

## The Exploration of the Causes of Financing Difficulties of China's Small and Micro Businesses

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### Abstract

Small and micro businesses play an important role in China's economy. But the small and micro businesses are confronted with financing difficulties at the present stage. After introduce the current financing situation of the small and micro businesses, this article analyses the causes of financing difficulties of the small and micro businesses, including the general causes and the special factors. These factors assume the businesses' own factors, information asymmetry in the financing market, disequilibrium of the financial structure, and imperfection of the credit system, etc.

**Key words:** Small and micro businesses; Financing difficulties; The causes

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The small and micro businesses are the enterprises including small businesses, micro businesses, family workshops, and individual business in China. Small and micro businesses play an important role in China's economy, such as creating more jobs, increasing aggregate demand, and adjusting economic structures and so on.

In recent years, the small and micro businesses are confronted with financing difficulties. According to the China's Ministry of Commerce, for the small and micro businesses, 65% development funds come from their equity

fund, 25% come from commercial bank loans, 10% come from civil financing. More than 60% small and micro businesses are confronted with lack of development finance.

### 1. PRESENT SITUATION OF FINANCING FOR THE SMALL AND MICRO BUSINESSES IN CHINA

The present situation of financing for the small and micro businesses in China may be briefly summarized in the following outline.

#### 1.1 Endogenous Financing is the Preferred Way of Financing for the Small and Micro Businesses

At the early period of an enterprise for the small and micro businesses in China, the develop capital mainly comes from their equity fund, from family and relatives, or from private lending. In a word, it is difficult to borrow from commercial banks. Even in the development period, endogenous financing is the preferred financing way for the small and micro businesses in China. A recent sample survey of National Bureau of Statistic indicated that only 15.5% small and micro businesses in China can get commercial bank loans. On the other hand, compared with external financing, endogenous financing can avoid information asymmetry in the financing market, reduce corporate financing costs.

#### 1.2 Banking Institutions is the Main Channel of External Financing for the Small and Micro Businesses

The report of the People's Bank of China showed that the loan balance to the small and micro businesses by the banking institutions was 150 million by the end of 2011, taking up 27.3% of the whole banking loan balance. There are also imbalance in the term structure of the credit funds, which showed more short term loans as opposed to insufficient long term loans.

### **1.3 The Multilevel Capital Market cannot Play a Major Role in Financing the Small and Micro Businesses at Present**

The multilevel capital market system comprises Small and Medium-sized Enterprise Board Market and the Growth Enterprises Market of Shenzhen Stock Exchange, and the OTC market, which consists of the new Third Board Market primarily and being supplemented by the Equity exchange in various regions of the country. By the end of 2011, there were more than 630 listed companies in the Medium-sized Enterprise Board Market, and more than 260 listed companies in the Growth Enterprises Market. The total amount of financing was more than ¥5000 billion. As most enterprises are difficult to reach the listing standards of Medium-sized Enterprise Board Market and the Growth Enterprises Market for small and micro businesses, with asset scale, sales revenue and some other requirements, the financing function for the small and micro businesses of the multilevel capital market is limited.

### **1.4 The Importance of the Informal Lending is Increasing as a Financing Way for the Small and Micro Businesses Recently**

Because of the information asymmetry in the financing market and being feeble in ability of capital mortgage, the small and micro businesses are difficult to borrow from regular banking institutions. Therefore private finance becomes an important financing channel for the small and micro businesses. In Wenzhou, where private economy is relatively more prosperous, nearly 80% funds of the small and micro businesses come from civil financing. But private finance means a higher financing cost, borrowing rate is usually 30% to 50% higher than the basic lending rate regulated by the People's Bank of China. These businesses have to bear a more heavier reimbursement burden.

## **2. THE GENERAL CAUSES OF FINANCING DIFFICULTY FOR THE SMALL AND MICRO BUSINESSES IN CHINA**

There are many factors bring about financing difficulties for the small and micro businesses, such as information asymmetry in the financing market, disequilibrium of the financial structure, government control and the businesses' own factors. Among these the major factors are the information asymmetry in the financing market and the businesses' own factors.

### **2.1 Imperfection in Operation and Development of the Small and Micro Businesses**

Average life of small and micro businesses is generally short, and there are great instability in operation and development of the businesses. Just as follows:

(1) Stability in operation of small and micro businesses is poor.

Small scales of management, less employees and limited assets mean higher risks and lower stability in operation of small and micro businesses, easier to be influenced by the external management environment, and weak anti-risk capability. Investigation shows that average life of small and medium-sized enterprises is 3.7 years in China, and for small and micro businesses is only 2.9 years.

(2) Management mode of small and micro businesses lag behind.

Typical characteristics of modern enterprise system is the separation of the ownership and management right. By contrast, the major management mode of small and micro businesses is a highly unity of the ownership and management right, the investor is the operator of the enterprise meanwhile. This brings about serious negative impact on the management of the enterprises. Most of small and micro businesses are private, strong feature of concentration of power and family-based management of the enterprises lead to lower management level, inattentive supervisory control and unauthorized action. All above result in obstacles and difficulties for small and micro businesses financing from market.

(3) The financial management level of small and micro businesses is lower.

In the early development stage of small and micro businesses, there are usually unsound financial regulations, no financial statements acknowledged by an audit department, and financial situation of the enterprise is usually not transparent. Quite a number of small and micro businesses will hide all kinds of information which is unfavorable to themselves for getting financing from market. There will come some actions as follows: fraudulent bankruptcy, namely true defaulted; provide collateral with insufficient value and fictitious financial statements, to conceal true operating status of the enterprise to mislead bank into granting loans, or change the use of funds after getting the loans from banks. Because of these popular dishonesty, banks are reluctant to lend to small and micro businesses.

(4) Unit financing costs of small and micro businesses is higher.

Restricted by its small capital scale, narrow business scope, and less efficient economic benefit, financing scale of small and micro businesses is smaller than large enterprises, but procedures and links are essential the same for each banking loan, thus there will be a higher unit financing cost to these enterprises for banking institutions.

(5) Credit rating of small and micro businesses is low, and they are often short of qualified collateral.

An financing system with diversified channels, which is more independent, has already been set up in China currently. But for small and micro businesses actually, because of their small capital scale, larger financing costs, and higher financing risk, leads to their poor credit rating and credit standing. On the other hand, they are often short

of qualified collateral. Some small and micro businesses are run under contract operation and leasing management, with on independent property right for collateral. Or as real right, their land, house property and equipment can't be used to take out a mortgage from banks as there is often no complete certification. In addition to this, because of the imperfect guarantee system by now, it's difficult to find an appropriate guarantee institution or guarantor for a small and micro business.

## 2.2 Information Asymmetry in the Financing Market

Information asymmetry exists in whole financing activities widely and objectively. Both direct financing and indirect financing, might encounter obstacles in lending market because of information asymmetry between capital supplier and capital demander. Information asymmetry of credit markets appears in the following three ways: first, recognizing inconsistency on investment risks. The project which is feasible thought by small and micro businesses, maybe a high risk one from the point of view of a commercial bank and refuse to make a loan or increase the lending rate and ask more qualified collateral. Second, burden on gains and losses are not symmetrical for investor and enterprises. A small and micro business can get more profits by the financial leverage, but it will be the investor to pay the bill for a wrong policy decision once a deficit state occurs. The third one, operation capacity is not symmetrical for investor and enterprises. Although the investor can investigate the operation capacity and decision-making capacity of the manager of the firms through all kinds of channels, they are difficult to get the exact and comprehensive information about the enterprise management.

In the financing market, there are so many enterprises with different operation risks. Due to the information asymmetry in the financing market, small and micro businesses have an advantage in getting the information about the enterprise operation status over the banking institutions. This condition will induce transactions in the financing market with fraud of small and micro businesses. To prevent financial risks, banking institutions will ask for a higher credit rate to make up for the high risks, or will be reluctant to lend to small and micro businesses. Thus this will bring about an increasing of financing costs and decreasing of profits for small and micro businesses. The projects with low risks will exit financing market because of a high cost and low gains. At last low risk enterprises exit the lending market. Therefore, banking institutions will make a new higher lending rate according to the high risk financing market state, there will be the high risk enterprises left in the market by the end. Then banks will make an adverse selection, that is, to be reluctant to lend to small and micro businesses.

## 3. THE SPECIAL CAUSES OF FINANCING DIFFICULTY FOR SMALL AND MICRO ENTERPRISES IN CHINA

There are also some special factors in China to explain the causes result in financing difficulty for small and micro enterprises as following.

### 3.1 Disequilibrium of Financial Structure

Financial structure in a country or a region determines directly financing efficiency. The unique financial structure in China is extremely unfavourable for small and micro businesses to finance from market. It shows mainly as follows:

(1) Commercial banks' credit funds always show favor to large and medium enterprise.

There is a certain relationship between the imbalance of credit resources and the current economic system development in China. If operating difficulties occur in national large enterprises, the government will take various measures to help the enterprise, and the enterprise usually have many realizable assets, which means much smaller credit risk for commercial banks lending to a large enterprise. Loans to the SMEs from commercial banks are mostly mortgages, but without sufficient collateralizable assets, small and micro enterprises are difficult to become the lending object of commercial banks, which prefer the medium mature business. Because of large funds scale, with considerable variety of business including settlements, bills, cash management, deposits and precipitation funds, etc, and more retail business brought about by public-private joint business, large enterprises often become the target pursued by most commercial banks whose appetite for credit risk are conservative. Especially for some banks whose risk management level is low prefer large enterprises to small ones in order to avoid credit risks.

(2) The juvenility of the direct financing market causes financing obstacle for small and micro enterprises.

China's capital market has made great progress in recent years. The main board market grows into maturity gradually, SME board market and GEM have been introduced in succession already. But entry conditions of the main board market is too strict to play a major role for SMEs. GEM is designed to help new high-growth innovative companies, especially high-tech companies in financing from the capital market. Most small and micro enterprises are outside the range of high-tech companies, and are also difficult to come up to the relevant listing standard. They are more likely to be excluded from capital market as a fundraiser that in urgent need of financing. SMEs collective bonds and collection bills that just starting out in recent years, are far from satisfying the financing demand of small and micro enterprises in scale.

### 3.2 Imperfection of Development of Credit System

In China, construction of the credit system is still in a starting period, credit system about many small and micro enterprises has not been set up by now, and personal credit standing is in a low level popularly, credit crisis keep on happening continually.

(1) Credit guarantee system for SMEs is not perfect.

Credit guarantee institutions in various countries (regions) aim at supporting SMEs primarily. A perfect credit risk compensation mechanism has not been set up until now in China. Financial strength of most credit guarantee institutions is relatively weak, in the mean time there is an asymmetry of obligation and right between commercial banks and guarantee institutions. Most of the banks are unwilling to undertake obligations, that is, the whole credit risks in the credit guarantee process must be assumed by the credit guarantee institutions. This situation results in the plight in credit guarantee operations.

(2) Credit investigation services are still not in place.

Compared with developed countries, credit investigation services in China are still in early stage. The absence of professional credit rating institutions to supply credit information about small and micro enterprises or the entrepreneur brings about a weak external constraint to the credit of small and micro enterprises or the entrepreneur. Therefore small and micro enterprises are hard to get credit financing from commercial banks because of their lower credit ratings.

Financing difficulties of small and micro enterprises in China will be prominent in the next period of time. So the financial services level for small and micro enterprises remains to increase. There should be some concrete and workable measures to resolve the problem, including completing statistics caliber of financial services and information disclosure system for small and micro enterprises, setting up incentive mechanism of financial services for small and micro enterprises, vigorously developing small and medium financial institutions and multiple capital market, improving financial infrastructure construction, ameliorating effectively survival and development circumstances and promoting healthy development of private finance, and so on.

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