Chapter 2
Can "Guaranty" Be Guaranteed?—SME Loan Guaranties

In 1993, when China's first credit guaranty entity, the China Economic and Technology Investment Guaranty Company, was established with the approval of China's State Council, the Chinese guaranty industry came into existence, and it has now been around for 20 years.[1] As a business that provides credit enhancement for microloans with relatively higher risks, the associated guaranties make the healthy development of microloans and SME financing possible. At present, the guaranty industry in China operates through government funding as its mainstay, commercialized non-governmental guaranty firms as its primary provider, and multiple forms of guaranty. The challenge, however, lies in the sustainability of the business models currently entrenched in the guaranty industry.[2] Several scandals, which occurred in the guaranty industry in recent years, have triggered concerns about the workability of the guaranty business in the long-run,[3] bringing to light inherent risks and causing experts to predict a nearly inevitable reshuffling of the industry.[4] As a result, it would be greatly instructive to explore this important but volatile industry for the business models adopted, the features of the guaranty firms, and the risks inherited in this industry with some representative case studies, in the following sections.

2.1 What Is a Financial Guaranty?

A guaranty in debt financing is generally defined as a promise by a guarantor to repay the principal and interest to the beneficiary of the guaranty on behalf of the guarantee, in the case that the guarantee can't fulfill his or her loan obligations on

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[1]Bosi Data: http://www.bosidata.com/jinrongshichang1208/493271FT27.html.
[2]Sun (2010).
[3]http://news.51zjxm.com/tourongzi/20120802/19279.html.
[4]http://www.rzdb.org/db/hyzx/hyyw/30847.html.

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the debt.[5] The financial products that are covered by guaranty agreement include loans, debt securities, over-drafts, deferred payment, and credit lines from commercial banks. As the most important guaranty products, a guaranty for debt financing bears double characteristics of finance and intermediaries, and, as a third party guarantor, provides a credit guaranty to lenders, typically financial institutions such as commercial banks, companies and individuals; and borrowers, typically comprise companies and individuals. Guaranty for debt financing is generally considered an intermediary credit activity.

Guaranty for debt financing can be generally classified into property right guaranty, guarantor guaranty, and loan guaranty. In the case of a property guaranty, the debtor may take the property right that an individual or institution has on fixed properties—such as land and buildings, tangible assets such as machinery, equipment, finished products, semi-finished products, and raw materials, and intangibles such as rights from contracts, bank accounts, and patents—in the case of default. Guaranty on property right can take two forms: one is collateral, in which the guarantee agrees to transfer the ownership of collateral to the debtors for the purpose of guarantying the loan. However, when the debt obligation is fulfilled, the transferred right will be returned to the borrowers. The second type is a guaranty that doesn't involve in the transfer of a property right, and is purely an agreement among the lenders, borrowers and guarantors.[6]

A guarantor's guaranty is a legal promise by the guarantor to undertake certain responsibilities on behalf of borrowers for the lenders, which can result in a secondary legal promise for a debt agreement. In the case of default, the guarantor assumes the responsibility of the borrowers. There are several forms of guarantor's guaranty. (1) The investor assumes the role of the guarantor, and establishes a professional and project-specific company in order to manage projects and arrange the financing; (2) A related third party is selected as the guarantor; and (3) A professional commercial guarantor is chosen. Because of diversified operations and the fees that are charged, the professional guarantors can guaranty the debt transactions, and diversify their own risks. Typically, these professional guarantors are commercial banks, investment banks, and other specialized financial institutions, and the products they provided are typically bank credits or bank guaranty.

A loan guaranty is a third party promise for borrowers to lenders. In the case of default, the guarantor will be responsible for the unpaid principal and interest. The guaranty agreement becomes effective once borrowers have received the loan, and the agreement becomes invalid when the loan principal and interest are fully paid back by either the borrowers or the guarantors. Loan guarantys are the primary business line of credit guaranty companies, and their major functionalities are to facilitate financing to SMEs, diversify risks, and secure the safety of credit loans.

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[5] http://baike.baidu.com/link?url=m95gkjzTww9g1Qqbl5P2Fmxbba-wMDpxBB_VqRPSlDMuTWHqUNsMKtEhDJ66e7H1.

[6] Ibid 5.

2.2 A Glance at Financial Guaranty Industry in China

Created as a companion to microloans, the financial guaranty industry grew rapidly as microloan firms mushroomed in China in recent years. Because the borrowers of microloans are typically in the "eighty percent," with relatively lower credit and relatively higher risk, finding a way to enhance the creditability of the borrowers and/or transfer the risk to a third party with stronger risk-bearing-ability becomes the key to sustainable growth in the microloan industry. Financial guaranty provide exactly these two functionalities to satisfy these yet unsatisfied demands in China.

Since 1993, the financial guaranty industry has undergone several stages and experienced fast growth, but not without ups and downs: (1) from 1993 to 2000, only a sparse number of financial guaranty firms existed, and they were basically supported by government funding; (2) from 2001 to 2010, as China's entered into the WTO and the development of private sectors burgeoned, the financial guaranty industry was put on a track of fast growth, thanks to the massive inflow of private equity. In particular, when the 2008 global financial crisis broke out, guaranty became even more crucial in SME financing. As a result, more capital, including foreign investments, were encouraged to enter into this industry, and the resulting growth was explosive; (3) In 2011, when China's central government agencies issued some guidelines regarding the regulating of financial guaranty, the entire industry became more organized, in terms of pre-established conditions, scope of business, rules and regulations, and legal responsibilities.[7]

As of year-end 2010, there were 6030 financial guaranty firms nationwide; among them, 1427 (23.7 %) were state-owned and 4603 (76.3 %) were owned by either private capital or foreign equity. There were 29 firms with a registered capital of over RMB 1 billion, with over 40 % of the firms having registered capital of over RMB 100 million. The total assets in the industry had reached RMB 592.3 billion, with net assets RMB 479.8 billion, and a guaranted balance of RMB 1.153 trillion that was growing at 64.6 % on a year-over-year basis. The rapidly expanding financial guaranty industry was serving over 140,000 SMEs in 2010 alone, with a guarantyd loan balance of RMB 689.4 billion, numbers which increased by 58.3 and 69.9 %, respectively, on a year-over-year basis.[8]

Meanwhile, as government agencies began announcing regulations on the industry, self-disciplined organizations in the industry were also being established. As industry norms began to set in, financial guaranty firms were also starting to operate in a more standardized manner. As a result of this systematic overhaul, the payment ratio in 2010 was at a low of 0.7 %, the loss ratio was down to 0.04 %, the total reserve balance reached RMB 35.3 billion, the guaranty allowance ratio was at 3.1 %, and the guaranty coverage ratio was at 507.28 %.[9]

[7]Bosi Data: http://www.bosidata.com/jinrongshichang1208/493271FT27.html.

[8]Ibid 7.

[9]Ibid 7.

As a fast growing industry with the majority of its customers in the lower end of the market, the risk inherent to financial guaranty could not be ignored. In 2013, three financial guaranty firms, Zhong Dan, Hua Ding, and Chuang Fu, were exposed by media as having incurred severe violations of the laws and regulations as a result of their operations, and commercial banks were mandated to terminate their collaborations with financial guaranty firms. The industry visibly slowed in growth: in 2012, the total guarantied balance was RMB 2.17 trillion, growing only 13.5 % over the previous year.

In particular, the payment ratio significantly increased from 0.16 % in 2010, for example, to 0.42 % in 2011, and further to 1.3 % in 2012. The total payment amount reached RMB 25 billion. The most significant payments were primarily from the steel and solar industries; a single payment in each could be as high as RMB 1 billion. As the payment ratio went higher and higher, however, the guaranty coverage ratio didn't increase accordingly. By the year end of 2012, the guaranty coverage ratio reduced to 280.3 %, down by 327 % points over last year, and the guaranty allowance ratio was only up infinitesimally, from 3.1 to 3.2 %.[10]

Overall, because financial guaranty is a risk transfer and credit enhancement tool for less creditable borrowers of microloans, micro loans won't be able to develop or grow independently of the financial guaranty industry; they have to grow in tandem. The ups and downs of financial guaranty in past years simply indicate that the industry is still in its early stage of development. As long as the financing needs of the "eighty percent" are still not satisfied, microloans will definitively be needed to fulfill that demand, and financial guaranty, the "brother" of microloans, will be similarly indispensable.

2.3 The Business Model of Financial Guaranty

Despite being companions to microloan firms, financial guaranty firms are quite different from microloan firms in their methods of operation. While microloan firms depend primarily on their own funding sources to generate cash flow, such as through lending with relatively low leverage, financial guaranty firms, as a risk transformer and SME credit enhancer, generate cash flows through guaranty premiums, consulting fees, and other businesses, such as lending with their own funds.[11] Since financial guaranty firms undertake the contingent liability in the case of default, their leverage level is much higher than that of microloan firms.

The business model of financial guaranty firms can be classified in different ways. One method is to categorize the loans into debt financing-related guaranty and equity investment-related guaranty. Because guaranty firms will undertake the

[10]China Industry Consulting, http://www.china-consulting.cn/news/20121122/s81921.html.
[11]Ruan (2012).

debt repayment responsibilities only when the borrower cannot fulfill his/her obligations to repay the debt in the case of debt financing-related loans, financial guaranty is considered a quasi-form of debt financing. The primary income source, under this model, will be the guaranty premium. Because the guaranty premium is typically about 2–3 % of the total loan value, and guaranty firms need to pay 100 % of the loan in the case of default for the original borrowers, financial guaranty is considered a relatively high risk but low return business.

In contrast, guarantys related with equity investments combine financial guaranty and venture capital investments. By obtaining returns through venture capital investments with convertible debt, there is an increased potential for higher equity investment returns, and is a way for financial guaranty firms to compensate for the relatively higher risk. Through this method, the nature of financial guaranty can be transformed from quasi-debt financing into quasi-equity financing. If the borrowing firm is successful in going public, the guaranty firms will be able to obtain equity shares through convertible securities they received as a "premium" on the guaranty. In the case that the IPO is unsuccessful, the guaranty firms will then receive compensation through liquidation at a priority higher than that of equity shareholders. Compared to "pure" venture capital firm, the risks bore by the guaranty company will be smaller, so the number of convertible securities received by the company will be less than the number received by venture capital investors for the same amount of debt guaranty, or equivalent amount of the venture capital investment. Incidentally, in the case of a successful IPO, the return for guaranty firms will be less than those for a venture capital as well.

As in many other financial areas, where asymmetric information is the root cause of risk in a financial transaction, asymmetric information is also one of the primary risks in financial guaranty. There are two facets to the asymmetry: one is the asymmetric information between the guaranty firm and guarantied SMEs, and another is within the guaranty firms themselves, between the guarantor and its agencies. But, no matter which party among these is dominant in any given transaction, it is always the financial guaranty firms that ultimately bear the default risk of borrowers, seeing as they "guarantied" that they would cover the risk of the loan transaction.[12]

The more fundamental issue regarding the risk of financial guaranty, however, lies in the business model of guaranty itself. Because the premium on a guaranty is typically but a small fraction of the total value of the transaction it guarantied—say, 2–3 %—but the guaranty firm needs to cover 100 % of the loss in the case of default, the guaranty companies have less than abundant incentive to take on these loans. However, creating a stricter risk control system and providing a certain level of scale for these companies may be the key to reducing risk, and make the business more attractive for guarantors. Stricter risk control will help eliminate unqualified borrowers while reducing the numerator of the default ratio, and the larger scale of the business may increase the denominator of the default ratio and provide room for

[12]Gu (2011).

the law of large numbers take effect. Currently as it is, even with re-guaranty and re-insurance, there will be no significant change to the nature of risk transfer in the guaranty business. In 2012, the mean multiplier for guaranty was 1.76—that is, the value of guaranty loans was only 1.76 times that of the registered capital of financial guaranty firms. Given the annualized interest rate on 1-year loan of about 6.56 % and the fact that the guaranty premium of the loan wasn't allowed to exceed 50 % of the bank interest rate, the annualized return (including other income sources) of guaranty firms was only 5.77 %. If further incorporating the operating cost into this equation, along with tax and other expenses, the net return for financial guaranty firms was truly on the bottom of the pile.[13]

One of the recent "innovations" in the guaranty market to address this issue is the "mutual guaranty", a situation in which several firms form a group in order to apply for bank loans jointly. While each firm aids in enhancing the overall credit for other members of the group using their own credit, it also shares the default consequence if any one of the group members suffer bad luck. It's clear that mutual guaranty are a double-edged sword, and, depending what stage of the business cycle each of these firms are in, it can be either beneficial or detrimental.

Another proposal for mitigating the risk issue is the "risk fund pool", which requires borrowers to pay into a "risk mutual fund". Commercial banks will use the fund as collateral when issuing loans to the borrowers. The value of the loan amount is typically in the range of RMB 500,000 to 5 million, and the required risk fund contribution is about 15–20 % of the total loan value. In addition, another risk reserve fund is also required, which is typically 0.5–2 % of the total loan value, for the established mutual assistance group members by region or by industry.[14]

2.4 The Shepard of the Chinese Guaranty Industry—Shenzhen HTI Corp

Shenzhen HTI Corp, established on December 29, 1994 with a registered capital of RMB 1.2 billion, was Shenzhen's first guaranty firm.[15] It provided guaranty, consulting and investment services for high tech companies, especially firms and industries with government policy support. Since its inception, Shenzhen HTI Corp has guaranteed over 1000 companies, and supported many start-ups in their pursuit to become the leading firms in their respective industries.[16] As one of the fourteen initiators of the National Guaranty Alliance in China, Shenzhen HTI has become one of the most well-known and influential firms in the guaranty industry in China.

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[13]Financial Guaranty Online: http://www.rzdb.org/db/hyzx/hyyw/30847.html.

[14]http://baike.baidu.com/view/10055028.htm.

[15]http://www.szhti.com.cn/.

[16]http://baike.baidu.com/link?url=f5OywIj1IWUM_1F9hxUDHNZfD6lRTXaOuHiFk1qEOotT0uzkE2mfRHt_KOFBoKh3DSSGYn18ueXljiURlvv5I_.

Shenzhen HTI started as a guarantor of projects with government policy support, and positioned itself as a “bearer and extender” of government industry policies and fiscal policies. HTI determined that, since it worked on government-policy-supported projects, it would be easiest to collaborate with state-owned commercial banks to obtain funding for the firms it plans to guaranty. HTI’s primary business line is financial guaranty for high tech start-ups, but it also operates other business lines such as commercial guaranty and venture capital investment. HTI’s products and services include guaranty for working capital loans, guaranty for fixed asset loans, guaranty for bank notes and commercial papers, guaranty for letter of credit, guaranty for project bids, and guaranty for law suits.

HTI developed several new business models such as the “exchange premium for profit sharing”, the “exchange premium for options”, and the “exchange guaranty for investments”, and through these business models achieved an aggregate RMB 12 billion of guaranty, providing guaranty services for over 2000 firms and undertaking over 3000 projects in a 19-year time span. Through the services of HTI, another RMB 10 billion yuan of investments were brought in for the guaranty firms and their projects. According to the 3.56 ratio of input and output for high-tech firms in Shenzhen, these guaranties lead directly to RMB 43 billion in high-tech product value, and indirectly supported many other SMEs on the supply chain of these guaranteed firms, with an estimated product value of RMB 60 billion. In addition, HTI invested over RMB 112 million on various high tech start-ups, and enabled them to grow and become leading firms in their respective industries. HTI’s annualized total return across all these firms is over 21 %. Here are several examples of such firms.

2.4.1 BYD, the Warren Buffet Favorite

BYD is among the most famous firms that HTI has guaranteed. A high-tech start up, BYD was founded in 1995 and specialized in producing rechargeable batteries.[17] Since 1996, HTI has provided 2 million yuan financial guaranty every year. In a particular instance, HTI issued an over 9 million guaranty in 1998 for a 3-year loan to support BYD’s R&D in the MH-Ni battery. In 2000, BYD further received guaranty of RMB 70 million for a 5-year loan to set up its high-tech park, which now spans 40 acres of land. 6 years later, BYD repaid back all its loans in advance, and became one of the largest battery and hybrid car makers in the world. In September 2008, BYD received a USD $230 million equity investment from Warren Buffet at a market valuation of USD $2.3 billion.

[17] http://www.bydauto.com.cn/.

2.4.2 SINOVAC Biotech, Ltd

SINOVAC Biotech (NASDAQ Ticker: SVA) is a bio-tech start up that produces vaccines combating infectious diseases.[18] When the firm first started operating, it had long R&D cycles and inadequate short-term cash flow, and so continuity and survival became a major concern. In 1999, when the company's existing loans reached maturity, SINOVAC applied for a guaranty of RMB 9.7 million and loans of HK $7.2 million from HTI in order to restructure its debts. Through due diligence, HTI carefully assessed the potential of SINOVAC's products, and provided a guaranty for RMB 18 million. With HTI's support, SINOVAC successfully passed through the bottleneck and became the largest vaccine producer in China, now with 60 % market share. The cumulative total of the loans guaranteed by HTI over the years is over RMB 100 million.

2.4.3 Shenzhen Terca Technology, Ltd

Shenzhen Terca, established in October 2000, is a technology firm specializing in electrical brakes for buses.[19] When it first sought out a guaranty from HTI, Terca was only a micro firm in the niche-sized high-end bus market. However, through thorough market research, HTI assessed that, since China has the largest bus market in the world, the demands for high end busing should increase as the Chinese economy grows. As a result, the demands for brake parts of such high end buses should rise as well. Based on this assessment, HTI decided to provide RMB 2 million guaranty for Terca, and increased its guaranty to 8 million in the following years. In 2005, HTI further provided 20 million guaranty for the set-up of Terca's industrial park. Today, Terca is the largest producer in its market in China.

2.4.4 Hans Laser

Hans Laser (Shenzhen Stock Ticker: 002008) is a laser cutting equipment maker, set up in 1996.[20] In 1999, HTI invested RMB 4.38 million in Hans Laser, and held 51 % shares of the firm. Within one year of HTI's investment, Hans Laser achieved annual sales of RMB 60 million. On April 4, 2001, Hans Laser purchased back 46 % of the shares held by HTI, with a premium over RMB 10 million. HTI gained 600 % return for its initial investment within 2 years. In 2004, Hans Laser went public on the SME Board of the Shenzhen Stock Exchange.

[18] www.sinovac.com.

[19] www.terca.cn.

[20] www.hanslaser.com.

2.4.5 Shenzhen HYT

Shenzhen HYT is a mobile communication equipment maker, set up in 1995.[21] HYT developed the first walkie-talkie in China. However, HYT didn't have enough funds to commercialize its product. It was HTI that provided the guaranty for HTY's first RMB 500,000 loan. In the following years, HTI separately provided more guarantees up to a total of RMB 20 million worth of loans, including the funds for building HTY's headquarters and factories. At present, HTY is the largest walkie-talkie maker in China with sales over RMB 800 million in over 70 countries. Its customers include the United Nations, the US Post Office, the Italian Police, and the Russian Police.

2.5 The Future of Guaranty Industry in China

The financial guaranty industry in China, after over twenty years of development, is facing several prominent challenges. As the history of the industry indicates, financial guaranty in China were originally designed to be a complement to government policy, and to fill a gap in the financing of high tech start-ups such as Shenzhen HTI. As the Chinese economy moves forward, however, the financing difficulties facing SMEs emerges as a new bottleneck in China's economy, one which threatens the sustainability of China's future economic growth. As we have seen that there has been a "market failure" in financing SMEs in China, financial guaranty were considered "credit enhancers" for SMEs, intended to obviate the need for SMEs to obtain adequate collaterals and credit before securing badly-needed loans. Ideally, this type of financial guaranty should be undertaken by the government through government funding, a practice carried out in countries such as the US, Japan, and South Korea.[22] In practice, however, it moves towards commercialized financial guaranty in China, due to inadequate funding from government budget, and inadequate regulations from related government agencies.

The issue with non-government-led commercialized guaranty lies in the potential lack of sustainability of the business model, given the significant asymmetry for guaranty firms between income and risk. Even with some government policy support, such as capital injection, risk compensation, awards, and the requirement of risk reserves, the results were unimpressive: in 2013, the multiplier of guaranty was only about 2.3, just slightly higher than 2.1 in the previous 3 years, but much lower than the multiplier of 20 in South Korea, of 50 in the US, and of 60 in Japan.[23] In these countries, setting up a nationwide SME guaranty system is considered common practice. In the US and Japan, for example, there is a fixed budget

[21] www.hytera.com.cn.

[22] http://www.rzdb.org/db/hyzx/hyyw/30860.html.

[23] Ibid 21.

that is allocated to the SME credit guaranty fund every year, and guaranty payments came from both guaranty funds and guaranty premiums.

Strictly speaking, the framework for a government-led national guaranty system in China has been in place since 1999, when China's Economic and Trade Commission issued its "Guidelines on Setting up Credit Guaranty System for SMEs",[24] at present, there are over 2000 guaranty firms funded by central, provincial and local government. The issue, however, is that the size of this effort, the funds provided and the capital structure had resulted in insufficient funding for these established guaranty firms. One way to improve this system would be to utilize government funds as the primary funding source, and to require that policy banks either provide low interest loans to guaranty firms or issue bonds for finance guaranty payments.

Here, it is important to clarify something about the legal status of the guaranty firms: guaranty firms don't patently appear to operate funds directly; however, they help fund operators, such as commercial banks, select qualified borrowers, and manage and control risk in the same way that commercial banks and other financial institutions do. As a result, guaranty firms should be treated as financial institutions in the context of policy regulation. The credit rating system used by commercial banks and interbank markets should also be open to guaranty firms under certain conditions. Other financing and investment channels with high liquidity, high frequency of issuance and low risk, such as the interbank bond market, central bank notes, and bank funds, should also be open to the guaranty firms.

Furthermore, a floating guaranty premium system should be adopted to help guaranty firms better react to changes in the market place. Tax deductions or exemptions should be considered for guaranty premium income received by guaranty firms. Because the guaranty premium is one of the primary sources for guaranty default payments, establishing a reduced or exempted tax for guaranty firms as a risk reserve fund will help enhance the guaranty firm's ability to reduce risk. In particular, sharing the risk with commercial banks could be a systematical way of reducing systematic risk in the entire industry.

For guaranty firms, having diversification in their business portfolio is crucial to the overall healthy development of the guaranty industry. Instead of depending solely on commercial banks as a funding source, guaranty firms can also consider non-banking guaranty, direct financing guaranty, private bonds, collective trusts, private equity funds, and non-financial guaranty such as project guaranty, legal financing guaranty, commercial guaranty, and other business lines. It can be expected that more comprehensive financial firms, with diversified business lines, will become mainstream in the future. The guaranty business will become only one of many business lines in a comprehensive financial firm's portfolio. The funding sources of guaranty firms should be "guaranteed".

After over thirty years of development, the traditional Chinese economic growth model is facing numerous and very valid questions as to its sustainability. These

[24]http://policy.sme.gov.cn/zhengcefagui/content/content.jsp?contentId=1122064419024.

questions have become serious concerns for decision makers, participants, and stake holders of the Chinese economy. Because SMEs and their innovations have been identified as the key drivers in this new stage of China's development, adequate financing for these businesses, which make up the majority of the business community, and their innovative activities will, no question, become a game changer, determining either the success or failure of the transition of Chinese economy. Given the inherently risky nature of SME financing, auxiliary tools that can serve the function of credit enhancement, such as guaranteed loans, should be indispensable. Consequently, it is reasonable to expect that the financial guaranty industry in China will continue to grow, although it is clear that a stronger legal positioning and a better funding solution for financial guaranty firms need to be first in place. While policy-oriented guaranty firms may take the lead, non-governmental commercialized guaranty firms will fill the gap for the remaining uncovered business areas.

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