China: SME Lending Programme II and III

Ex-post evaluation

OECD sector	24030/Formal sector financial intermediaries	
BMZ project ID	1998 67 185, 1999 65 559 (sample 2009)	
Project executing agency	**II:** HuaXia Bank, **III:** China Merchant Bank, China Minsheng Banking Corporation	
Consultant	Frankfurt School of Finance & Management gGmbH	
Year of ex-post evaluation report	**2010**	
	Project appraisal (planned)	**Ex-post evaluation (actual)**
Start of implementation	**II** Q 4 2001 **III** Q 4 2003	**II** Q 2 2010 **III** Q 2 2010
Period of implementation	**II** 46 months **III** 46 months	**II** 58 months **III** 81 months
Investment costs, counterpart contribution	No figures	No figures
Financing, of which Financial Cooperation (FC) funds	**II** EUR 19.17 mill. EUR 0.35 mill. (training) **III** EUR 51.13 mill. EUR 2.00 mill. (training)	**II** EUR 19.17 mill. EUR 0.35 mill. (training) **III** EUR 81.71 million EUR 2.00 million (training)
Other institutions/donors involved		
Performance rating	**II: 3 III: 2**	
• Relevance	**II: 3 III: 2**	
• Effectiveness	**II: 3 III: 2**	
• Efficiency	**II: 2 III: 2**	
• Overarching developmental impacts	**II: 3 III: 2**	
• Sustainability	**II: 2 III: 1**	

Brief description, overall objective and programme objectives with indicators

The programmes comprised one FC loan each to altogether three Chinese commercial banks (SME II: HuaXia Bank, SME III: China Merchant Bank and China Minsheng Banking Corporation) for refinancing loans to small and medium-sized enterprises (SMEs) in China. All three banks are listed on the Shanghai Stock Exchange, but only the shares of the China Minsheng Banking Corporation (CMBC) are completely in private hands. State-owned enterprises are the largest aggregate shareholders in the others.

Through complementary personnel support measures, the partner banks were also to be assisted in setting up or improving SME business and in-house procedures.

The programmes pursued the overall objective of making a contribution to environmentally compatible (only SME II) economic growth, to securing and creating jobs and deepening the financial system by promoting non-governmental enterprises. At Phase II appraisal, no overall objective indicators were initially defined. For Phase III, overall objective achievement was defined as a) a satisfactory return on equity of the promoted enterprises and b) an increase in the ratio of the loans to non-governmental borrowers in the loan portfolios of the banks.

The specific objective of the programmes was the sustainable expansion of efficient, profitable, long-term lending business to meet the needs of SMEs. To measure the programme objective achievement, some different indicators were selected in the programmes.

Objective indicators in SME II were: a) At least 70% of loans issued in the SME lending programme are long-term (with a maturity of at least 5 years). b) Loan interest rate is positive. c) PaR>90 days amounts to less than 15%. d) The equity ratios of the partner banks do not fall below the relevant standard of the Bank for International Settlements. e) The capacity utilisation of the financed facilities amounts to at least 65% in the 3rd operating year.

In SME III, the objective indicators were: a) The programme funds are fully appropriated within 4 years after availability for withdrawal. b) After full appropriation, at least 75% of the refinanced loans are scheduled for a term of at least 1 year and at least 30% for a term of at least 5 years. c) PaR>90 days makes up less than 7.5% of the total loan portfolio. d) Real loan interest rate remains positive.

Programme design/major deviations from original planning and main causes

The FC funds amounting to EUR 99.05 million (SME II and SME III) were issued as a loan to the Chinese Government represented by the Chinese Ministry of Finance (MoF), with the State Equity and Corporate Finance Department as the borrower. This onlent the funds as loans in SME II via the Exim Bank to the participant HuaXia Bank, and in SME III directly to the partner banks. Loans to the final borrowers were made in keeping with the prevailing terms and conditions in China with the requirement in SME III of arranging these to cover the risk and administrative costs of the final loan. Lending to the final borrowers was denominated in EUR or RMB (only SME III). With foreign currency loans, the final borrowers bore the currency risk and repayment was made in EUR. In SME II, it was agreed that each final loan be submitted to KfW for approval; in SME III, this only applied for the initial phase and only for loans exceeding EUR 2.5 million. Under SME III, it was explicitly agreed that individual approval should no longer be undertaken by the Finance Ministry and instead that loans were to be issued solely in keeping with competitive criteria. Repayments of principal by the final borrowers were to be used by the participant banks for further lending to non-governmental SMEs. Besides the banking loan application appraisals as such, SME II required an explicit environmental impact assessment of each financed project. This was already standard procedure for lending in China at the time of SME III and was no longer explicitly included in the final lending terms and conditions. The consultant financed in the complementary measure conducted altogether 92 training workshops totalling 675 training days with the three partner banks in the SME II and SME III programmes. The training contents included both training for the top management at the banks and training of personnel in SME lending principles, loan portfolio management, accounting and auditing, sales and product development. Sustainability was assured by training bank personnel as trainers for future workshops.

Key results of impact analysis and performance rating

a) Relevance: In the transition of the Chinese economic system to a Socialist market economy, SMEs play a major role in economic growth and in creating and securing jobs. Access to medium-term and long-term finance in particular, however, still poses a decisive bottleneck for SMEs, since the financial sector mainly concentrates(d) on large state-owned enterprises. The promotion of both SME development as a driver for employment and growth and the financial sector in general conforms with the priorities of the Chinese Government. At the time of appraisal, the programmes reviewed in the ex-post evaluation were in keeping with the priorities of the country strategy for China and conform with the BMZ financial sector development strategy. As TC engagement in the Chinese financial sector concentrates on setting up microfinance institutions and improving the legal framework for microfinance and securities trading, it provides a suitable complement to German FC. Lending via banks in these programmes is largely in keeping with the procedure in current German FC strategy, i.e. the banks select the final borrowers on their own after a thorough risk assessment. Currently, there is no explicit coordination of the individual engagements of various bilateral and multilateral donors. Altogether, we assess the relevance of the SME III programme as good (Subrating 2) and the SME II programme as only satisfactory (Subrating 3) due to the requisite individual loan appraisal by MoF and KfW at that time as well as the requirement for environmentally compatible growth in the set of objectives, though not in programme design.

b) Effectiveness: As to the amount of finance disbursed, the objectives of the SME lending programme III were met in full, those of SME II only in part, however, due to the withdrawal of one of the partner banks. Although all the real interest rates were positive as required, there are indications that a cost-effective interest margin was not charged for all loans (particularly coverage of risk costs). The maturity of the loans disbursed was considerably higher on average than the average for the overall portfolio of the participant banks, even though the programme objective indicators were not achieved in full. The participant banks have, however, built up long-term customer relationships with almost all borrowers, so that formal short-term loans have frequently been converted into long-term ones in effect via revolving lending. All the SMEs financed in the programmes service their loans properly and a large part has already been redeemed. Till now, no loan losses have been recorded and are not expected for the remaining outstanding loans, either. Considering the many defaults in the non-evaluated SME Phase I (see below), which were guaranteed by government warrantors, this can be rated as a particular success. The programme loans in combination with the related training programme met with very high acceptance by the partner banks and have had a clear demonstration effect on them. All participant banks have now devised some very innovative SME strategies and begun with their implementation (e.g. setting up separate SME departments and/or branch offices). The objective indicators for the requisite overall portfolio quality at the banks were well exceeded and the same applies for return on equity. Despite the financial crisis, all the banks inspected appeared to be stable, growing and profitable. Altogether, the effectiveness of the SME II programme is judged to be satisfactory only (Subrating 3) due the withdrawal of one partner bank and that of the SME III programme is rated as good (Subrating 2).

c) Efficiency: All participant banks have built up suitable organisational structures, operate lending based on standardised procedures, have a high risk awareness and are in the process of setting up professional risk management systems specialising in SMEs. The low delinquency rates also attest to a high degree of professionalism and efficiency in lending. A contributory factor here has also been the broad training of personnel in the complementary measure. Production efficiency can therefore be rated as satisfactory at least. The demonstration effects and impact sustainability (see below) attest to high allocative efficiency. Accordingly, the SME II and III programmes are rated as good in terms of efficiency (Subrating: 2).

d) Overarching developmental impacts: As already mentioned in programme objective achievement, the programmes have had demonstration effects and made a clear contribution to the development of SME business in participant banks. All of these clearly focus their lending business on the SME target group and are visibly positioned on the Chinese financial market, particularly the banks in the SME III programme. Based on visits to three final borrowers, which are all profitable, expanding enterprises with innovative products suitable for the international market, and considering that almost all final borrowers have built up a long-term banking relationship and some are now even large customers of the bank, we can infer that the programme has given an impetus to economic and employment growth. This should not be overestimated, though, in view of the size of the Chinese economy. The contribution to financial system development can be expected to continue to have additional beneficial effects on economic and employment development in future as well. In the SME II lending programme, no special importance was evidently attached to the environmental impacts of the financed SMEs. Initiatives for this kind of finance are just beginning in the participant banks. The overall objective achievement of SME III is rated as good (Subrating 2) and that of SME II as satisfactory (Subrating 3).

e) Sustainability: All banks view SMEs as one of their most important customer groups and have set up professional units to serve SMEs and/or are in the process of doing this. All banks are financially stable and growing and record good profitability. The programmes' impacts can therefore be expected to be sustainable. Since the partner banks of SME II have evidently taken far-reaching measures for the sustainable development of SME business, the sustainability of the SME III programme is rated as very good (Subrating 1) and that of the SME II programme as good (Subrating 2).

Weighing up the individual evaluation criteria above, the SME II programme performance overall is assessed as satisfactory (Rating 3) and the SME III programme as good (Rating 2).

General conclusions

SME Lending Programme I: Although the SME Lending Programme I is not part of the ex-post evaluation, as it was not included in the sample, the performance assessment of the SME programmes II and III cannot be completely divorced from the first programme, particularly since the lessons learnt influenced the design of the subsequent programmes. Since in the SME I programme responsibility for the selection of financed SMEs was assigned to the Chinese Finance Ministry at that time, substantial deficits could be anticipated, particularly in lending professionality, risk assessment and monitoring. In fact, almost all final borrowers have not redeemed their loans or not on schedule, the loan terms were standardised regardless of the needs of the enterprises and the interest margins proved to be completely insufficient for cost recovery, considering the many defaults. Besides borrower selection by the Finance Ministry, a major reason for the failure of the programme would seem to have been the absence of personnel support, as the participant banks completely lacked the necessary know-how for SME lending at that time. Thanks to the technical assistance in the SME programmes II and III and the increasing delegation of responsibility for borrower selection to the banks, there has been a distinct improvement in the outcomes of programmes II and III in comparison with the SME I programme. The SME I-III programmes thus show that developmental success and sustainability at programme executing agency level and hence also the intended capacity development effects depend heavily on the relevant standard of know-how of the executing agency and/or the implementation of complementary measures for their improvement. In addition, they provide impressive evidence of how important it is for lending to be based on purely commercial considerations with no political influence.

Apart from the poor implementation or the unsatisfactory outcomes, the significance of the SME I programme should not be underestimated as a forerunner for the follow-on programmes and must be viewed as performing an important 'bridgehead' function. Particularly in view of the very early stage of the Chinese reform process at the time of programme start, without the confidence-building effects of SME I - particular at the Finance Ministry – cooperation under SME II and SME III would not have been possible. The statements of the partner financial institutions also substantiate this.

Notes on the methods used to evaluate project success (project rating)

Projects are evaluated on a six-point scale, the criteria being relevance, effectiveness (outcome), "overarching developmental impact" and efficiency. The ratings are also used to arrive at a final assessment of a project's overall developmental efficacy. The scale is as follows:

1	Very good rating that clearly exceeds expectations
2	Good rating fully in line with expectations and without any significant shortcomings
3	Satisfactory rating – project falls short of expectations but the positive results dominate
4	Unsatisfactory rating – significantly below expectations, with negative results dominating despite discernible positive results
5	Clearly inadequate rating – despite some positive partial results the negative results clearly dominate
6	The project has no positive results or the situation has actually deteriorated

A rating of 1 to 3 is a positive assessment and indicates a successful project while a rating of 4 to 6 is a negative assessment and indicates a project which has no sufficiently positive results.

Sustainability is evaluated according to the following four-point scale:

Sustainability level 1 (very good sustainability)

The developmental efficacy of the project (positive to date) is very likely to continue undiminished or even increase.

Sustainability level 2 (good sustainability)

The developmental efficacy of the project (positive to date) is very likely to decline only minimally but remain positive overall. (This is what can normally be expected.)

Sustainability level 3 (satisfactory sustainability)

The developmental efficacy of the project (positive to date) is very likely to decline significantly but remain positive overall. This rating is also assigned if the sustainability of a project is considered inadequate up to the time of the ex post evaluation but is very likely to evolve positively so that the project will ultimately achieve positive developmental efficacy.

Sustainability level 4 (inadequate sustainability)

The developmental efficacy of the project is inadequate up to the time of the ex post evaluation and an improvement is very unlikely. This rating is also assigned if the sustainability that has been positively evaluated to date is very likely to deteriorate severely and no longer meet the level 3 criteria.

The overall rating on the six-point scale is compiled from a weighting of all five individual criteria as appropriate to the project in question. A rating of 1 to 3 indicates a "successful" project while a rating of 4 to 6 indicates an "unsuccessful" project. In using (with a project-specific weighting) the five key factors to form an overall rating, it should be noted that a project can generally only be considered developmentally "successful" if the achievement of the project objective ("effectiveness"), the impact on the overall objective ("overarching developmental impact") and the sustainability are considered at least "satisfactory" (rating 3).