

ITEM FOR FINANCE COMMITTEE

HEAD 180 - TELEVISION AND ENTERTAINMENT LICENSING AUTHORITY

Subhead 700 General other non-recurrent

Item 008 Film Development Fund

New Item "Film Guarantee Fund"

Members are invited to approve the creation of a new Capital Account commitment of \$50 million for the setting up of a Film Guarantee Fund

PROBLEM

The film industry has difficulties in obtaining loans from lending institutions to finance film productions. We need to facilitate the establishment of a local film-financing infrastructure in order to sustain the long-term development of the film industry.

PROPOSAL

2. We propose to set up a Film Guarantee Fund (the Fund) with a commitment of \$50 million, to be offset by the reduction of an equivalent amount from the approved commitment of the Film Development Fund (FDF). The objective of the Fund is to provide guarantee for assisting local film production companies to obtain loans from lending institutions for producing films and to stimulate the development of a film-financing infrastructure in Hong Kong. The Government has no intention to invest or take part in film production.

3. The Fund will provide, on a pilot basis for two years, loan guarantee to local participating lending institutions (PLIs) which will offer loan facilities to film productions that have secured a film completion arrangement. The Fund will operate on a revolving basis, i.e. loan guarantee provided, once discharged by the PLIs, will be ploughed back into the Fund for providing guarantee to new applications.

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JUSTIFICATION

4. The local film industry has been a vibrant, robust and creative industry of Hong Kong for many years. Its economic contribution to Hong Kong is significant. Some studies reported that for every \$1 spent on film production, the multiplier effect on the local economy is \$2.5; 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.

5. Since the late 1990s, the local film industry has been facing new challenges and difficulties. In 1993, a total of 234 local films were released and the local box office stood at \$1,132 million. However, the number of films produced decreased significantly during the past few years due to the downturn of the local economy. In 2002, only 92 local films were released and the box office amounted to a meagre \$352 million.

6. Many observers have attributed the decline of the local film industry to a number of factors, including the economic problem brought on by the Asian financial turmoil. 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 local 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.

7. Hitherto local banks have not been involved in lending business for film production. They do not have the knowledge and experience in assessing film-financing proposals and they have considerable concern about the exposure to risks, and the management of such risks, in providing loans for film production, particularly to the smaller production companies. As a result, local film production companies cannot obtain bank financing and are facing a problem of cash flow, like many other local small and medium enterprises (SMEs). It is unlikely that local banks would change their present lending policy (i.e. not providing loan for film production), unless the perceived risk is minimized or shared by other parties. However, with Hong Kong's position as a leading 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. This will in turn boost local film production.

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8. We consider that the proposed Fund will serve as a catalyst to encourage local banks to provide loans for film production and to equip themselves with expertise in managing risks relating to film financing as the risks involved will be partly shared through the loan guarantee provided by the Fund. In the end, the Fund should be able to stimulate the establishment of a film financing infrastructure in Hong Kong, which would be conducive to the long-term and healthy development of the local film industry, and to the benefit of the economy. Details of the proposed Fund are set out in the ensuing paragraphs.

PROPOSED MODE OF OPERATION OF THE FUND

(A) *Eligibility*

9. It is essential that the proposed Fund should benefit local productions. So only film production companies which are registered in Hong Kong and credit-worthy (i.e. with no bad loan) are eligible for applying to this scheme. Besides, at least 50% of the major cast and film crew¹ of the film production must be Hong Kong permanent residents and the film has to be a feature film for commercial theatrical release in Hong Kong.

10. In order to ensure that the film under guarantee will be up to a standard for commercial theatrical release –

- (a) the eligible film production companies must have produced at least three films in the past ten years for commercial theatrical release in Hong Kong; or
- (b) in case of a newly formed company with no track record, it will be eligible if the producer or the director of the film in question has produced or directed at least three films in the past ten years for commercial theatrical release in Hong Kong.

Such requirement in track record gives confidence to local banks for providing loan to support film productions under this loan guarantee scheme. With the flexibility allowed, new talent in the film industry can link up with more experienced partners to benefit under the scheme.

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¹ Major cast and film crew refer to the following ten categories: i) film director; ii) screenwriter; iii) leading actor; iv) leading actress; v) supporting actor; vi) supporting actress; vii) producer; viii) cinematographer; ix) film editor; and x) art director.

11. No single entity may at any time receive loan guarantee for more than one of its films. For this purpose two entities are treated as the same if they involve the same production company, or producer, or film director. In the case of a director of a film also acting as the producer of another film, the two combinations will be treated as the same entity. This seeks to enable the scheme to benefit as many film production companies, producers and directors as possible.

12. Moreover, the film production company also has to declare on application as to whether it has any bad loan. To avoid possible conflict of interest, the film production company cannot be a related company of the PLI or of the company engaged to provide the film completion arrangement.

(B) *Conditions of Loan Guarantee*

13. As a large majority of local films produced in the last decade have a film production budget of not more than \$7.5 million, we propose to use this amount as the reference for determining the maximum amount of loan guarantee to be provided by the proposed Fund for each film project, i.e. for films with budget at or below \$7.5 million, we will use the budget to work out the loan guarantee; for films with budget above \$7.5 million, we will use \$7.5 million to work out the loan guarantee. This will on the one hand ensure that the Fund will not be over-exposed to large budget productions which may result in smaller productions having fewer opportunities to benefit from the scheme, while on the other hand large budget productions (which can encourage more completion bond companies to take part in the scheme) will not be excluded. There is thus flexibility to benefit film productions of different scale, but an absolute limit is maintained on the loan guarantee for each film. The budget submitted by the film production company in its application to the PLI should include all costs of production, promotion, distribution, printing of copies, and engagement of completion arrangement. However, the budget should not include any sponsorship secured.

14. Loan guarantee will be provided by the Fund on the following conditions –

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

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- (b) for film budget at \$7.5 million or below, the film production company has to bear at least 30% of the budget and the PLI provides a loan of not more than 70% of the budget. The proposed Fund will provide a 50% (i.e. the risk-sharing ratio between the Fund and the PLI) guarantee to a maximum of \$5.25 million out of the loan provided by the PLI. In other words, the maximum loan guarantee for each film will be 35% of the budget, or \$2.625 million, whichever is the less;
- (c) for film budget exceeding \$7.5 million, the film production company has to bear at least 30% of \$7.5 million of the budget in the first instance (in addition to any amount on top of the \$7.5 million which the film production company has to prove that it has the means to provide it). The proposed Fund will provide a 50% (i.e. the risk-sharing ratio between the Fund and the PLI) guarantee to a maximum of \$5.25 million out of the loan provided by the PLI. In other words, the maximum loan guarantee for each film will be \$2.625 million; and
- (d) the film production company must have secured a film completion arrangement for the film prior to applying for the loan guarantee. The film production company bears the cost of the film completion arrangement and this cost may be included in the budget.

15. Applications for the loan guarantee will be submitted to the Fund through the PLIs and will be considered on a first-come-first-serve basis. The Fund and the PLI concerned will have the first call on any income received or proceeds recovered from the film for repayment of the loan. This requirement will be stipulated in the contractual documents to be signed amongst the film production companies, the PLIs and the Fund. Moreover, it will also be stipulated in the documents that the loan can only be used solely and exclusively for the film project, through the operation of a separate account or sub-account in the PLI.

(C) *Film Completion Arrangement*

16. 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. The agent should take over the production in case of cost overrun, non-completion, or if the production deviates from the implementation plan. The agent should also underwrite the risks of non-completion.

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(D) *Roles of the PLIs*

17. All authorised institutions under the Banking Ordinance (Cap. 155) will be invited to participate as PLIs in the pilot scheme. The participation is entirely on a voluntary basis. The Fund will publish a list of the PLIs when the scheme is launched. The list will be updated regularly. The responsibilities of a PLI are –

- (a) to verify that an application made under the scheme satisfies all eligibility requirements as set out in paragraphs 9 to 12 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 Fund's agreement of providing guarantee under the scheme to the loan it approved in principle;
- (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 Fund 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 Fund on the loan guarantee.

(E) *Interest*

18. The interest rate of the loan is a commercial issue to be decided between the film production company and the PLI concerned. The Fund will not be involved in the process.

(F) *Form of Loan Guarantee*

19. After the loan guarantee is approved by the Fund, agreements amongst the film production company, the PLI offering the loan and the Fund will be signed, setting out the rights and obligations of each party as well as the relevant arrangements and requirements.

20. The loan guarantee may be offered for a term loan or 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 provided by the Fund will have to be activated within 90 days from the date of approval of the guarantee.

(G) Default

21. If a film production company fails to repay the principal of the loan 60 days after the payment due date, the PLI concerned may deem a default case constituted. In case of default, the PLI and the Fund 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.

Any amount eventually recovered from the film production company and through the auction of the copyright, less the administrative cost² incurred, will be shared between the Fund and the PLI according to the risk-sharing ratio. The Fund will share the administrative costs incurred by the PLI in securing repayment of the loan according to the risk-sharing ratio, subject to the amount as guaranteed by the Fund.

22. The PLI has to provide all evidence and justifications to the Fund in calling the guarantee. Upon completion of the verification process, the Fund will release the guarantee to the PLI. The amount of guarantee to be released will be determined by the amount of outstanding principal re-payment and the risk-sharing ratio between the Fund and the PLI.

(H) Target

23. The minimum number of films that can be guaranteed by the Fund at any one time will be 19 (i.e. assuming all with a budget of \$7.5 million or above). The total budget of the films guaranteed on this basis can be well over \$140 million. The actual number of films that can benefit from the scheme will be greater as not all films would apply for the maximum loan guarantee of \$2.625 million and any loan guarantee discharged would be immediately ploughed back to the Fund to support new applications.

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² Administrative costs incurred by the PLI do not include any bank interest arising from the loan nor will bank interest be counted as part of the outstanding loan.

(I) *Theme or Content*

24. Loan guarantee will be provided if all criteria set out in paragraphs 9 to 14 above are met. The Fund 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 in Hong Kong is approved.

(J) *Professional Advice*

25. To enhance the understanding of local banks about the film production process so as to increase their confidence in film financing and to provide professional advice to banks in the assessment of loan applications in areas such as film budget, production arrangements, overseas distribution agreements, etc., the film industry will draw up a list of advisors or organizations that can offer professional advice and consultancy in these areas. The PLIs may on their own discretion approach the individuals or organizations on the list to seek their professional advice, with fees to be charged on mutual agreement basis. The Government would not be involved in the advisory process.

CONTROL MECHANISM

26. The proposed Fund will be administered by the Film Services Office under the Television and Entertainment Licensing Authority (TELA), with the Commissioner for Television and Entertainment Licensing as the Controlling Officer.

27. In the event of a film production company defaulting on loan repayment, the FGF will make guarantee payment to the PLI subject to the provision of evidence and justifications. Notwithstanding the guarantee payment, the PLI will continue to take all possible actions to recover the loan. Any amount eventually recovered from the film production company will be shared between the Fund and the PLI according to the risk-sharing ratio. However, if the guarantee payment ultimately proves to be not recoverable from the film production company, it will become a loss of public moneys and the amount of loss has to be written off in accordance with the Public Finance Ordinance (Cap. 2). While the loan applications would be approved by the Commissioner for Television and Entertainment Licensing, we intend to delegate to the Permanent Secretary for Commerce, Industry and Technology (Information Technology and Broadcasting) the authority to write off any losses not involving fraud or negligence up to \$2.625 million for each guarantee.

28. For cases not involving fraud or negligence, subject to any conditions, exceptions or limitations specified by the Finance Committee, the Financial Secretary is empowered under section 38 of the Public Finance Ordinance (Cap. 2) to write-off the loss of public moneys, stores etc without financial limit. For cases involving fraud, negligence or an important point of principle, Members delegated on 19 July 1989 to the then Secretary for the Treasury (i.e. Secretary for Financial Services and the Treasury at present) the power to write off losses up to \$500,000 in any one case, or in respect of any one cause. Where the loss in any one case or in respect of any one cause is in excess of \$500,000, it would be referred to the Finance Committee for approval. We will follow the same approach in respect of default cases under the FGF.

FINANCIAL IMPLICATIONS

29. We propose to create a new commitment of \$50 million for setting up the Fund for an initial period of two years. The actual provision to be used will depend on the actual number of applications, the amount of loan guarantee approved, and the default rate. As there is no comprehensive data in respect of default of film productions, it is therefore not possible to estimate the cashflow of the Fund for the two-year period nor the amount which may eventually have to be written off. Staffing requirements for administration of the Fund will be met through redeployment of existing resources within TELA.

30. The proposed Fund has no implications on fees or charges for services provided by TELA.

31. Subject to Members' approval of the proposed Fund, the creation of the commitment of the \$50 million Fund will be offset by the reduction of an equivalent amount, i.e. \$50 million, from the approved commitment of the FDF. As a result, the approved commitment of Subhead 700 Item 008 Film Development Fund will be reduced from \$100 million to \$50 million. Consequent to the reduction of the commitment, the remaining balance of the FDF will become \$9.3 million. Based on the projection of forthcoming applications, we expect that the FDF has sufficient balance to operate for the remaining 14 months until the end of the financial year 2003-04.

REVIEW

32. We propose to conduct a review of the operation of the Fund and provide the Legislative Council Panel on Information Technology and Broadcasting with a report setting out our observations and recommendations 18 months after the Fund has come into operation.

/PUBLIC

PUBLIC CONSULTATION

33. We carried out a public consultation between 17 October and 6 November 2002 to collect the views of the local film industry, the banking sector and the general public on the establishment of the Fund. A total of 48 organisations and individuals have responded, with 77% of them expressing explicit support to the proposal. The details of the public consultation results are set out in the

Encl. Enclosure.

34. We consulted the Film Services Advisory Committee on 21 November 2002 and the Committee supported the proposal.

35. We briefed the Legislative Council Panel on Information Technology and Broadcasting on the proposal on 3 December 2002. The Panel accepted the proposal and advised that we could approach the Finance Committee to obtain funding approval.

BACKGROUND

36. Members approved a commitment of \$100 million on 27 November 1998 for the establishment of the FDF in April 1999 for a period of five years. The FDF aims to facilitate the healthy and long-term development of the local film industry and to enhance its competitiveness. The current uncommitted balance of the FDF is \$59.3 million.

37. Section 28 of the Public Finance Ordinance (Cap. 2) provides that no guarantee involving financial liability upon the Government can be given unless such guarantee is in accordance with the provision of an Ordinance, a resolution of the Legislative Council or with the prior approval of the Finance Committee.

38. 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 on the Establishment
of the Film Guarantee Fund**

Statistics on comments received

Individuals/ organizations which have submitted views	Number of submissions received	For the proposal	Against the proposal	Other comments
Local film industry	28	25(89%)	1(4%)	2(7%)
Locally incorporated banks, restricted banks and deposit- taking companies	16	10(63%)	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