control for SME loans is achieved by requiring more collateral. This mindset should be transformed so that SME loans are controlled through accurate pricing while collateral is merely a supplement.

Banks should make full use of the data they have accumulated for years on SME clients. With abundant data and powerful data-mining skills, it is probable that they could compute the cost accurately and then add the risk premium to the benchmark accordingly. In addition, risk specialists should be allocated to the community bank branches to learn the SMEs' situation in a timely manner. Such pricing could help cover the risk and shorten the loan-granting period.

#### **4.4.1.3 Committing more IT resources and optimizing the structure of human resources to enhance the efficiency of the loan process**

In order to achieve the desired results of the policies mentioned above, banks should commit more resources to their IT system. It is necessary to make a capital investment in IT systems, especially in big-data technology. Big-data technology could help banks to dig, analyze, and use the huge amounts of data banks have accumulated for years. Specifically, banks could apply the big-data technology to identify customers with market potential and to provide a credit rating to customers. The banks could,

therefore, grant the loans to the customers that they fully understand and risk premiums could be computed more accurately.

Meanwhile, the commercial banks should optimize the structure of their human resources. One of the critical elements that result in the low efficiency of commercial banks' response to clients' demands is that it has too many redundant staff, especially in the operation line. Although the rigid operation procedure could to some extent ensure safety, it could hardly match the rapid changes in clients' requirements in financing. Hence, it will be necessary to cut staff from operation lines. Operation teams should be lean and its staff should be able to master big-data technology rather than merely implement the procedure repeatedly.

Despite the fact that the number of client managers is large, the number of qualified SME-oriented client managers is still insufficient. As we learned from the interviews, many of the “SME client managers” were originally corporate client managers. Some of them have no expertise in SMEs and they merely apply the same practice that they would use with large firms. Hence, a team of qualified SME client managers should be cultivated.

Robust business and management IT systems should be accessed by different levels of staff. The power of big-data technology can only be brought completely into play when it can be grasped and applied sufficiently by various levels of staff. Frequent training is also necessary to equip the staff with cutting-edge skills.

#### **4.4.1.4 Cultivating a group of dynamic rural banks**

Rural banks refer to the banking institutions that provide financial services in rural areas for local farmers, agriculture, and rural economic development. Such banks are usually a subsidiary of larger commercial banks. As Zhang (2016) stated, rural banks are the most effective and promising among small financial institutions. The development of rural cooperatives has been quite slow and does not have a promising

future. Microfinance companies and peer-to-peer platforms, although enjoying rapid growth, face severe pressure in bad loans. Till the end of May 2015, the non-performing loan ratio of microfinance companies amounted to an astonishingly high level of 12%. In the first half of 2015, about 419 peer-to-peer platforms have confronted difficulties in China. Mybank, despite its competitiveness, mainly focuses on online clients. It is quite unlikely that it could completely replace these offline banks. Therefore, due emphasis should be laid on the development of rural banks.

During the first half of 2015, about 71 rural banks opened in Zhejiang Province (Zhang, 2016). Pertinent measures should be taken for these banks of different quality. For those banks performing badly, a sponsoring bank should enhance management or reorganize the institution if necessary. For those banks with biased market positioning, measures should be taken in structural adjustment. Meanwhile, rural banks should be set up voluntarily rather than as a political task. Opportunities to set up rural banks should also be given to those private entrepreneurs who are eager to serve the SMEs and share their understanding of SME financing.

#### **4.4.2 Policy suggestions for SMEs**

In this part, we put forward three proposals for SMEs to improve their business so that they could be in a better position to obtain funds.

##### **4.4.2.1 Building their reputation and being engaged in credit rating**

As we found in Chapter 2, reputation and having received a credit rating help when SMEs try to obtain funds from formal financing institutions. Therefore, SMEs should try to build their reputation. A recommended practice is to take an active role in local social activities and to let more local people get to know the firm. Making a

contribution to the local community naturally attracts the attention of banks and other institutions.

Meanwhile, as more and more credit-rating firms grow in China, SMEs should try to be engaged in credit rating. Conducting credit rating is beneficial for SMEs in many ways. Credit rating sends diagnostic signals to the firms as to which parts have been done well and which parts need to be further improved. Furthermore, such a move gives formal financial institutions confidence in the firm's operation and gives them a better way to judge the firm and to price the loan more accurately.

#### **4.4.2.2 Enhancing corporate governance**

As Ramakrishnan (2013) and Mahzan and Yan (2013) argue, it is imperative for SMEs to strengthen their governance. Sound corporate governance is helpful in building mutual trust with formal institutions, especially banks.

For SMEs, the first step to take is to set a standardized corporate charter, and next, sound internal control systems and incentive schemes for senior managers should be set up. A firm's transparency could be enhanced through periodical disclosure to the stakeholders.

Frequent communication with financial institutions like banks is helpful. For financially health SMEs, they fear any unexpected sudden withdrawal of their credit line from commercial banks. For example, banks may have orally promised that the matured loan will be rolled over, but monetary tightening or risk aversion over non-performing loans may lead them to call in the loans. In this case, communication with banks before the maturity date could alleviate the situation to some extent. With the reluctance of banks to roll over the loan noticed beforehand, they could take other measures.

#### **4.4.2.3 Being more engaged with banks, rather than merely building relationships**

In Zhejiang Province, banks tend to behave in a pro-cycle pattern. Specifically, banks tend to over-lend when the economy is overheating and they tend to be too risk-averse when the economy takes a downturn. Such behavior is quite disadvantageous for firms, especially SMEs. Being further engaged with banks, rather than building temporal relationships, could help SMEs weather economic cyclicalities.

With more community banks set up, SMEs should use the opportunity to show banks their strength and advantages. Through such engagement, both sides could learn more about each other, and mutual confidence could then be increased.

When the local economy goes well, commercial banks could learn through contact with SMEs whether firms or a niche industry may enjoy further growth. If so, procedures like collateral evaluation could be fulfilled beforehand; more convenient and flexible lending covenants could be arranged. If not, risk specialists should give clear signals that over-lending may lead to a surge in non-performing loans in the future.

When the local economy is going badly, the banks could, through close interaction, better detect unfavorable developments in the firm or within the industry, and then procedures like risk mitigation should be adopted. For those SMEs trapped in temporal difficulties, they could communicate with banks frankly about their situation and work out feasible solutions to weather the difficulties. Thus, both sides could benefit from closer cooperation.



#### **4.4.3 Policy suggestions for improving the background of SME lending**

From the empirical findings, we know that nearly all kinds of SMEs may tap into the informal financing market. Meanwhile, as we have discovered from the interviews, the behavior of informal financial institutions is quite cyclical. In other words, their function is severely disrupted when crises hit. Therefore, macro-policies should guide the informal market to develop properly and healthily, regardless of the business cycle. Here, we propose to set up a rainy day fund as a counter-cyclical mechanism.

The rainy day fund should be set up mainly locally (at the county level). The SMEs within the county could participate in the fund willingly as registered partners; a third party (ideally, a bank or a group of banks) could participate in the fund as special registered partners as they could commit some funds or merely manage the funds on the SMEs' behalf. Registered SMEs should provide basic information so that a monitoring and supervising mechanism could be built accordingly. Meanwhile, registered SMEs could put funds into the rainy fund when their business runs well and they have excess capital. Such an arrangement could, to some extent, alleviate the concern of moral hazard. During tranquil times when the funding market works properly, the reserve fund could do nothing but accumulate money as the funds collected could be invested into liquid assets such as treasury bills. However, when a crisis hits, such funds could be lent out to the registered partners. The capital could be offered at the market rate plus appropriate margins. With the rainy fund in place, the volatility of the informal financing market could be lowered.

#### **4.5 Conclusion**

In this chapter, we firstly consult the extant literature to learn the SMEs' practice around the world, and then we interviewed five managers from a commercial bank to learn the formal and informal financial institutions' mindset regarding SMEs. The focus is on commercial banks: their strategic incentives, as well as regulative and tactical constraints, are discussed. We find that capital market could offer little to

SME financing under the current circumstances. Moreover, it has been found that informal institutions' behavior is quite cyclical.

Through the combination of what we find from the literature, interviews, and the empirical results from the previous two chapters, we propose specific policy suggestions, and eight recommendations are developed from three dimensions: the fund providers for SMEs, the SMEs, and the background that underpins them. For fund providers (mainly banks), we advise setting up community banks to serve SMEs, simplifying the SME financing procedure, committing more human and IT resources and cultivating a group of dynamic rural banks to enhance the efficiency of the loan process. For SMEs, we advise that they should build their reputation, try to be engaged in credit rating, should enhance corporate governance, and should be more engaged with banks. Last but not least, we propose setting up a rainy day fund as a counter-cyclicity mechanism.

## **Chapter 5 Conclusion**

This thesis mainly focuses on studying the SME financing in Zhejiang Province and exploring the how informal lending could play a greater role. In Chapter 2, after consulting the literature, we designed a tailor-made questionnaire to determine the basic information, business establishment, business growth, and funding sources of the firms. With the data collected from 150 valid copies, we could gain an understanding of these firms and its financing situation through basic descriptive statistics.

Subsequently in Chapter 3, we gain further insight into SME financing in Zhejiang. From the empirical results conducted, we find that firms with strong political ties, higher education, larger turnover, and having received a credit rating are more likely to employ formal financing practices. No consistent results were found for informal financing practices. Moreover, we find that more factors worked during the Global Financial Crisis while only political ties and credit-rating status worked during the tightened monetary background of the period after 2010. Combining these results, we conclude that reputation and relationships are vital in helping SMEs to obtain funds from formal financing channels in China, whilst basically all SMEs are able to obtain informal finance. This finding is critical: on the one hand, the criteria necessary to obtain formal finance seem to be quite stringent, while on the other hand, almost any SME can obtain informal finance. In these circumstances, informal financing will inevitably play a dominant role in the financial system. These empirical findings call for specific policy suggestions.

In Chapter 4, we consult the extant literature to determine the global SME practice, and then interview five managers from a commercial bank to learn the formal and informal financial institutions' mindset towards SMEs. The focus is mainly on commercial banks: their strategic incentives, as well as regulative and tactical constraints, are fully discussed. Meanwhile, we find that capital markets could offer

little to SME financing under the current circumstances. Moreover, it has been found that informal institutions' behavior is quite cyclical. Combining what we find from the literature, interviews, and the empirical results, we propose specific policy suggestions. Eight proposals are developed from three dimensions: the fund providers for SMEs, the SMEs, and the background that underpins them. For fund providers (mainly banks), we advise four measures: setting up community banks to serve SMEs, simplifying the SME financing procedure, committing more human and IT resources and cultivating a group of dynamic rural banks to enhance the efficiency of the loan process. For SMEs, we advise that they should build their reputation, try to be engaged in credit rating, should enhance corporate governance, and should be more engaged with banks. Last but not least, we propose to set up a rainy day fund as a counter-cyclicity mechanism, detailed arrangement is also introduced.

## **Appendix 2 Interview questions list**

We invited five managers in the headquarters of commercial bank A, which is a mid-sized bank with their headquarters in Zhejiang. The five managers were from different departments, including corporate banking department (in charge of the daily management of corporate banking business), SME business management and operation center (in charge of the daily management of SME business), investment-banking department (in charge of the investment-banking business, including undertaking SME bonds), financial institution department (in charge of the management of the financial institutions' relationships), asset liability management department (in charge of the resource alignment and the performance appraisal management of the whole bank). Specific questions were asked accordingly:

### **SME lending strategy**

What is your bank's strategy toward SME financing?

What measures have your bank been taking in boosting SME businesses?

What are the constraints your bank face in lending to firms and SMEs?

### **SME lending practice**

How could your bank put the strategy into practice?

What products could you provide to SMEs apart from loans?

Could these capital market products help alleviate SMEs' financing?

How soon could your bank meet SMEs' financing needs?

What difficulties do you face in real business?

What solutions could you offer?

**Informal financial institutions in SME lending**

Do you have a business relationship with informal financial institutions?

What's your opinion of informal financial institutions' role in SME lending?

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