Legislative Council Panel
on Information Technology and Broadcasting

Proposal on the Establishment of the Film Guarantee Fund

Purpose

This paper seeks Members' views on the proposed establishment of the Film Guarantee Fund (FGF).

Background

2. To help build the local film-financing infrastructure, the Government proposes to set up a FGF and provide, on a pilot basis, a loan guarantee to participating lending institutions (PLIs) which will offer loan facilities for film production with the support of film completion arrangement. The pilot scheme will initially operate for a period of two years on a revolving basis. This is a loan guarantee scheme to create a conducive environment for the development of a film-financing infrastructure in Hong Kong. The Government has no intention to invest or take part in film production. Please refer to **Annex I** for the background information on building a film-financing infrastructure in Hong Kong.

Public Consultation

3. The Television and Entertainment Licensing Authority (TELA) published a consultation paper on the proposed establishment of the FGF (please refer to **Annex II** for the consultation paper) on 17 October 2002 to solicit the views of the film industry, the banking sector and the public. Paragraphs 4 to 14 below introduce the major elements of the Consultation Paper.

Source of Funding

4. We propose to set aside $50 million from the Film Development Fund for the establishment of the FGF. The $100 million Film Development Fund was set up in 1999 for a period of five years. There is a current balance of about $62 million.

Eligibility for Guarantee

5. It was proposed in the Consultation Paper that all film production companies registered in Hong Kong that have produced at least three films in the past five years for commercial theatrical release in Hong Kong are eligible under the

scheme. In case of a newly formed company with no track record, it is eligible if the producer or the director of the film in question has produced or directed at least three films in the past five years for commercial theatrical release in Hong Kong. The FGF will provide guarantee to film production proposals which satisfy the following criteria –

(a) at least 50% of the major cast and film crew are Hong Kong permanent residents;

(b) the budget of the film does not exceed $7.5 million; and

(c) the film is a feature film for commercial theatrical release in Hong Kong.

6. To avoid possible conflict of interest, the film production company cannot be a related company of the PLI or the company engaged to provide the completion arrangement. No film production company may at any time have loan guarantee for more than one of its films. The restriction aims to maximise the number of film production companies which can benefit from the scheme.

Conditions of Loan Guarantee

7. Loan guarantee will be provided by the FGF on the following conditions –

(a) the film production company must have secured an in-principle approval of loan from a PLI;

(b) the film production company bears at least 30% of the budget and the PLI provides a loan of not more than 70% of the budget;

(c) the FGF will guarantee 50% (i.e. the risk-sharing ratio between the FGF and the PLI) of the loan provided by the PLI, i.e. a maximum of 35% of the budget, or $2.625 million at the maximum;

(d) the film production company must have secured a film completion arrangement for the film prior to applying for the loan guarantee;

(e) the film production company bears the cost of the film completion arrangement and this cost may be included in the budget; and

(f) the guarantee may be offered for a term loan or in the form of a new credit line for a maximum period of two years, counting from the date when the facility is made available to the film production company. Under normal circumstances, a loan guaranteed by the Government under the scheme will have to be activated within 90 days from the date of Government's approval of the guarantee.

Role of a PLI

8. The participation of a lending institution in this scheme is entirely on a voluntary basis. All authorized institutions under the Banking Ordinance will be invited to participate as PLIs in the pilot scheme. The responsibilities of a PLI are –

(a) to verify that an application made under the scheme satisfies all requirements as set out in paragraphs 5 to 7 above;

(b) to exercise prudent professional judgment and proper due diligence in assessing an application based on the financial soundness and the commercial viability of the business proposal;

(c) to seek the Government's agreement of providing guarantee under the scheme to the loan approved in principle by the PLI;

(d) to establish and maintain a separate account or sub-account for the exclusive purpose of handling all loan payment to and repayment from the film production company; and

(e) to exercise proper due diligence in securing repayment of the loan from the film production company; and in case of default, to provide justification and documentary proof for demonstrating to the Government that proper due diligence and prudent professional judgment have been exercised in approving the loan and in securing repayment before a call is to be made to the FGF on the loan guarantee.

Interest Rate of the Loan

9. The interest rate of the loan is a commercial issue to be decided between the film production company and the PLI concerned. The Government will not take part in the process.

Film Completion Arrangement

10. As a means of risk management against non-completion, it is necessary for the film production company to satisfy the PLI concerned that sufficient

arrangement has been made to ensure completion of the film project. It would be an acceptable arrangement for the film production company to engage an independent agent to monitor the progress of production of the proposed film on behalf of the PLI concerned, and to take over the production when necessary in case of cost overrun, non-completion, or in case the production deviates from the implementation plan. The agent should also underwrite the risks of non-completion.

Default Cases

11. In case of default, the PLI and the Government will co-own the copyright of the film in question until –

(a) the film production company repays all of the outstanding loan under the conditions set by the PLI; or

(b) the copyright of the film is publicly auctioned, with the revenue less administrative costs shared between the PLI and the Government according to the risk-sharing ratio of the loan guarantee as proposed in paragraph 7(c) above.

12. The PLI will provide all evidence and justifications to the Government in calling guarantee from the latter. The amount of guarantee that the Government has to pay will be determined by the risk-sharing ratio as proposed in paragraph 7(c) above. On default, any amount eventually recovered from the film production company will be shared between the Government and the PLI according to the risk-sharing ratio.

Theme or Content

13. The FGF will provide the loan guarantee if the criteria set out above are met. It will not vet the theme or content of the film, which will eventually have to be classified like any other films under the three-tier film classification system before exhibition is approved in Hong Kong.

Target

14. The minimum number of films that can be guaranteed under the proposed $50 million loan guarantee scheme will be 19 at any one time, with a budget of $7.5 million for each film. The total budget of the films guaranteed can be over $140 million. The actual number of films that can benefit from the scheme will be greater as not all films which receive the loan guarantee would have a budget of $7.5 million and any loan guarantee discharged could be immediately ploughed back to the FGF to support new applications.

Reference

15. The proposed scheme is drawn up with reference to the former Special Finance Scheme launched to support small and medium enterprises (SMEs), and the Business Installations and Equipment Loan Guarantee Scheme for SMEs currently in operation.

Result of Public Consultation

16. The public consultation period ended on 6 November 2002. TELA has also organized briefing sessions for the film industry and the banking sector on 23 and 24 October 2002 respectively for detailed discussion of the consultation paper as well as gathering of views.

17. During the consultation period, TELA received a total of 48 submissions. The film industry and the banking sector in general welcomed the proposed scheme, considering the implementation of the scheme as conducive to the building of the local film-financing infrastructure. Of the submissions received, 37 (i.e. 77%) are supportive of the scheme while only 2 are against it. The remaining 9 submissions only gave some comments or expressed no interest in the scheme. The statistics of the submissions received during the consultation period are set out at **Annex III**.

18. After summing up the views received during the consultation period and analyzing the feasibility of the various suggestions, TELA reported the findings of the public consultation to the Film Services Advisory Committee and made recommendations for its consideration on 21 November 2002.

Amendments to the Proposal

19. After considering the comments made by various sectors and the Film Services Advisory Committee, we propose to make some specific amendments to the scheme as follows-

(a) Eligibility of the film production companies (paragraph 17 of the Consultation Paper)
It was proposed in the Consultation Paper that only film production companies registered in Hong Kong that have produced at least three films in the past five years for commercial theatrical release in Hong Kong are eligible to apply for the loan guarantee. In case of a newly formed company with no track record, it is eligible if the producer or the director of the film in question has

produced or directed at least three films in the past five years for commercial theatrical release in Hong Kong.

As far as the eligibility for guarantee is concerned, the film industry considered the requirement in relation to film producing experience was too strict and hoped that it could be relaxed. We are of the view that applicants should possess track record and experience, which can serve as references for the lending institutions in vetting and approving the applications. This can also ensure that films under guarantee will attain a certain commercial standard. However, we agree that the number of films produced in the past five years was relatively low, with only 609 Hong Kong films released. Whereas in the decade between 1992 and 2001, according to the record, a total of 1,441 Hong Kong films were released. Using the record of the past five years as a reference might be too strict a criterion. After consideration, we propose to amend <u>the eligibility criteria by requiring the applicant company or the producer or director of the film in question to have produced or directed at least three films in the past ten years for commercial theatrical release in Hong Kong.</u>

(b) <u>Budget ceiling</u> (paragraph 17(b) of the Consultation Paper)

There were calls from the film industry for the Government to raise the proposed budget ceiling of $7.5 million for each film so as to benefit larger productions as well. Some overseas completion bond companies remarked that it was not cost effective to provide completion bond services to film production with a budget below $7.5 million, and hoped that the budget ceiling could be raised. In deciding on the budget ceiling in our original proposal, we have already taken into consideration the fact that a large majority of local films produced in the last few years have a budget below $7.5 million. Besides, the film industry in general also considers that the budget ceiling of $7.5 million is a reasonable one. In order to make the scheme as flexible as possible to generate maximum benefit, to encourage more high-quality film productions to apply for the loan guarantee and to attract more completion bond companies to take part in the scheme, we propose that the scheme may also provide loan guarantee to film productions with a budget over $7.5 million. However, we must at the same time strive to protect the scheme from exposure to excessive risk. With limited resources, we also have to make sure that the number of film productions which can benefit from the scheme will not be adversely affected. We therefore propose that the scheme should only provide <u>a 50% guarantee to a maximum of $5.25 million out of the loan offered by a PLI. In other words, the maximum amount of the loan guaranteed by the scheme for each film remains at $2.625 million.</u> The film production company should be responsible for financing the extra amount above $7.5 million of the budget. This proposed revision should provide flexibility to benefit film productions of different scales, but without increasing the loan guarantee for each film.

(c) <u>Capital to be contributed by production companies</u> (paragraph 19(b) of the Consultation Paper)
It was proposed in the Consultation Paper that a film production company should contribute at least 30% of the budget. The banking sector opined that the Government should clearly define the capital to be contributed by the film production companies so as to reduce the lending risks of banks. We propose, after consultation with film experts, that <u>the 30% budget (30% of the budget if the budget is below $7.5 million, or 30% of the $7.5 million of the budget if the budget is above $7.5 million) to be borne by production companies should only take into account the cash or other assets provided by investors which own the copyright of the films, while projected incomes such as deposit for the pre-sale agreement or revenue generated from commercial release in cinemas should not be included.</u>

(d) <u>Sponsorship secured by production companies</u> (paragraph 19(b) of the Consultation Paper)
The banking sector opined that the Government should clearly define sponsorship obtained for a film so as to reduce the lending risks of banks. According to the information provided by the film industry, the

sponsorship secured by production companies was in the past mostly used for non-production purposes such as publicity and marketing. We propose, after consultation with film experts, that cash sponsorship should be excluded from the 30% budget required to be contributed by the production companies, but production companies can notify lending institutions of the sponsorship secured in order to give the institutions more confidence in approving the loan applications. Moreover, production companies have to treat cash sponsorship (after deducting publicity expenses) as income and deposit such amount into the bank accounts specified by the lending institutions concerned.

(e) Prevention of double applications (paragraph 21 of the Consultation Paper)
The banking sector is concerned that a film production company might submit applications to several lending institutions for the same film project and this would lead to a waste of resources of the lending institutions in vetting the loan applications. We are of the view that in a free market, a production company should be free to submit the same application to any lending institution on the list of PLIs. Although lending institutions are not required to pay any fee when applying for a loan guarantee from the Fund, they can charge production companies a handling fee to offset part of the administrative cost incurred in vetting and approving the loan applications and they should set their own scale of fees.

However, to prevent a film production company from obtaining loans from more than one lending institutions and obtaining loan guarantee from the Fund for the same film project under a different name, we propose to treat the film production company, the producer and director of the film in question as a single entity. In other words, after a film production company has obtained a loan guarantee for a particular film, the producer and director of the film in question cannot obtain loan guarantee for that film or any other films within the guarantee period.

(f) Repayment method (paragraph 25 of the Consultation Paper)

To assist film production companies in solving their cash flow problem, lending institutions may adopt flexible repayment method such as requiring a film production company to pay interest only in the first six months after granting a loan, and allowing it to start repaying the principal and interest of the loan after the first six months when the film begins to generate revenue. We do not object to this proposal, but the fund guarantee period should remain a maximum of two years.

(g) Default cases(paragraphs 28 and 29 of the Consultation Paper)

The banking sector opined that there should be a clear definition as to when default takes place so as to reduce the lending risks. In this respect, we propose to model on the Business Installations and Equipment Loan Guarantee Scheme for SMEs currently in operation. Should a film production company fail to repay the principal of the loan 60 days after the payment due date, the PLI concerned may deem a default case constituted. Moreover, the Government will, in case of default, share the administrative costs incurred by the lending institutions in securing repayment of the loan according to the risk-sharing ratio, subject to the maximum guaranteed amount of the Government. This policy is in line with the arrangements of the Business Installations and Equipment Loan Guarantee Scheme for SMEs currently in place.

20. In response to the request of the banking sector, we have also formulated the following proposals to facilitate the PLIs to vet and approve the loan applications :

(a) Providing professional advice (paragraph 25 of the Consultation Paper)

The banking sector requested that the Government should provide assistance in the assessment of loan applications in areas such as film budget, production arrangements, overseas distribution agreements and so on. The film industry also opined that there was a need to enhance the understanding of the banking sector about film production process so as to increase its confidence in film financing. We propose, after consultation with film experts, that the film industry can draw up a list of advisors or organisations that can offer professional advice and consultancy in the areas of film production and distribution, etc. so as to facilitate the banking sector's to assess the loan applications. The lending institutions may approach the individuals or organizations on the list to seek their professional advice, with consultancy fees to be charged at a level to be determined by the parties concerned. The Government would not be involved in these advisory procedures.

(b) Providing model legal documents (paragraph 25 of the Consultation Paper)
The banking sector expressed that the Government should provide model legal agreements so as to reduce the transaction costs and to standardize the vetting procedures. The Government recognizes the importance of having commonly used model legal documents. In view of the need of the film industry in film financing, the Film Development Fund has already provided funding for a law firm to draft the relevant model documents (including sample agreements for film financing) in bilingual form for free use by the film industry, the banking sector and the legal profession. It is expected that such model documents will be ready in April next year.

Other comments

21. Other than the comments described in paragraphs 19 and 20, TELA also received other views, a summary of which is set out below. After consideration, we propose that no changes should be made to the original proposal because of the following reasons -

(a) To increase the loan guarantee ratio (paragraph 19(c) of the Consultation Paper)

Some banks expressed that the Government should increase the loan guarantee ratio from 50% to 70% in order to reduce the risks borne by lending institutions. We consider that lending institutions should bear some risks since film financing, being commercial lending, basically involves a business decision. If the loan guarantee ratio is to be increased, the number of small and medium size film productions that can benefit from the scheme will become smaller, and the Government will also have to bear higher risks. As the use of public funds is involved, we consider that maintaining the loan guarantee ratio at 50% of the maximum amount of $5.25 million of the loan provided (i.e. the maximum amount of the loan guaranteed by the scheme for each film remains at $2.625 million) is justified.

(b) To establish a loan guarantee vetting committee or advisory body (paragraph 25 of the Consultation Paper)

Some film personnel propose that the Government should establish a loan guarantee vetting committee or advisory body to assess loan guarantee applications and to offer advice to lending institutions so as to help them examine the loan applications. We consider that film financing, being commercial lending, basically involves a business decision. Just like their overseas counterparts which offer film financing, local lending institutions that are interested in providing such a kind of service have to upgrade their professional knowledge in this area. The proposed loan guarantee scheme is to boost the confidence of banks in film financing. To offer loan facilities for film production is a commercial activity. And the proposed operational mechanism of the Fund is simple and direct – if a film production company satisfies all the requirements stipulated and a loan has been approved in principle by a PLI, the Government will provide guarantee for the loan. We need to improve efficiency in processing loan guarantee applications while at the same time avoiding unnecessary administrative procedures. As such, we consider that it is not necessary for us to establish a vetting committee or an advisory body.

However, as stated in paragraph 20(a) above, to assist banks in assessing issues such as reasonableness of a budget and overseas distribution, the Government will invite film industry bodies to draw up a list of advisors and organisations for the lending institutions to draw reference. The lending institutions, if necessary, can look for the right professionals from the list for advice to help assess the applications.

Way Forward

22. Subject to Members' endorsement of the proposal, we plan to seek the Finance Committee's approval for the funding arrangement early next year.

Commerce, Industry and Technology Bureau
November 2002

Annex I

Background of establishing a financing infrastructure for film production in Hong Kong

The local film industry has been a vibrant and robust creative industry of Hong Kong for many years. And Hong Kong has been recognized as a major film production centre in the world. The industry is characterized by a diverse range of players, with major production companies co-existing with a number of smaller ones with their own market niche. However, the industry has been facing new challenges and difficulties since the late 1990s. The number of films produced decreased significantly during the past five years due to the downturn of the local economy. In 2001, the number of local films released and box office were 126 and $456 million respectively.

2. Many observers have attributed the decline of the local film industry to a number of factors. These include the decline in quality of the films, the high production costs, the proliferation of other forms of entertainment, the drop in box office receipts and revenue from overseas market which can be attributed to the existence of piracy and/or parallel imports. The economic problem brought on by the Asian financial turmoil has aggravated the situation. A decrease in the number of investors in the wake of the financial turmoil has led to the tightening of the traditional source of financing for film companies which hitherto have been mainly relying on distributor or equity financing. As a result, local film production companies are often facing a cash-flow problem . For the film industry to re-establish its leading position in the region, it has to improve its quality of production, to find ways to enhance its competitive edge, to explore new ideas and to develop new markets. At the same time, the film companies would need to identify new sources of funds to finance their film projects.

3. To address the concerns of the film industry in film financing, the Government commissioned a consultant in 2000 to study appropriate means to improve the opportunities of film financing. Having studied the current film financing practice in the US, Japan and the UK, and the suitability of adaptation of different modes of financing in Hong Kong, the consultancy report recommended, inter alia, the wider use of lender financing as a major source for funding local film

production, which is a common financial tool in the US for financing film productions. It is estimated to account for about 25% of film financing there, and is the mode preferred by independent filmmakers. In the US, banks engaged in film financing accept film companies' asset and pre-sale agreements as collateral. Meanwhile, completion bond companies can assist the banks in assessing their exposure to lending risks and be involved to oversee the progress of production and to ensure that the projects will not exceed their pre-set budgets.

4. As filmmaking is a commercial activity, it should remain a private-sector enterprise. Due to the lack of knowledge and experience in assessing film-financing proposals, local banks have considerable concerns about providing loans for film production, particularly to the smaller production companies, notwithstanding that local banks need to explore new outlets for funds under existing circumstances. On the other hand, local film production companies are unable to offer sufficient collateral to underwrite the lenders' risks, although they may be able to produce evidence that there could be a steady return in film investments. Thus local film production companies are indeed facing the same problem as many local small and medium enterprises (SMEs) in obtaining financing from the market.

5. With Hong Kong's position as a financial centre and at the same time a major film exporter in the region, there are inherent favourable factors for the development of a film-financing infrastructure locally. Through the building of a proper lender financing infrastructure for film production, local production companies will be able to obtain loans from banks more easily and their cash-flow position will improve. This will in turn boost local film production. We hold the view that it would be conducive to the long term and healthy development of the local film industry, and to the benefit of the economy, if we could devise a scheme to stimulate the establishment of a lender financing infrastructure for film production in Hong Kong. Drawing on the experience in the US, we consider it feasible to establish a lender financing infrastructure locally with the involvement of local banks, complemented by a film completion arrangement.

Consultation Paper on the Establishment of the Film Guarantee Fund

Television and Entertainment Licensing Authority

CONTENT

Consultation Paper on the Establishment of the Film Guarantee Fund

Purpose

The Government proposes to set up a Film Guarantee Fund (FGF) on a pilot basis to assist local film production companies to obtain loans from local participating lending institutions (PLIs) for producing films. Comments on the proposal are hereby invited.

Background

Development in the Last Decade

2. The local film industry has been a vibrant and robust creative industry of Hong Kong for many years. It is characterized by a diverse range of players, with major production companies co-existing with a number of smaller ones with their own market niche. The industry has experienced its own ups and downs since the 1970s, but has been facing new challenges and difficulties since the late 1990s. In the early 1990s, the number of films released locally was around 200 a year. At its peak in 1993, a total of 234 local films were released and the local box office stood at $1,132 million. And Hong Kong has been recognized as a major film production centre in the world. However, the number of films produced decreased significantly during the past five years due to the downturn of the local economy. In 2001, the number of local films released and box office were 126 and $456 million respectively.

3. According to the Statistical Digest of the Service Sector 2002 compiled by the Census and Statistics Department, the number of local film industry establishments in the last decade largely remained at the level of 1 100 while the number of persons engaged fluctuated between 5 100 and 7 100. In 2001, there were over 6 000 persons in the industry. During 2000, the film industry generated a net output/value added of about $1.6 billion, compared to $1.3 billion in 1992. The details are at *Appendix A*. The economic value of the local film industry to Hong Kong is therefore important. Indeed, some studies carried out overseas reported that for every $1 spent on film production, $2.5 goes into the economy; and for every one person directly employed in film production, another 1.7 jobs are created in the local economy, benefiting ancillary services such as equipment rental, catering, transportation, etc. Moreover, many local productions are exhibited overseas and have gained wide recognition, showcasing Hong Kong to an international audience, and this has helped to generate many other economic benefits for Hong Kong, e.g. promoting tourism.

4. Many observers have attributed the decline of the local film industry to a number of factors. These include the decline in quality of the films, the high production costs, the proliferation of other forms of entertainment, the drop in box office receipts and revenue from overseas market which can be attributed to the existence of piracy and/or parallel imports. The economic problem brought on by

the Asian financial turmoil has aggravated the situation. This has led to the tightening of the traditional source of financing for film companies which hitherto have been mainly relying on distributor or equity financing. For the film industry to re-establish its leading position in the region, it has to improve its quality of production, to find ways to enhance its competitive edge, to explore new ideas and to develop new markets. At the same time, the film companies would need to identify new sources of funds to finance their film projects.

<u>Film Financing in Hong Kong</u>

5. In the last two decades, the majority of the Hong Kong films are financed by either distributor financing or equity financing. By "distributor financing", a film production company obtains funds through pre-sale agreements with distributors and exhibitors on the distribution rights of a film. As for "equity financing", the common modes in Hong Kong are –

(a) single-project investment – a proprietor group provides funds for a film project. Sometimes overseas investors are involved, e.g. investors of Southeast Asian countries;

(b) joint venture – parties with different active roles to play in the production, distribution or management of a film project contribute to the capital for the film; and

(c) co-production with foreign investors – foreign film companies provide capital for a film project and participate in the production. Very often, the project will include location shooting in the home country of the foreign investor.

6. However, largely due to economic factors, these two traditional sources of financing have tightened. There was a decrease in the number of investors, and the absolute amount that the film production companies could obtain from each investor had also reduced. As a result, local film production companies are facing a problem of cash-flow and have to look for new source of funding for film production.

7. To address the concerns of the film industry in film financing, the Government commissioned a consultant in 2000 to study appropriate means to improve the opportunities of film financing. Having studied the current film financing practice in the US, Japan and the UK, and the suitability of adaptation of different modes of financing in Hong Kong, the consultancy report recommended, inter alia, the wider use of lender financing as a major source for funding local film production, which is a common financial tool in the US for financing film productions. It is estimated to account for about 25% of film financing there, and is the mode preferred by independent filmmakers. More details of the film financing arrangement in the US are set out in paragraph 11 below.

8. As filmmaking is a commercial activity, it should remain a private-sector enterprise. To a large extent, film financing may not be a pressing problem for large productions as there are avenues for financing these productions. However, it has become a pressing problem for the smaller-budget productions, which constitute the majority of the local film productions, to secure financing in this economic climate. We need to find ways to assist these productions in overcoming the problem of cash-flow as they play a key part in the development of a healthy and dynamic film industry in Hong Kong.

9. Due to the lack of knowledge and experience in assessing film-financing proposals, local banks have considerable concerns about the exposure to risks and the management of such risks in providing loans for film production, particularly to the smaller production companies, notwithstanding that local banks need to explore new outlets for funds under existing market situation. On the other hand, local film production companies are unable to offer sufficient collateral to underwrite the lenders' risks, although they may be able to produce evidence that there could be a steady return in film investments. Thus local film production companies are indeed facing the same problem as many local small and medium enterprises (SMEs) in obtaining financing from the market. We hold the view that it would be conducive to the long term and healthy development of the local film industry, and to the benefit of the economy, if we could devise a scheme to stimulate the establishment of a lender financing infrastructure and culture for film production in Hong Kong.

10. With Hong Kong's position as a financial centre and at the same time a major film exporter in the region, there are inherent favourable factors for the development of a film-financing infrastructure locally. Through the building of a proper lender financing infrastructure for film production, local production companies will be able to obtain loans from banks more easily and their cash-flow position will improve. This will in turn boost local film production. The establishment of such an infrastructure would also give the local banking sector wider exposure to the entertainment industry and thus open up more business opportunities for the banks, not only confining to Hong Kong but may also be extending to other Asian countries where the film industry has started to grow.

Film Financing in the United States

11. The existence of a comprehensive and efficient film-financing infrastructure in the US is one of the fundamental factors contributing to the prosperity of its film industry. Banks engaged in film financing accept film companies' asset and pre-sale agreements as collateral. For additional security, they may require the involvement of completion bond companies to assess the loan applications, oversee the progress of production and to ensure that the projects will not deviate from their pre-set budgets. When there is a completion bond, the banks can insure against any loss caused by delay or other contingencies. The banks therefore assess and manage their exposure to lending risks through the monitoring work of completion bond companies. A completion bond company normally charges a fee of 3% of the budget, depending on the risk level and the size of the

budget, which is on top of the insurance premium of about 1.5%. It is worth noting that the size of films to be bonded is normally not less than US$2 million, which is much higher than a small and medium size film produced in Hong Kong.

Consideration

12. Drawing on the experience in the US, we consider it feasible to establish a lender financing infrastructure locally with the involvement of local banks, complemented by a customized completion arrangement. While we agree that completion bond provides the best security against non-completion risks, the premium involved can be an obstacle for low-budget productions. The fact that there is so far only one overseas company established to provide completion bond in Hong Kong also indicates that the market may not be as mature as that in the US. Nonetheless, this should not be a reason for us not to put forward proposals which would help create an environment that would be conducive to the development of such an infrastructure. We understand from the local film industry that cases of non-completion are few in Hong Kong. Hence, local lending institutions may be prepared to accept a form of completion arrangement that is applicable in the local context.

The Proposal

Introduction

13. To help build the film-financing infrastructure, we propose that the Government should set up a Film Guarantee Fund (FGF) and provides, on a pilot basis, a loan guarantee to PLIs which will offer loan facilities for film production with the support of film completion arrangement[1]. The pilot scheme will initially operate for a period of two years on a revolving basis, i.e. loan guarantee discharged by PLIs will be ploughed back into the FGF for providing guarantee to new applications.

14. This is a loan guarantee scheme to help create a conducive environment for the development of a film financing infrastructure in Hong Kong. The Government has no intention to invest or take part in film production.

Source of Funding

15. We propose to set aside $50 million from the Film Development Fund for the establishment of the FGF. The $100 million Film Development Fund was set up in 1999 for a period of five years. There is a current balance of about $62 million.

1 Film completion arrangement may either be completion bond or any other acceptable measures to ensure the completion of the film in question.

Eligibility for Guarantee

16. It is essential that those which stand to benefit from this scheme are local productions. Moreover, there is a need to put a cap on the production cost so as to achieve the aim of benefiting the smaller-budget productions.

17. As a starting point, we propose that all film production companies registered in Hong Kong that have produced at least three films in the past five years for commercial theatrical release in Hong Kong are eligible under the scheme. In case of a newly formed company with no track record, it is eligible if the producer or the director of the film in question has produced or directed at least three films in the past five years for commercial theatrical release in Hong Kong. This serves as a safeguard to ensure that the film under guarantee will be up to a standard for commercial theatrical release. The FGF will provide guarantee to film production proposals which satisfy the following criteria –

(a) at least 50% of the major cast and film crew[2] are Hong Kong permanent residents;

(b) the budget[3] of the film does not exceed $7.5 million; and

(c) the film is a feature film for commercial theatrical release in Hong Kong.

18. To avoid possible conflict of interest, the film production company cannot be a related company of the PLI or the company engaged to provide the completion arrangement. No film production company may at any time have loan guarantee for more than one of its films. This seeks to enable the scheme to benefit as many film production companies as possible.

Conditions of Loan Guarantee

19. Loan guarantee will be provided by the FGF on the following conditions –

(a) the film production company must have secured an in-principle approval of loan from a PLI;

(b) the film production company bears at least 30% of the budget and the PLI provides a loan of not more than 70% of the budget;

---

[2] The major cast and film crew include the following production roles – i) director; ii) screenwriter; iii) leading actor; iv) leading actress; v) supporting actor; vi) supporting actress; vii) producer; viii) cinematographer; ix) editor; and x) art director.

[3] Budget includes all costs of production, promotion, distribution, printing of copies and engagement of completion arrangement.

(c) the FGF will guarantee 50% (i.e. the risk-sharing ratio between the FGF and the PLI) of the loan provided by the PLI, i.e. a maximum of 35% of the budget, or $2.625 million at the maximum;

(d) the film production company must have secured a film completion arrangement for the film prior to applying for the loan guarantee;

(e) the film production company bears the cost of the film completion arrangement and this cost may be included in the budget; and

(f) the guarantee may be offered for a term loan or in the form of a new credit line for a maximum period of two years, counting from the date when the facility is made available to the film production company. Under normal circumstances, a loan guaranteed by the Government under the scheme will have to be activated within 90 days from the date of Government's approval of the guarantee.

A diagram setting out the key features of the proposed loan guarantee arrangement for illustration purpose is at *Appendix B*.

Application

20. All authorised institutions under the Banking Ordinance (Cap. 155) will be invited to participate as PLIs in the pilot scheme.

21. Applications for the loan guarantee will be submitted to the Government through the PLIs and will be considered by the Government on a first-come-first-serve basis.

22. Only applications that have secured film completion arrangement and obtained in-principle loan agreement from PLIs will be considered by the Government. A flow chart setting out the procedures for processing loan guarantee applications is at *Appendix C*.

Film Completion Arrangement

23. As a means of risk management against non-completion, it is necessary for the film production company to satisfy the PLI concerned that sufficient arrangement has been made to ensure completion of the film project. It would be an acceptable arrangement for the film production company to engage an independent agent to monitor the progress of production of the proposed film on behalf of the PLI concerned, and to take over the production when necessary in case of cost overrun, non-completion, or in case the production deviates from the implementation plan. The agent should also underwrite the risks of non-completion.

24. The film completion arrangement will minimize the risk of the PLIs in providing the loan as well as that of the Government in providing the loan guarantee.

Role of a PLI

25. The participation of a lending institution in this scheme is entirely on a voluntary basis. The Government will invite all eligible lending institutions to join the scheme and will publish a list of PLIs when the scheme is launched. The list will be updated continuously. The responsibilities of a PLI are –

(a) to verify that an application made under the scheme satisfies all requirements as set out in paragraphs 16 to 19 above;

(b) to exercise prudent professional judgment and proper due diligence in assessing an application based on the financial soundness and the commercial viability of the business proposal;

(c) to seek the Government's agreement of providing guarantee under the scheme to the loan approved in principle by the PLI;

(d) to establish and maintain a separate account or sub-account for the exclusive purpose of handling all loan payment to and repayment from the film production company; and

(e) to exercise proper due diligence in securing repayment of the loan from the film production company; and in case of default, to provide justification and documentary proof for demonstrating to the Government that proper due diligence and prudent professional judgment have been exercised in approving the loan and in securing repayment before a call is to be made to the FGF on the loan guarantee.

Form of Loan Guarantee

26. The loan guarantee will be in the form of an agreement between the PLI offering the loan and the Government, setting out the rights and obligations of each party as well as the relevant arrangements and requirements.

Interest Rate of the Loan

27. The interest rate of the loan is a commercial issue to be decided between the film production company and the PLI concerned. The Government will not take part in the process.

Default Cases

28. In case of default, the PLI and the Government will co-own the copyright of the film in question until –

(a) the film production company repays all of the outstanding loan under the conditions set by the PLI; or

(b) the copyright of the film is publicly auctioned, with the revenue less administrative costs shared between the PLI and the Government according to the risk-sharing ratio of the loan guarantee as proposed in paragraph 19(c) above.

29. The PLI will provide all evidence and justifications to the Government in calling guarantee from the latter. The amount of guarantee that the Government has to pay will be determined by the risk-sharing ratio as proposed in paragraph 19(c) above. On default, any amount eventually recovered from the film production company will be shared between the Government and the PLI according to the risk-sharing ratio.

Target

30. The minimum number of films that can be guaranteed under the proposed \$50 million loan guarantee scheme will be 19 at any one time, with a budget of \$7.5 million for each film. The total budget of the films guaranteed can be over \$140 million. The actual number of films that can benefit from the scheme will be greater as not all films which receive the loan guarantee would have a budget of \$7.5 million and any loan guarantee discharged could be immediately ploughed back to the FGF to support new applications.

Theme or Content

31. The FGF will provide the loan guarantee if the criteria set out in paragraphs 16 to 19 above are met. The FGF will not look into the theme or content of the film, which will eventually have to be classified under the three-tier film classification system before exhibition is approved in Hong Kong.

Reference

32. The proposed scheme is drawn up with reference to the former Special Finance Scheme launched to support SMEs, and the Business Installations and Equipment Loan Guarantee Scheme for SMEs currently in operation.

Public Consultation

33. We welcome views from all quarters of the community on the proposal outlined in this consultation paper. Please forward your views and comments by completing and returning the proforma at *Appendix D* to us **on or before 6 November 2002** in the following manner –

- **by post:** Film Services Office, 40/F, Revenue Tower,
  5 Gloucester Road, Wan Chai, Hong Kong

- **by fax:** 2824 0595

Views and comments can also be sent to the Film Services Office by e-mail at info@fso-tela.gov.hk.

34. The Government may publish all or part of the views and comments received and disclose the identity of the source in such manner as considered appropriate, unless the party submitting the views and comments requests any part of the views and comments and/or its identity be treated in confidence.

35. Copies of the consultation paper are available at the Television and Entertainment Licensing Authority at 39/F, Revenue Tower, 5 Gloucester Road, Wan Chai and the Information Technology and Broadcasting Branch of the Commerce, Industry and Technology Bureau at 2/F, Murray Building, Garden Road, Central. The paper can also be accessed on the Internet at the following addresses –

- http://www.info.gov.hk/itbb

- http://www.info.gov.hk/tela

36. For enquiries, please contact the Film Services Office of the Television and Entertainment Licensing Authority at 2594 5729.

Television and Entertainment Licensing Authority
October 2002

Appendix A

Statistics of the Hong Kong Film Industry

Year	No. of local films released[1]	Local box office takings[1] ($ million)	No. of establishments[2]	No. of persons engaged[2]	Net output/ Value added[2][3] ($ million)
1992	138	1,239	1,057	6,428	1,351
1993	234	1,132	1,155	7,090	1,380
1994	190	957	1,301	5,851	1,929
1995	154	776	1,301	6,062	1,371
1996	116	659	1,168	6,406	1,458
1997	94	547	1,141	5,491	1,320
1998	92	421	991	5,129	1,109
1999	146	352	1,100	5,248	963
2000	151	382	1,112	5,535	1,648
2001	126	456	1,130	6,101	N.A.

Notes

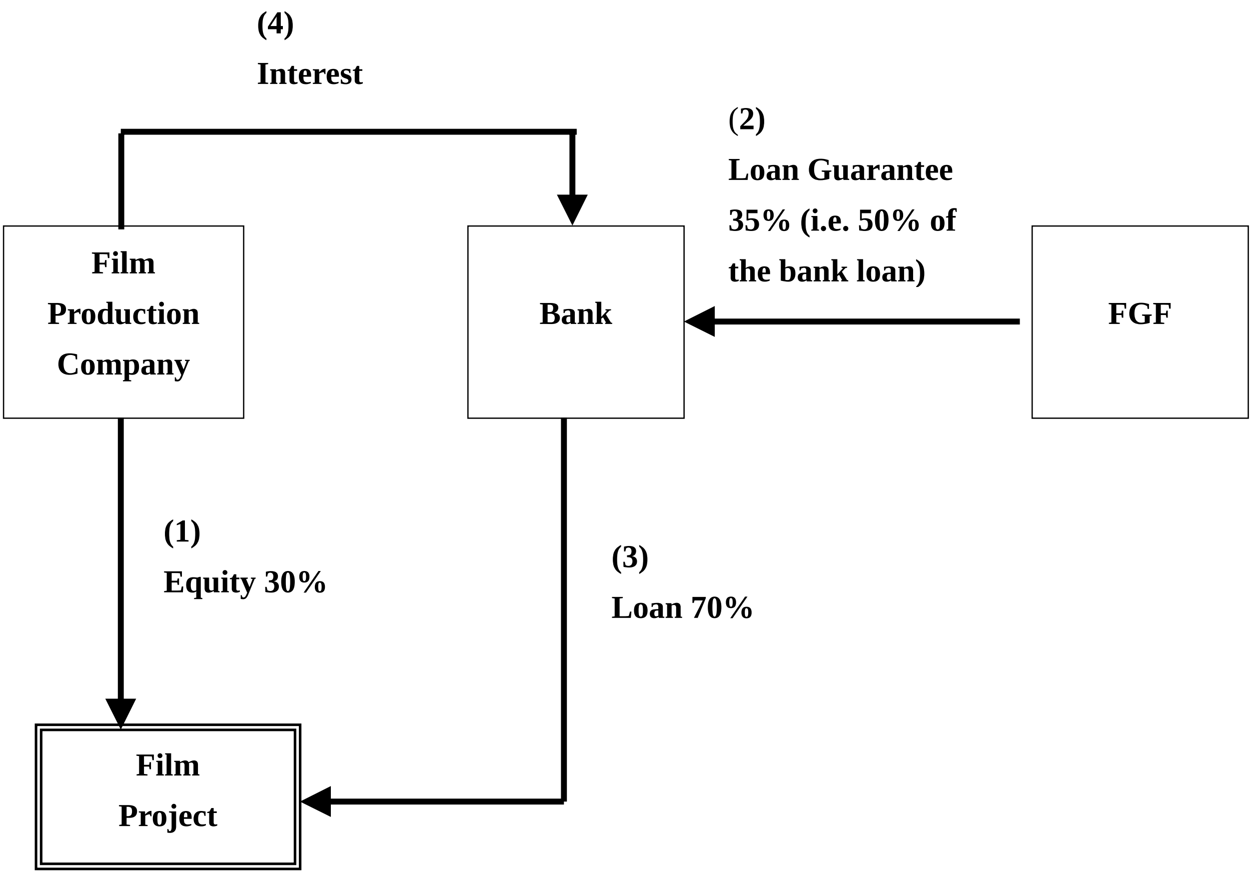
(1) Source: Hong Kong Kowloon & New Territories Motion Picture Industry Association Ltd.

(2) Source: Statistical Digest of the Services Sector 2002 published by the Census and Statistics Department.

(3) These are rough estimates which are compiled based on limited data. They may be subject to considerable revisions when more data become available. Special care should be taken when interpreting them.

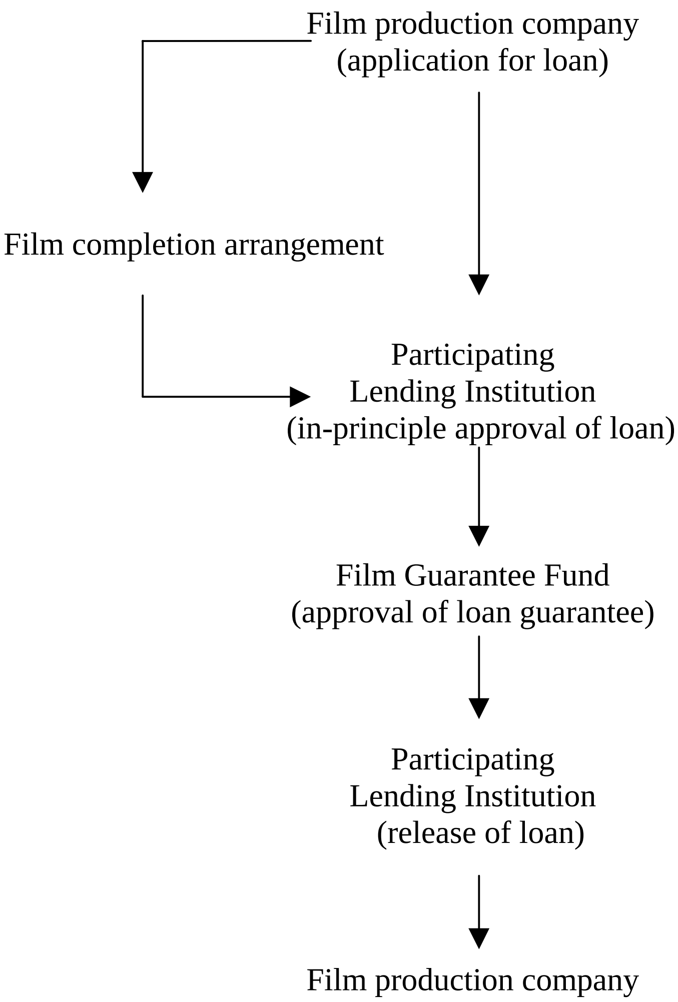
Appendix B

Key Features of the Loan Guarantee Proposal



<u>Appendix C</u>

<u>Flow Chart for FGF Application Procedure</u>



<u>Appendix D</u>

To : **Film Services Office,**
Television and Entertainment Licensing Authority
Fax : 2824 0595

Consultation Paper on the Establishment of the Film Guarantee Fund

I / we have the following views on the proposal of setting up the Film Guarantee Fund :

❑ The proposal is supported.
Comments:

____

____

____

____

____

❑ The proposal is not supported.
Comments:

____

____

____

____

❑ Other suggestions

____

____

____

____

❑ I request that my comments and/or my identity be treated in confidence.

Signature : ____________________ Name : ____________________

Organisation/
Company : ____________________ Contact tel. no. : ____________________
(if applicable)

Annex III

Consultation Paper on the Establishment of the Film Guarantee Fund

Statistics on comments received

Individuals/ organizations which have submitted views	Number of submissions received[1]	For the proposal	Against the proposal	Other comments[3]
Local film industry	28	25(89%)	1(4%)	2(7%)
Locally incorporated banks, restricted banks and deposit-taking companies	16	10(63%)[2]	1(6%)	5(31%)
Completion bond companies	1	0	0	1(100%)
Members of the public	3	2(67%)	0	1(33%)
Total	**48**	**37**	**2**	**9**

(1) More than 700 copies of the consultation paper have been distributed to relevant organizations, including film industry bodies, film production related companies, Hong Kong Association of Banks, local licensed banks, restricted licence banks and deposit-taking companies, to seek their views on the proposal of establishing the Film Guarantee Fund. The consultation paper could also be accessed at Government website. Members of the public were welcome to make reference to it and submit their views.

(2) Four banks supported the scheme in principle subject to certain conditions, such as raising the percentage of loan guarantee, assistance to be offered in vetting the applications and drawing up model agreements.

(3) "Other comments", accounting for 19% of the submissions received, mainly provided some analysis such as the positive and negative impacts of establishing the Fund, or provided information about film financing overseas. It has not stated

clearly in those submissions whether the respondents are for or against the establishment of the Fund.