For discussion **FCR(2012-13)12**
on 20 April 2012

ITEM FOR FINANCE COMMITTEE

HEAD 152 – GOVERNMENT SECRETARIAT :
COMMERCE AND ECONOMIC DEVELOPMENT BUREAU (COMMERCE, INDUSTRY AND TOURISM BRANCH)
Subhead 700 General non-recurrent
New item "SME Financing Guarantee Scheme – Special Concessionary Measures"

Members are invited to approve under Head 152 Commerce and Economic Development Bureau (Commerce, Industry and Tourism Branch) a new loan guarantee commitment of $100 billion with an expected maximum expenditure of $11 billion for The Hong Kong Mortgage Corporation Limited to provide loan guarantees under the time-limited special concessionary measures introduced under its SME Financing Guarantee Scheme and to meet the contingent liabilities arising from the measures.

PROBLEM

In the light of the current uncertain external economic environment, local enterprises, in particular small and medium enterprises (SMEs), may face liquidity problem as a result of possible credit tightening. To tide enterprises over a potentially difficult period, we need to strengthen support to facilitate them in obtaining loans from the commercial lending market so as to resolve cashflow problems.

/**PROPOSAL** …..

PROPOSAL

2. The Secretary for Commerce and Economic Development proposes to introduce special concessionary measures under the existing SME Financing Guarantee Scheme (SFGS) of The Hong Kong Mortgage Corporation Limited[1] (HKMC) with a total loan guarantee commitment of $100 billion, to be open for application for nine months, which may be reviewed and extended if necessary, starting from the date of implementation. Under the special concessionary measures, a new 80% loan guarantee ratio at a low guarantee fee will be introduced for approved loans taken out by eligible enterprises from the participating lending institutions[2] (PLIs). The expected maximum expenditure to be incurred by the Government under the special concessionary measures is $11 billion.

JUSTIFICATION

3. Given the bleak economic prospects in Europe and the United States, the noticeable slowdown in the growth momentum of Asian and emerging market economies, our overall economy is facing an unusually large degree of uncertainties in the external economic environment. We are concerned that local enterprises, particularly SMEs may suffer financial hardship as a result of credit crunch in the coming year. SMEs currently constitute around 98% of the business establishments in Hong Kong and employ around 1.2 million people, representing half of the total number of employees in the private sector. They are the backbone of Hong Kong's economy. The Government sees the need to support SMEs by enhancing the existing SFGS through introducing a number of time-limited concessionary measures to facilitate them to obtain loans from the commercial market. There have also been growing demands from the business sector that the Government should introduce swift and effective measures to assist the enterprises, particularly SMEs, before the economic situation further worsens.

4. SFGS is a market-based and sustainable loan guarantee scheme launched by the HKMC on 1 January 2011, with a view to helping Hong Kong enterprises, particularly SMEs, to obtain financing to meet their needs. Under the SFGS, the HKMC acts as guarantor for up to 70% of the approved loans that enterprises obtain from PLIs. A guarantee fee is payable by the PLIs/enterprises. The Government's support for enterprises can be best provided through the introduction of time-limited special concessionary measures under the SFGS.

/Features …..

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1 The HKMC is wholly owned by the Hong Kong Special Administrative Region (HKSAR) Government through the Exchange Fund.

2 PLIs must be Authorized Institutions under the Banking Ordinance (Chapter 155).

Features of the proposed special concessionary measures

5. The special concessionary measures to be introduced under the SFGS will have the following features –

Increase in Loan Guarantee Ratio

6. At present, the loan guarantee ratio offered under the SFGS ranges from 50% to 70%. The loan guarantee ratio under the special concessionary measures will be 80%. The increase in loan guarantee ratio under the special concessionary measures would provide greater incentive to the PLIs to make effective use of the SFGS to meet the financing needs of enterprises including SMEs, especially during times of lending market stress and adverse economic climate.

Low Guarantee Fee

7. Under the existing SFGS, lending institutions/enterprises have to pay a guarantee fee, the rate of which is linked to the annual interest rate of the loan and the loan guarantee ratio offered. Specifically, for loans with an annual interest rate not exceeding 10%, the annual guarantee fee rate will range from 0.18 of the annual loan interest rate (for loan guarantee ratio of 50%) to 0.32 of the annual loan interest rate (for loan guarantee ratio of 70%); and for loans with an annual interest rate exceeding 10% but not more than 12%, the annual guarantee fee rate will range from 0.2 of the annual loan interest rate (for loan guarantee ratio of 50%) to 0.35 of the annual loan interest rate (for loan guarantee ratio of 70%)[3]. The annual guarantee fees for loans at different interest rates under the existing SFGS are set
Encl. 1 out at Enclosure 1.

8. To relieve the enterprises' burden, the annual guarantee fee of the loans with 80% loan guarantee ratio under the special concessionary measures will be set at a low level. For loans with an annual interest rate not exceeding 10%, the annual guarantee fee rate will be 0.1 of the annual loan interest rate; and for loans with an annual interest rate exceeding 10% but not more than 12%, the annual guarantee fee rate will be 0.12 of the annual loan interest rate[4].

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[3] Subject to a minimum annual guarantee fee rate of 0.5%.

[4] The existing minimum annual guarantee fee rate of 0.5% will continue to apply.

9. For example, for a loan of $1 million at an annual interest rate of 5%, the annual guarantee fee for a 70% guarantee under the existing SFGS is $16,000. For the same amount of loan, the annual guarantee fee for an 80% guarantee under the special concessionary measures will be $5,000, i.e. the guarantee fee will be substantially reduced by about 70%. The annual guarantee fees for loans at different interest rates under the special concessionary measures are also set out at Enclosure 1. We consider that a limited guarantee fee payable is in line with the market-based principle of the SFGS and will help share the default risks amongst the PLIs, enterprises and the Government.

Maximum Loan Guarantee Period and Loan Ceiling

10. Following the arrangements under the existing SFGS, the maximum guarantee period for each approved loan under the special concessionary measures is proposed to be five years from the first drawdown of the facility (for term loans) or the date on which the facility is first made available by the PLI (for revolving facilities). The maximum amount of loans, including those to be approved under the special concessionary measures, in respect of which each enterprise can obtain loan guarantee under the SFGS will be maintained at $12 million at any point in time (including both term loans and revolving facilities without any restriction on the proportion between the two). Enterprises which have obtained loan guarantee under the existing SFGS may apply to switch the loan concerned to 80% guarantee under the special concessionary measures during the application period. Upon approval by the HKMC, the loan will be covered by an 80% guarantee and the PLI/enterprise concerned will pay the required guarantee fee under the special concessionary measures[5].

11. A comparison of the major features of the existing SFGS and the
Encl. 2 special concessionary measures under the SFGS is at Enclosure 2.

CONTROL AND SAFEGUARD MECHANISM

12. For prudent use of public money, the existing safeguard measures under the SFGS would continue to apply, so as to ensure that only those enterprises with genuine need and a reasonable business prospect would be able to benefit from the special concessionary measures. The relevant safeguard measures are summarised as follows −

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5 If an enterprise wishes to obtain a refund of the guarantee fee paid due to an early termination of a loan guarantee approved under the existing SFGS, the HKMC will process the request in accordance with the existing practice.

(a) PLIs are required to exercise professional skill, judgment and care in processing the enterprise's application for a proposed facility to be covered by a guarantee provided by the HKMC under the SFGS (including the special concessionary measures)[6];

(b) Eligible enterprises must have business operation in Hong Kong and be registered in Hong Kong under the Business Registration Ordinance (Chapter 310). They must also have business operation for at least one year on the date of guarantee application;

(c) Personal guarantee would need to be provided by individual shareholder(s) who directly or indirectly hold more than 50% of the equity interest of the enterprise;

(d) The enterprise should have no outstanding defaults[7] among the Authorized Institutions under the Banking Ordinance (Chapter 155) at the time of loan application; and

(e) The loan guaranteed under the SFGS (including the special concessionary measures) cannot be used for repaying, restructuring or repackaging existing debts (except for allowing refinancing of facilities guaranteed under the Special Loan Guarantee Scheme (SpGS) of the Trade and Industry Department (TID) or the SFGS).

13. The HKMC will be responsible for operating the special concessionary measures under the SFGS. The Government will sign an agreement with the HKMC (the Agreement) which sets out clearly the rights and obligations of the two parties in connection with the operation of the special concessionary measures. In particular, the HKMC will be required to exercise due diligence in operating the special concessionary measures under the SFGS in accordance with the "Deed for the HKMC SME Financing Guarantee Scheme" entered into between the HKMC and the PLIs and other relevant procedures[8], and adopt the same principles and standards of care and diligence as those adopted by the HKMC for other guarantee products under the SFGS. Besides, the Government will set

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6 PLIs have to abide by the terms and conditions as set out in the "Deed for the HKMC SME Financing Guarantee Scheme" entered into between the PLIs and the HKMC, which is a legally binding document setting out the rights and obligations of the PLIs for participation in the SFGS.

7 "No outstanding defaults" refers to: (a) the enterprise does not have any outstanding loan repayment in any Authorized Institution which is due for more than 60 days as evidenced by the latest report issued by credit information provider(s) available to the PLI concerned; and (b) the enterprise does not have any outstanding loan repayment in the PLI concerned which is due for more than 30 days based on information available to the PLI concerned.

8 Other relevant procedures include operating procedures and internal guidelines governing the operation of the SFGS as laid down by the HKMC.

out in detail in the Agreement requiring the HKMC to, amongst others, report regularly to the Government on the operation of the special concessionary measures including but not limited to the usage of the $100 billion loan guarantee commitment, the number of applications approved, the number of beneficiary enterprises, guarantee fees collected, default claims lodged by the PLIs to the HKMC and the associated payouts made and expenses incurred. We will closely monitor the operation of the special concessionary measures to ensure the prudent use of public money.

FINANCIAL IMPLICATIONS

14. The special concessionary measures under the SFGS will be open for applications for nine months starting from the commencement date, subject to the Government's total guarantee commitment of $100 billion. All guarantee fees collected by the HKMC will be set aside to pay default compensations to the PLIs in connection with loans guaranteed under the special concessionary measures, as well as to meet the necessary out-of-pocket expenses arising from recovery of defaulted loans or incidental to the operation of the special concessionary measures[9]. The remaining balance of the guarantee fees, if any, will be returned to and any shortfall will be borne by the Government.

15. Assuming that the total guarantee amount of $100 billion will be fully utilised during the application period under the special concessionary measures and the average annual interest rate of guaranteed loans is 5%, by taking into account the factor of loan amortisation over an assumed five-year average loan period, the estimated amount of guarantee fees to be collected by the HKMC under the special concessionary measures will be around $1.8 billion. Based on an assumed default rate of 12% and taking into account the necessary out-of-pocket expenses to be incurred by the HKMC, which is estimated to be 4.5% of the total default claims, the Government's estimated maximum expenditure net of guarantee fees collected under the special concessionary measures will be around $11 billion[10]. The HKMC will meet the day-to-day administrative costs for operating the special concessionary measures under the SFGS. Additional expenses within the Government arising from the special concessionary measures would be absorbed by existing resources of the Commerce and Economic Development Bureau.

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9 Out-of-pocket expenses include for instance relevant costs arising out of the recovery actions made by the PLIs or by the HKMC through its exercise of subrogation rights for the purpose of recovering the outstanding loans, and other expenses like audit fee for the special concessionary measures.

10 $12 billion ($100 billion x 12%) - $1.8 billion + $0.54 billion ($12 billion x 4.5%) = $10.74 billion, say $11 billion.

16. For the sake of financial prudence, except with Members' further approval, the HKMC would not provide any loan guarantee beyond the $100 billion loan guarantee commitment or when the expenditure for settling default claims and related costs is about to reach $11 billion, whichever happens first.

EXPECTED BENEFITS

17. The special concessionary measures would help tide enterprises, particularly SMEs, over the potential financing difficulties which may arise as a result of a possible credit crunch under the uncertain external economic environment. Given the 80% loan guarantee is a new product under the SFGS, the number of beneficiaries would depend on various factors, such as the prevailing economic environment during the application period and the financing needs of individual enterprises, etc. On the assumption that the average loan amount to be guaranteed under the special concessionary measures per enterprise is $4.2 million[11], the $100 billion total loan guarantee commitment can benefit around 29 800 enterprises, involving around 119 200 employees[12].

IMPLEMENTATION TIMETABLE

18. Subject to Members' approval of the proposed special concessionary measures and completion of necessary preparatory work for the introduction of the measures by the HKMC, we plan to launch the special concessionary measures in May 2012.

PUBLIC CONSULTATION

19. We briefed the Small and Medium Enterprises Committee of the TID on the proposed special concessionary measures on 22 February 2012. Members were supportive of the proposal. We consulted the Legislative Council Panel on Commerce and Industry on 20 March 2012 and Members supported the proposal. To address Members' enquiries about the difference in the major features of the proposed special concessionary measures under the SFGS and the SpGS introduced by the TID, we have provided the relevant information to the Panel on 3 April 2012.

Commerce and Economic Development Bureau
April 2012

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[11] The average loan amount per enterprise with approved guarantee under the existing SFGS as at end of February 2012 is around $4.2 million.

[12] 119 200 employees = 29 800 enterprises x average number of employees per SME (around 1.2 million employees in SMEs in total ÷ around 300 000 SMEs in Hong Kong).

Comparison of Annual Guarantee Fee Payable under the Existing SME Financing Guarantee Scheme (SFGS) and the Proposed Special Concessionary Measures under the SFGS

<u>Scenario A: Loan with interest rate charged by bank at **5%** per annum</u>

- Borrowed sum: $1 million
- Loan interest per annum charged by bank: $50,000

	Existing SFGS			**Proposed Special Concessionary Measures under SFGS**
Loan guarantee ratio	50%	60%	70%	80%
Guarantee fee factor	0.18	0.24	0.32	0.1
Annual guarantee fee rate*	5% x 0.18 = 0.9%	5% x 0.24 = 1.2%	5% x 0.32 = 1.6%	5% x 0.1 = 0.5%
Annual guarantee fee payable	$9,000 ($1 million x 0.9%)	$12,000 ($1 million x 1.2%)	$16,000 ($1 million x 1.6%)	$5,000 ($1 million x 0.5%)

<u>Scenario B: Loan with interest rate charged by bank at **10%** per annum</u>

- Borrowed sum: $1 million
- Loan interest per annum charged by bank: $100,000

	Existing SFGS			**Proposed Special Concessionary Measures under SFGS**
Loan guarantee ratio	50%	60%	70%	80%
Guarantee fee factor	0.18	0.24	0.32	0.1
Annual guarantee fee rate*	10% x 0.18 = 1.8%	10% x 0.24 = 2.4%	10% x 0.32 = 3.2%	10% x 0.1 = 1%
Annual guarantee fee payable	$18,000 ($1 million x 1.8%)	$24,000 ($1 million x 2.4%)	$32,000 ($1 million x 3.2%)	$10,000 ($1 million x 1%)

<u>Scenario C: Loan with interest rate charged by bank at **12%** per annum</u>

- Borrowed sum: $1 million
- Loan interest per annum charged by bank: $120,000

	Existing SFGS			**Proposed Special Concessionary Measures under SFGS**
Loan guarantee ratio	50%	60%	70%	80%
Guarantee fee factor	0.20	0.26	0.35	0.12
Annual guarantee fee rate*	12% x 0.2 =2.4%	12% x 0.26 = 3.12%	12% x 0.35 = 4.2%	12% x 0.12 = 1.44%
Annual guarantee fee payable	$24,000 ($1 million x 2.4%)	$31,200 ($1 million x 3.12%)	$42,000 ($1 million x 4.2%)	$14,400 ($1 million x 1.44%)

* The annual guarantee fee payable is obtained by multiplying the annual guarantee fee rate and the loan amount. In turn, the annual guarantee fee rate depends on the annual interest rate of the loan and the loan guarantee ratio offered.

Comparison of the Existing SME Financing Guarantee Scheme (SFGS) and the Proposed Special Concessionary Measures under the SFGS

Feature	Existing SFGS	Proposed Special Concessionary Measures under SFGS (i.e. 80% guarantee ratio with reduced guarantee fee)
(a) Target Segment and Eligibility	Eligible enterprises must have business operation in Hong Kong and be registered in Hong Kong under the Business Registration Ordinance (Chapter 310). They must also have business operation for at least one year on the date of guarantee application, and have good loan repayment record. Listed companies, lending institutions and affiliates of lending institutions are not eligible for the Scheme.	No change.
(b) Approval of Credit Facility	To be done by the lending institutions.	No change.
(c) Guarantee Coverage	50%, 60% or 70%	80%
(d) Maximum Guarantee Period	5 years	No change
(e) Maximum Amount of Credit Facility Per Enterprise (including its related companies) at any point in time	$12 million	No change (Note: the limit includes loans approved under the existing SFGS.)

Feature	Existing SFGS	Proposed Special Concessionary Measures under SFGS (i.e. 80% guarantee ratio with reduced guarantee fee)
(f) Reuse of guarantee amount after loan repayment	Unlimited reuse of guarantee amount after loan repayment, subject to the loan ceiling of $12 million at any point in time (per (e)).	No change.
(g) Form of Credit Facilities	Term loans and revolving credit lines, without any restriction on the proportion between the two.	No change.
(h) Use of Credit Facilities	The credit facility must be used for providing general working capital for the enterprise's business operations, or acquisition of equipment or assets (excluding residential properties) in relation to the enterprise's business. The credit facility must not be used for repaying, restructuring or repackaging existing debts (except for allowing refinancing of facilities guaranteed under the Special Loan Guarantee Scheme of the Trade and Industry Department or SFGS).	No change. No change. Enterprises with credit facilities guaranteed under the existing SFGS may make new applications for switching to an 80% guarantee coverage for the loans concerned during the application period of the special concessionary measures.
(i) Maximum Loan Interest Rate	10% per annum in general (loans with annual interest rate over 10% but not more than 12% will be considered on a case-by-case basis). The maximum loan interest rate will be reviewed from time to time.	No change.

Feature	Existing SFGS	Proposed Special Concessionary Measures under SFGS (i.e. 80% guarantee ratio with reduced guarantee fee)
(j) Personal Guarantee by Individual Shareholder(s)	Personal guarantee by individual shareholder(s), directly or indirectly, holding more than 50% of the equity interest of the enterprise is required.	No change.
(k) Guarantee Fee	Guarantee fee is payable [1].	Guarantee fee is payable but is substantially reduced [2]. Lending institutions/ enterprises can obtain an 80% loan guarantee by paying about 30% of the guarantee fee for a 70% guarantee for approved loans under the existing SFGS.
(l) Maximum Guarantee Commitment	No ceiling.	$100 billion (as provided by the Government).

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[1] For loans with an annual interest rate not exceeding 10%, the current annual guarantee fee rate ranges from 0.18 to 0.32 of the annual loan interest rate; and for loans with an annual interest rate exceeding 10% but not more than 12%, the current annual guarantee fee rate ranges from 0.2 to 0.35 of the annual loan interest rate. The loans are subject to a minimum annual guarantee fee rate of 0.5%.

[2] For loans with an annual interest rate not exceeding 10%, the annual guarantee fee rate will be 0.1 of the annual loan interest rate; and for loans with an annual interest rate exceeding 10% but not more than 12%, the annual guarantee fee rate will be 0.12 of the annual loan interest rate. The existing minimum annual guarantee fee rate of 0.5% will continue to apply.