THE ADVISORY GROUP ON APEC FINANCIAL SYSTEM CAPACITY-BUILDING

A Public-Private Sector Initiative

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Meeting Paper 7-B

IFC Secured Transactions Advisory Project in China

International Finance Corporation

PURPOSE	For information.
ISSUE	Report of IFC's project in China that has successfully led to the establishment of a solid secured transactions system and resulted in a sustainable flow of additional credit to the SME sector.
BACKGROUND	In 2004, the People's Bank of China (PBOC) recognized wide spread financing difficulties among small and medium enterprises (SMEs) and requested technical support from IFC in the modernization of China's Secured Transactions system. The main objective of IFC's Secured Transactions Advisory Project in China was to increase access to credit to firms, especially SMEs, by developing an appropriate legal and institutional framework to allow and facilitate the use of movable assets such as receivables as collateral for loans. This was particularly important for China's large number of SMEs, whose assets were mostly in the form of equipment, inventory and receivables and who reported access to credit as their most significant business constraint.
PROPOSAL	N.A.
DECISION POINT	Note the report.

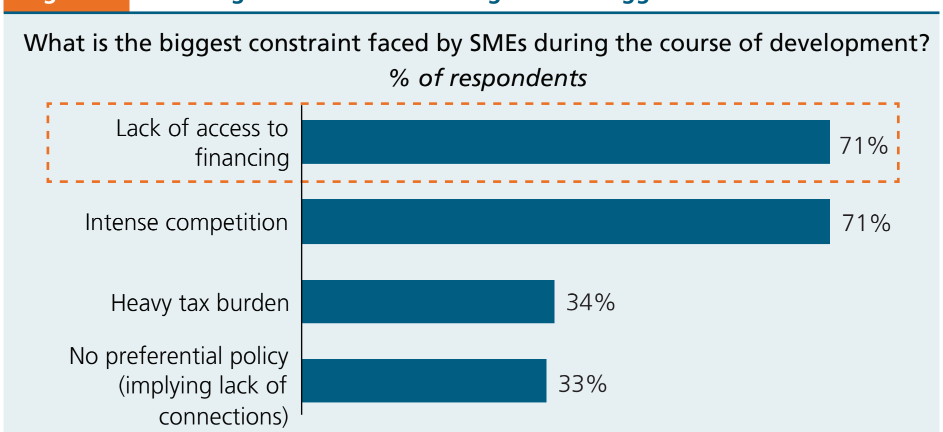
International Finance Corporation
World Bank Group

IFC Secured Transactions Advisory Project in China

I Background

In 2004, the People's Bank of China (PBOC) recognized wide spread financing difficulties among small and medium enterprises (SMEs) and requested technical support from IFC in the modernization of China's Secured Transactions system. The main objective of IFC's Secured Transactions Advisory Project in China was to increase access to credit to firms, especially SMEs, by developing an appropriate legal and institutional framework to allow and facilitate the use of movable assets such as receivables as collateral for loans. This was particularly important for China's large number of SMEs, whose assets were mostly in the form of equipment, inventory and receivables and who reported access to credit as their most significant business constraint (see Figure 1).

Figure 1 SMEs regard access to financing as their biggest constraint



Source: NDRC/PEP-China 2005/2006 SME Finance Survey (1,000 SMEs in Five Cities)

Secured Transactions in China Before the Reform

- One key factor contributing to the SME financing difficulties was the severe restriction on the use of movable collateral under China's secured financing laws.
- Chinese banks were reluctant to provide credit to a majority of SMEs which had no or little real estate collateral. As a result, Chinese businesses hold more than 2 trillion USD in "dead capital" (their movable assets).
- Assets owned by private firms, SMEs and farmers could not be used as collateral to generate loans to fund business investment and growth due to the lack of an adequate secured transactions law and the poorly functioning registries.
- Lenders did not want to take movable assets as collateral because of an unfavorable legal framework and a lack of knowledge and experience in dealing with movables.
- The China secured transactions law lacked all the essential elements required to support the efficient and effective utilization of the secured lending market. It was not possible either to create security interest over revolving assets and future assets. Security interests on some assets such as receivables had no registry to be publicized.

2 Results

Achievements

The Project has successfully fulfilled its objective of establishing a solid secured transactions system that has resulted in a sustainable flow of additional credit to the SME sector. The main project achievements include:

The 2007 Property Law

The new Property Law in China was enacted in 2007. It adopted a number of important principles of modern secured transactions system and it opened up the scope for movables lending (including receivables), set up a clearer priority rule, and provided a better basis for enforcement.

Thanks to the contribution of this project and the efforts of China's stakeholders to reform its secured transactions system and bankruptcy framework, in Doing Business 2012, ***China gained 6 points out of an 8 point scale on the "legal rights" index of the "getting credit indicator,"*** *which measures the quality of lenders and borrowers rights.*

Security Interest Registry

A modern security interest registry for account receivables was created in October 2007 and for leasing in 2009. The registry is managed by the Credit Reference Center, which is a public service unit under PBOC. It is China's first nation/wide, central and internet-based filing system for secured transactions. The new receivables registry incorporates all the key features of a modern movable collateral registry (such as accessible on-line to the users and public, user accounts, notice based registry in which information limited to the creditor, debtor, loan amount and the description of assets, centralized information, reasonable fees).

Public awareness and education—Building industry capacity

Training and capacity building were key elements for the project's success. The project targeted both client and public sector stakeholders to create awareness about the new system; and private sector stakeholders (such as Financial Institutions, NBFIs, firms, lawyers) mostly focused on creating awareness and building bank' expertise on movable assets based financing products. News articles and advertisements about receivables financing are now common in China and at least 62 training events have been delivered by the project since early 2004.

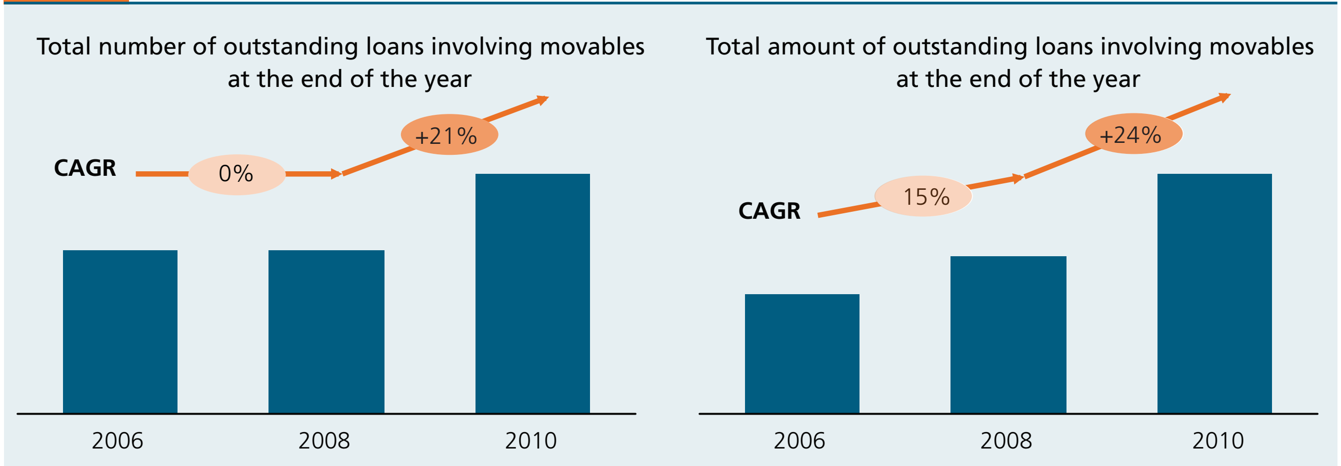
Impact

Dalberg, an international development consulting firm, conducted an independent evaluation of this project to validate the results and gather additional information about the impact on different levels (financial sector, financial institutions and businesses/SMEs). The report was delivered to IFC in November 2011. The main impact findings of this evaluation are[1]:

On the Chinese financial sector:

- Total number of commercial loans involving movable assets grew by 21 percent per year in 2008-2010 versus a flat rate in 2006-2008 (see Figure 2).
- China's Big five banks (Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China, China Construction Bank and Bank of Communications) posted strong gains in the share of financing that is secured by movable assets.
- The Credit Reference Center recorded cumulative accounts receivable financing of about USD $3.5 trillion since Oct. 2007, representing around 385,000 registrations (see Figure 3).

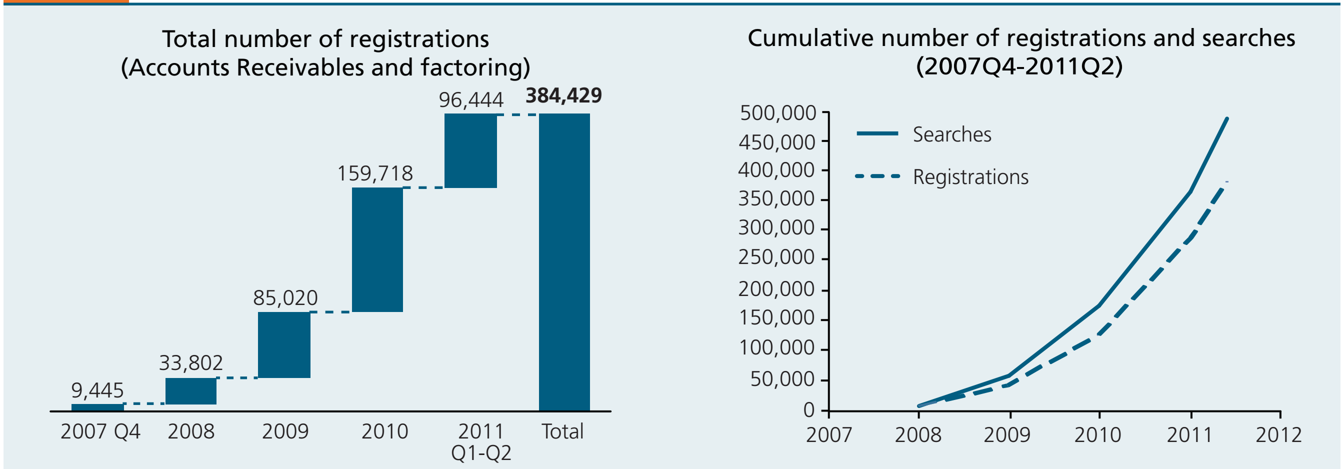
Figure 2 Growth of commercial loan portfolio secured by movable assets



Source: 32 financial institutions surveyed in Anhui, Guangdong, Shaanxi, Shandong, Shanghai, Zhejiang, including three Big five banks, four large policy and commercial banks and 25 local banks.

Note: Include loans secured exclusively by movables as well as those secured by a combination of movables and immovables

Figure 3 Growth in the number of registrations of Accounts Receivables transactions



Source: Credit Reference Center Movables Security Interest Registry

1. The evaluation is based on extensive desk research, an in-country mission to interview key stakeholders, surveys of 247 SMEs and 50 financial institutions, data from Credit Reference Center (CRC) Registry, and case studies of SMEs and financial institutions.

On SME lending by financial institutions:

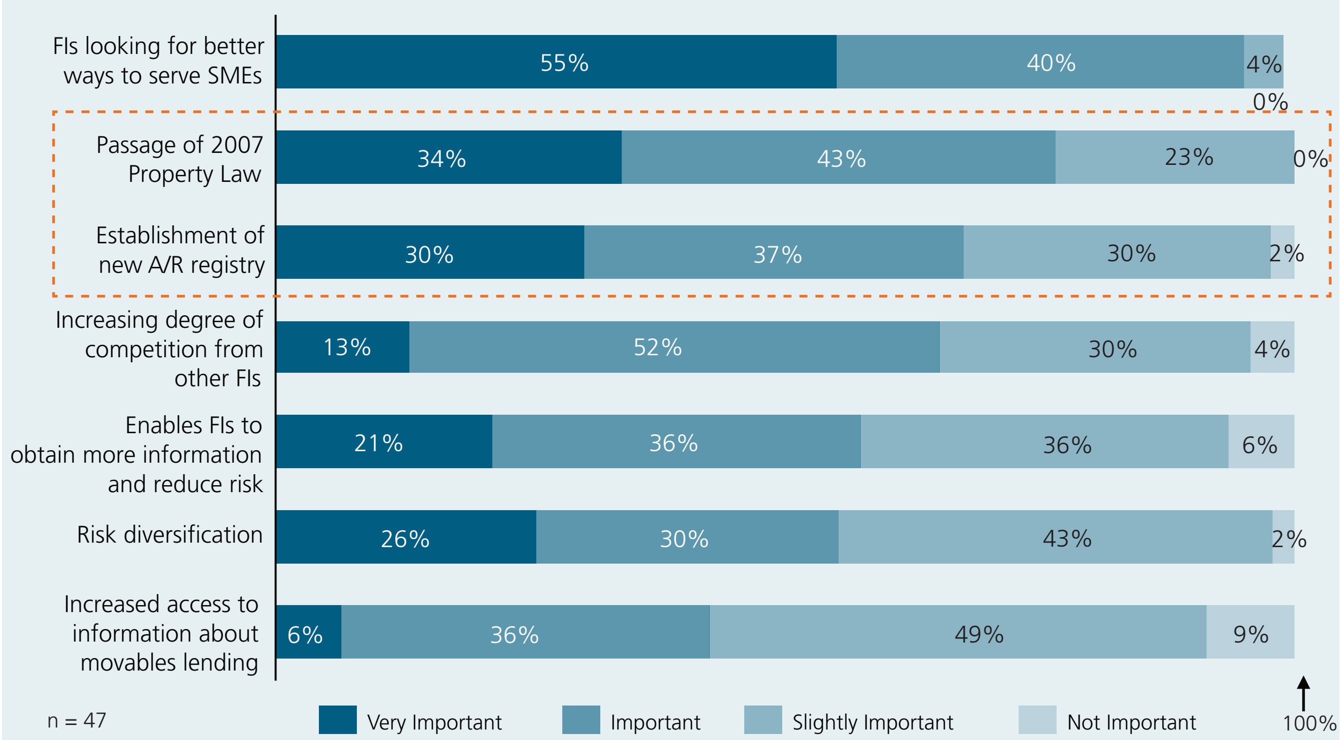
- The 2007 Property Law and the accounts receivable Registry were among key drivers of the adoption of lending secured by movable collateral (see Figure 4).
- Important spillover effects into other types of financing such as leasing and factoring. The lease registry has recorded 35,426 leasing transactions cumulatively. The value of factoring grew from 2.6 billion Euros in 2003 to 67.3 billion Euros in 2009, according to data from Factors Chain International.
- Overall default rates for loans secured by movable assets remain low. The mean default rate for Accounts Receivables lending is 0.45 percent and for inventory is 0.6 percent.
- Four of the Big five banks reported an average 25 percent compound annual growth rate (CAGR) of their movables lending in 2008-2010, up from 2 percent in 2006-2008; seven other large commercial banks reported an average of 45 percent over 20 percent.
- 87 percent of surveyed financial institutions rated the 2007 Property Law as very/somewhat important to “serve new segments of SME market” (see Figure 5).
- Financial products were created based on movable assets. Financial News independently reported 36 cases of new financial products based on movable assets in 2010 and PBOC published 120 cases in a book in 2010.

On SMEs:

As of June 30, 2011, cumulatively this project has **facilitated USD $3.58 trillion** accounts receivable financing including **USD $1.09 trillion of SME lending** in China, as indicated by the Registry´s data.

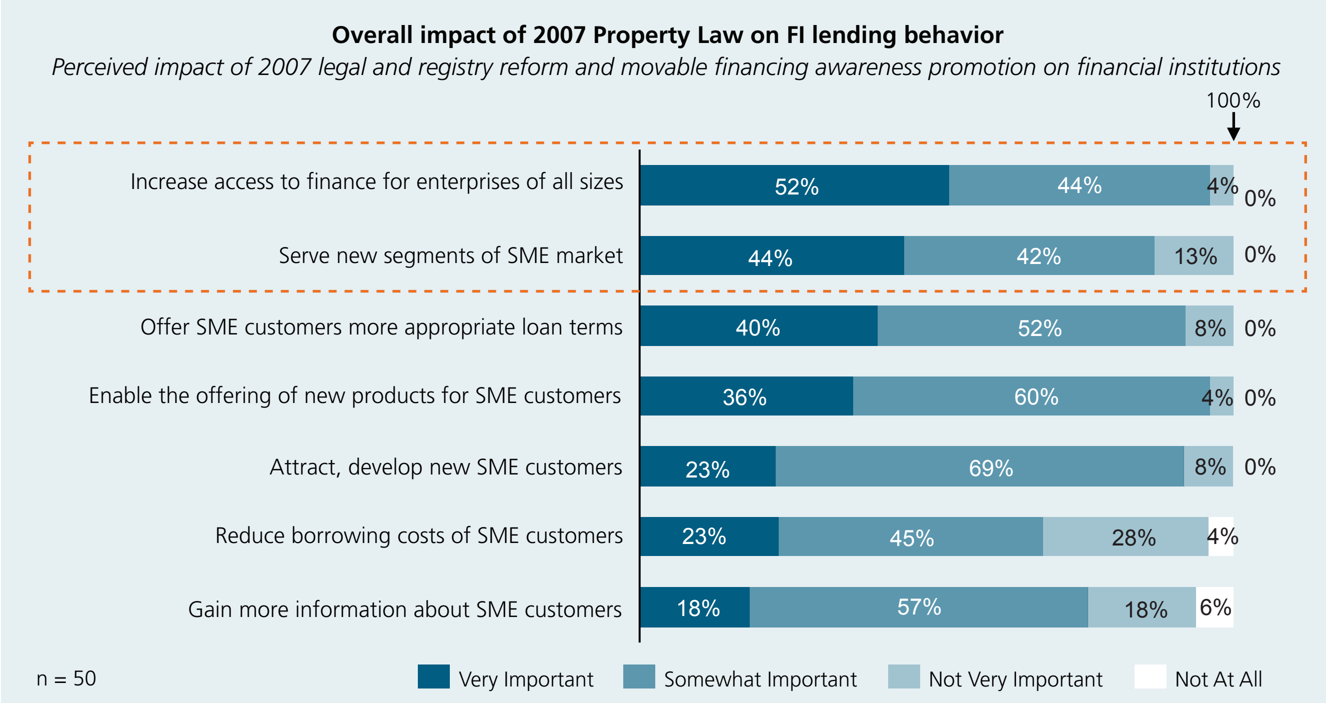
- SMEs perceive “unacceptable collateral” as by far the #1 reason for why their loan applications were denied in the past. 59 percent of surveyed SMEs believe that their business development would be severely impacted, or worse, if their current access to movables financing were to be removed. 88 percent of surveyed

Figure 4 Reasons for the increased lending secured by movable collateral among surveyed financial institutions



Source: 50 financial institutions (FIs) surveyed in Anhui, Guangdong, Shanxi, Shandong, Shanghai, Zhejiang

Figure 5 **Perceived impact of IFC project outcomes**

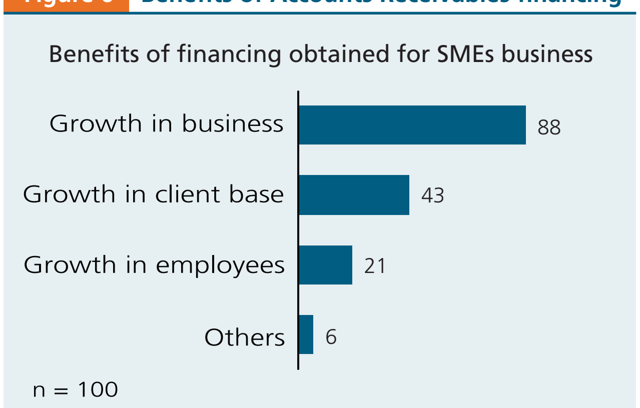


Source: 50 financial institutions surveyed in Anhui, Guangdong, Shanxi, Shandong, Shanghai, Zhejiang, Beijing

SMEs said that business growth was a benefit resulting from obtaining accounts receivables financing (see Figure 6).

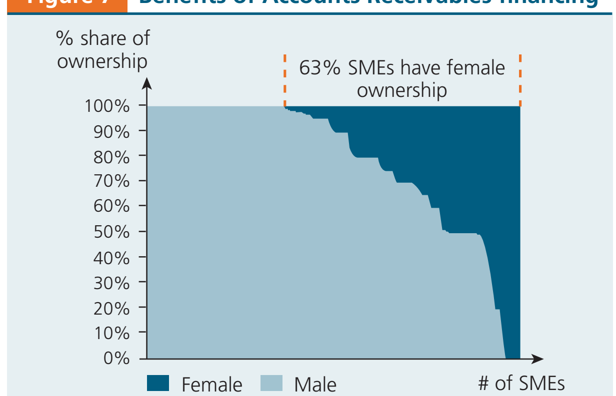
- 63 percent of SMEs that obtained new loans using accounts receivable had female ownership while 20 percent are majority owned by women (see Figure 7).
- 68,575 SME borrowers (excludes unincorporated borrowers) were extended loans secured by accounts receivables which represent 62 percent of the transactions (Note: this is not the total number of borrowers; only incorporated legal persons).

Figure 6 **Benefits of Accounts Receivables financing**



Source: 124 SMEs surveyed in Beijing, Chengdu, Ha

Figure 7 **Benefits of Accounts Receivables financing**



Source: 100 SMEs surveyed in Beijing, Chengdu, Hangzhou, Wuhan and Zhengzhou

3 Lessons learned

Four Replicable Lessons Were Identified

- **Partner with a politically powerful agency with market knowledge and administrative capacity.** People´s Bank of China has been a strong local champion for reform efforts and its understanding of the credit market facilitated the use of international best practices for the design of the reform and registry. Its nationwide network of regional branches has been instrumental in facilitating effective outreach and awareness among financial institutions throughout the country.

- **Position the reform as the "creation of a market".** The complementary activities to promote the movables financing sector were essential to the Project's success. Successful market development and reform requires efforts on multiple fronts including administrative reform, judicial reform, and capacity building of the industry. Even though the Property Law is not completely aligned with global best practices the movable lending industry has been able to grow substantially.

- **Merge local knowledge with global subject-matter expertise.** Consistent management support of a tripartite team of IFC global and local members, and government (PBOC) members has contributed to effective management and dissemination of knowledge. Asset-based lending is becoming a credible lending mechanism in the way that financial statement lending already is. SMEs, in addition to large and state-owned enterprises, have become target clients of commercial lending, by virtue of their movable assets.

- **Sustain a long-term effort with a professional team over time.** The impact of building or reforming a country´s financial infrastructure takes years to materialize. The program manager has been involved in the reform process since 2003. The Project team´s ability to build a working relationship with a diverse range of stakeholders has been critical to the effective implementation of the Project.

4 Remaining challenges

- **Improve the legal and regulatory framework of movables financing through judicial interpretations.** Some of the regulations associated with movables financing such as priority rights in more complex situations and procedures for claims enforcement require further clarification.

- **Lower the costs of establishing priority over security interest in equipment and inventories by building a national registry.** There are opportunities to build on the success of the Accounts Receivables Registry by improving the existing registry and potentially building up a national electronic registry for equipment and inventories.

- **Increase financial institutions' capacity by adopting and innovating lending technologies.** There is room for further strengthening of the service sector that supports movables financing such as third party firms that specialize in evaluating and monitoring assets, and related "market infrastructure" building that would reduce the transaction costs associated with movables lending.

- **Reach out to the SME sector through an educational campaign to boost the business community's awareness of the benefits of movables financing.** There are still opportunities to promote adoption of movables financing by smaller financial institutions through further awareness raising and technical assistance. Many SMEs are also unaware of the possibility of using Accounts Receivables and movables collaterals.

- **To promote movables financing for rural and small borrowers by small lenders.**

Case 1: Construction Company in Zhejiang

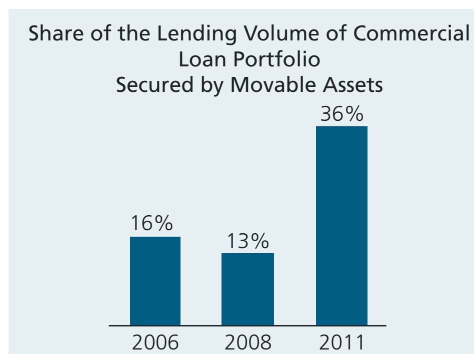
Benefits brought by access to movables financing:

- **Growth in operations:** from RMB 100 million (approximately USD $12.8 million) in sales in 2006 to RMB 900 million (approximately USD $134.8 million) in 2010 and hired 400 more employees in the same period. It has been able to increase its movables-backed borrowing three to four times since 2007.
- **Increased plant efficiency:** three party agreement (company, bank and collateral management firm) shortened production cycle by three to five days. This led to reduced inventory days and increased working capital without any increase in inventory storage capacity.

Case 2: A Large Financial Institution Introducing Movables Lending Nationwide

Impact of adopting movables financing on lending activities:

- Diversify business portfolios and build up a more reliable stream of revenues.
- Movables financing now plays a critical role in the financial institution's growth and product offering.

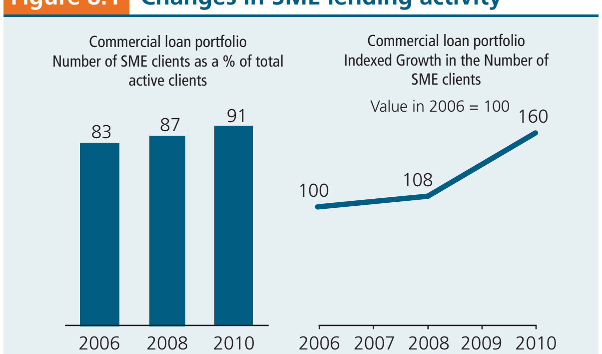


Source: 2011 IFC financial institution Survey

Implications for SME lending:

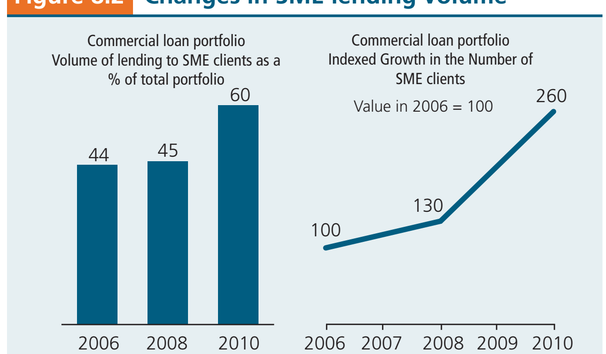
- Expansion into serving SMEs in the manufacturing, trade, and construction sectors.
- Risk associated with movables financing is lower than the real property-based financing.
- Movables financing enables the financial institution to have greater access to the borrower's businesss performance information, and is much more insightful for predicting the chance of loan default than the value of property.
- The financial institution significantly increased both the number of SME clients and the total lending volumes to SMEs.

Figure 8.1 Changes in SME lending activity



Source: 2011 IFC financial institution Survey

Figure 8.2 Changes in SME lending volume



Source: 2011 IFC financial institution Survey

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