For discussion **FCR(2002-03)53**
on 24 January 2003

ITEM FOR FINANCE COMMITTEE

HEAD 181 - TRADE AND INDUSTRY DEPARTMENT
Subhead 700 General other non-recurrent
Item 520 SME Business Installations and Equipment Loan Guarantee Scheme
Item 521 SME Training Fund
Item 522 SME Export Marketing Fund

Members are invited to approve the following changes to Head 181 Trade and Industry Department Subhead 700 General other non-recurrent –

(I) Item 520 SME Business Installations and Equipment Loan Guarantee Scheme (BIG) –

(a) increase the maximum amount of government guarantee for business installations and equipment loan to $2 million or 50% of the loan offered by the lending institution, whichever is less for each small and medium enterprise (SME), and extend the guarantee period to five years;

(b) provide government guarantee of up to $1 million or 50% of the lesser of the associated business installations and equipment loan guarantee or the associated working capital loans offered by the lending institution, whichever is less for each SME for a maximum period of two years;

(c) provide government guarantee of up to $1 million or 50% of the account receivable loans offered by the lending institution, whichever is less for each SME for a maximum period of two years;

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(II) Item 521 SME Training Fund (STF)

(d) increase the maximum amount of grant under the STF to $30,000 per SME;

(e) allow SMEs to submit applications for the STF either before or after the commencement of the training courses. In the case of the latter, applications have to be submitted not later than 30 days after the completion of the courses; and

(III) Item 522 SME Export Marketing Fund (EMF)

(f) increase the maximum amount of grant under the EMF to $40,000 per SME. The maximum amount of grant for each successful application will be $20,000 or 50% of the total expenditure on fundable items, whichever is less.

PROBLEM

We need to strengthen further our support for SMEs to help them enhance competitiveness and rise to new challenges.

PROPOSAL

2. The Director-General of Trade and Industry, supported by the Secretary for Commerce, Industry and Technology, proposes to make the following changes, as recommended by the Small and Medium Enterprises Committee (SMEC), to enhance the effectiveness of the BIG, the STF and the EMF –

(a) For BIG

(i) increase the maximum amount of business installations and equipment loan guarantee per SME from $1 million to $2 million. The existing condition that the amount of guarantee will not exceed 50% of the loans approved by lending institutions will still apply;

/(ii) .....

(ii) extend the guarantee period for business installations and equipment loans from three years to five years;

(iii) expand the scope of government guarantee to include two types of working capital loans. The first type is loans for SMEs to meet increases in operational expenses as a result of purchase of or enhancement in business installations and equipment. The second type is for SMEs to obtain loans by presenting accounts receivable, i.e., bills proving that they would receive payment from purchasers of their goods or services within a specific period of time. The maximum amount of government guarantee for the first type of loans is up to $1 million or 50% of the lesser of the associated business installations and equipment loan guarantee or the associated working capital loans offered by the lending institution, whichever is less for each SME . The maximum amount of guarantee for the second type is up to $1 million or 50% of the account receivable loans offered by the lending institution, whichever is less for each SME. The maximum guarantee period for both is two years;

(b) For STF

(iv) increase the maximum amount of grant an SME may receive from $15,000 to $30,000;

(v) allow SMEs to submit applications either before or after the commencement of the training courses. In the case of the latter, SMEs have to submit applications not later than 30 days after the completion of the courses; and

(c) For EMF

(vi) increase the maximum amount of grant an SME may receive from $10,000 to $40,000. The maximum amount of grant for each successful application will be the lesser of $20,000 or 50% of the total expenditure on fundable items.

/ JUSTIFICATION .....

JUSTIFICATION

3. SMEs constitute over 98% of the business establishments and provide about 60% of the total employment in the private sector in Hong Kong. They are the major driving force of the Hong Kong economy. Acknowledging that SMEs require additional support to rise to new challenges, we sought Members' approval vide FCR(2001-02)38 to set up four SME funding schemes (BIG, STF, EMF, and the SME Development Fund (SDF)) in December 2001/January 2002 to help SMEs enhance productivity, improve human resources, expand markets, and enhance overall competitiveness. The total commitment of the four schemes is $7.5 billion, with an expected maximum expenditure of $1.9 billion. As at end December 2002, over 10 000 SMEs have benefitted from the schemes, involving a total amount of guarantee/grant of over $1.2 billion. The BIG alone has helped SMEs obtain over $2.5 billion loans from lending institutions for procuring business installations and equipment. The funding and utilisation position of the individual schemes is set out
Encl. 1 at Enclosure 1.

4. The SMEC completed a comprehensive review of the four SME funding schemes last month (December 2002). In gist, it concludes that the schemes are of practical use to SMEs, and are effective in helping SMEs equip themselves for new challenges and opportunities. It advises that by suitably raising the ceilings of the guarantee/grant for individual SMEs, broadening the scope of individual schemes, extending the loan guarantee period, and rationalising the application procedures, the funding schemes will address the needs of SMEs in the areas of financing, marketing, and manpower training more fully and effectively. The Chief Executive (CE) has accepted the SMEC's recommendations in full.

5. At present, many local SMEs are suffering from insufficient orders, reduction in trade volume, and prolonged credit term for buyers. These have in turn created cash flow problems for SMEs. The present economic climate also discourages SMEs from buying new or better business installations and equipment, even if they may have a practical need to do so. The proposals to extend the scope and increase the amount of government guarantee for loans under the BIG will encourage SMEs to invest in business installations and equipment more readily, and help them meet their working capital needs.

6. The proposals to increase the maximum amount of grant under the EMF and the STF will provide additional incentives for SMEs to expand into the Mainland and overseas markets, and to provide more comprehensive training to their employers and employees. The proposal to allow submission of applications for grants under the STF either before or after the commencement of the training courses will provide greater flexibility to SMEs .

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DETAILS OF THE IMPROVEMENT MEASURES

(I) SME Loan Guarantee Scheme

(A) Objective and Eligibility

7. The BIG will be renamed as "the SME Loan Guarantee Scheme" (SGS) to reflect the expanded scope of government's loan guarantee under this scheme. The SGS will comprise three components -

(a) business installations and equipment loan guarantee;

(b) associated working capital loan guarantee; and

(c) accounts receivable loan guarantee.

On (b), the provision of the associated working capital loan guarantee will be conditional on the provision of the business installations and equipment loan guarantee in (a) above. On grounds of equity, SMEs which have already obtained government guarantee for installations and equipment loans under the BIG will also be eligible for an associated working capital loan guarantee linked with their BIG loan guarantees within six months after the SGS is implemented.

8. The operation of the SGS will primarily follow the existing arrangements of the BIG. The scheme will operate on the principles of market-driven, risk-sharing, risk-capping, and administrative simplicity. Target beneficiaries are SMEs which are creditworthy, have a good track record, and are able to demonstrate business prospects. To ensure that participating lending institutions (PLIs) are fully aware of this objective, the aforementioned criteria will be stated explicitly in the Deeds to be signed between PLIs and the Government. All locally registered SMEs [Note 1] will be eligible to apply for the SGS. However, the scheme will not cover loan transactions between a lending institution and any of its related companies in order to avoid possible conflicts of interest.

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[Note 1] The Government defines "SMEs" as any manufacturing firms which employ fewer than 100 persons in Hong Kong; or any non-manufacturing firms which employ fewer than 50 persons in Hong Kong. In this connection, "business" refers to any form of trade, commerce, craftsmanship, professional, calling or other activity carried on for the purpose of gain, but shall not include any club within the meaning of the Business Registration Ordinance unless the club is for the purpose of gain. "The number of persons employed" shall include -

(i) individual proprietors, partners and shareholders actively engaged in the work of the company; and

(ii) salaried employees of the company, including full-time or part-time salaried personnel directly paid by the company, both permanent and temporary, at the time of submitting applications.

9. PLIs will assess the creditworthiness of the applicants based on all relevant and available information. To encourage SMEs to improve their financial management and transparency of their accounts, SMEs wishing to make use of the SGS will be required to submit financial accounts to the relevant PLIs when applying for loans. A limited company will be required to submit its latest audited accounts, and an unlimited company which does not have audited accounts will be required to submit its latest statement of accounts. This requirement will not apply to SMEs which have been established for less than 18 months at the time of submitting loan applications.

(B) Participating Lending Institutions

10. All authorised institutions under the Banking Ordinance will be invited to participate in the SGS. The Government will rely on PLIs to exercise their usual prudent professional judgement in assessing applicants' creditworthiness.

(C) Use of Loans

11. Business installations and equipment loans guaranteed under the SGS have to be used for acquiring installations and equipment relating to the business operations of SMEs. Business installations and equipment may include machinery, tools, computer software and hardware, communication system, office equipment, transport facilities, furniture, and fixtures (e.g. air-conditioning system, built-in cabinets and lighting system but not decoration works). The loans may be used for acquiring second-hand installations and equipment. The installations and equipment may be located outside Hong Kong. However, the SGS will not provide guarantee for loans to finance or re-finance machinery and installations already in the applicants' possession.

12. The SMEC reckons that SMEs which require installations and equipment financing may also require working capital financing, as the two needs are often inter-related. Working capital loans guaranteed under the SGS have to be used for financing additional operational expenses arising from the acquisition of installations and equipment under the SGS. Associated working capital loans must be provided by the same PLIs which are providing the SMEs concerned with the business installations and equipment loans.

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13. SMEs in general do not have too much cash in hand. As they extend credit to buyers, their liquidity would be further tightened. The accounts receivable loans guaranteed under the SGS are for meeting the working capital needs of SMEs which have accounts receivable in hand. All SMEs will be eligible for applying for the guarantee, regardless of whether they are recipients of the associated working capital loans.

14. There will be provisions in the Deeds to be signed between the Government and PLIs to prohibit a PLI from using the SGS to help SMEs repay and restructure any other loans and credit facilities from, or payment obligations to, any lending institutions. This is to ensure that the SGS can achieve the objective of helping SMEs obtain new money for buying business installations and equipment and/or for working capital, rather than helping PLIs reduce their business risks by offloading non-performing loans to the Government.

(D) Ceiling

15. The maximum amount of business installations and equipment loan guarantee for an SME is increased from $1 million to $2 million or 50% of the loans approved by PLIs, whichever is the less.

16. The maximum amount of guarantee for associated working capital loans is 50% of the corresponding business installations and equipment loan guarantee (i.e. $1 million at the maximum) or 50% of the associated working capital loans approved by PLIs, whichever is the less.

17. The maximum amount of guarantee for loans based on accounts receivable an SME may receive is $1 million or 50% of the loans approved by PLIs, whichever is the less.

18. There will not be a minimum amount for loans guaranteed under the SGS. Also, there will not be any upper limits on the loan facilities provided by PLIs. This takes into account the fact that the costs for business installations and equipment may vary substantially, depending on the types of equipment and quantities purchased. We consider it reasonable to provide flexibility to SMEs to work out the most appropriate loan size with PLIs according to their needs.

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19. SMEs may apply to more than one PLI for loans to be guaranteed under the SGS, provided that the total amount of the Government's guarantee for an SME under each loan scheme does not exceed the specified ceilings. As mentioned in paragraph 12 above, associated working capital loan under the SGS has to be provided by the same PLI from which the SME is receiving the relevant business installations and equipment loan.

(E) Interest and Other Charges

20. As the SGS will be market driven, PLIs will determine the loan interest rates and other charges according to their own practices and considerations. However, we will encourage PLIs to take into account the reduced risk they bear as a result of the availability of government guarantee. We envisage that competition among PLIs and the transparency of the lending market should help SMEs obtain loans at reasonable interest rates and fees. Feedback from users of the BIG indicates that in general SMEs have been able to obtain a relatively larger amount of loan, a longer repayment period, and/or more preferential terms and conditions for loans under the BIG than is otherwise the case.

(F) Guarantee Period and Draw Down Dates

21. The guarantee period for business installations and equipment loan under the SGS will be extended from a maximum period of three years to five years, counting from the first draw down date of the loan. Under normal circumstances, a business installations and equipment loan will have to be activated within 90 days from the date of the Government's approval of the guarantee.

22. The guarantee period for associated working capital loan and accounts receivable loan will both be for a maximum period of two years, counting from the draw down or effective date of the loan. Under normal circumstances, the associated working capital loans will have to be activated within 90 days from the date of the Government's approval of the guarantee. Since provision of the associated working capital loan guarantee would be conditional on the provision of the business installations and equipment loan guarantee, the Government guarantee on the former will be revoked if the latter is withdrawn or revoked. To avoid unnecessary dispute, the draw down or effective date of the associated working capital loan should not be earlier than that of the corresponding business installations and equipment loan. The accounts receivable loans will have to be activated within 60 days from the date of the Government's approval of guarantee.

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(G) Form of Loans and Repayment Terms

23. Business installations and equipment loans under the SGS must be in the form of either a non-revolving loan or a hire purchase agreement. Associated working capital loan may either be non-revolving or revolving in nature. Accounts receivable loans will be revolving in nature, which is in line with normal market arrangements. Repayment of non-revolving loans must be by instalments, with an interval between each instalment not exceeding three months. The first instalment shall take place not later than six months after the loan has been activated.

(H) Compensation and Recovery Arrangements

24. All loan payments to and repayment from SMEs will be handled by PLIs. The Deeds to be signed between the Government and each PLI will set out the rights and obligations of each party and the appropriate mechanism for settling the transactions and arrangement for default cases. When processing default claims, the Government may, where necessary, require the PLI to provide additional justifications and documentary proof to demonstrate that it has conducted due diligence and exercised professional judgement and prudence in approving the loans. Upon completion of the verification process, the Government will release the guaranteed amount to the concerned PLI to discharge its responsibility as the guarantor of the non-performing loans. The PLI is required to recover as far as possible the indebtedness from the SME. Any amount recovered from the SME, through the disposal of collateral if any or otherwise, will be shared between the Government and the PLI on a pro-rata basis according to their respective risks.

(I) Transitional Arrangements

25. After the implementation of the SGS, the Government will continue to honour its responsibilities and obligations for all the outstanding guarantees under the BIG, according to the terms and conditions set out in the Deed jointly signed by the Government and the lending institutions under the BIG.

(J) Government's Commitment

26. The Government has earmarked $1 billion for expenditure under the BIG. Also, on the assumption that the default rate should not exceed 15%, the Government has undertaken to provide loan guarantee totaling $6.6 billion under the BIG.

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27. The SMEC considers it reasonable to assume that the projected default rate of the SGS would not be greater than that projected for BIG, i.e. 15%. This is because the SGS is intended to assist SMEs which are creditworthy, of good track record, and are able to demonstrate business prospects. Moreover, the requirement for SMEs to submit financial accounts to PLIs in support of their loan applications will help reduce the incidence of default. Restrictions on using the loans to repay or restructure existing loans will prevent PLIs from offloading unsatisfactory and high-risk loans to the SGS.

28. Our intention is to transfer all the unused loan guarantee amount under the BIG to the SGS. As at end December 2002, the Government has committed $1.1 billion under the BIG. We estimate that the Government will commit another $0.2 billion under the BIG from January 2003 to end March 2003. We have received 16 claims for compensation under the BIG, involving an amount of about $3.9 million as of now. They are being processed. So far, no compensation has been made. As the total Government commitment for BIG is $6.6 billion, we estimate that when SGS is in place by end March 2003, there will be an unused amount of about $5.3 billion available for transfer from the BIG to the SGS.

29. We will strive to keep the combined maximum expenditure under the scheme to $1 billion. To this end, we will keep the loan approval, the total outstanding loan amount and the default situation under close review. However, we cannot rule out the possibility that the total expenditure may exceed $1 billion as loans will be processed on a first-come first-served basis and the actual overall default rate may be more than what the SMEC has estimated. We will report to Members should it appear in due course that the expected maximum expenditure is likely to exceed $1 billion.

30. For better risk management and for more equitable distribution of available resources, we will continue to impose an indicative ceiling of $600 million on each PLIs participating in the SGS as we did under the BIG. Their loan guarantee portfolio under the BIG will be counted towards this ceiling. We will monitor the situation closely and may revise the indicative ceiling across the board or for individual PLIs in the light of operational experience.

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(II) <u>STF</u>

31. This scheme aims to provide financial assistance to SME employers and employees to attend training courses relevant to their business operation. The maximum amount of grant an SME may obtain, on a cumulative basis, for employers' training will be increased from $5,000 to $10,000, and that for employees' training will be increased from $10,000 to $20,000. In other words, the total maximum amount of grant an SME may obtain under the STF will be increased from $15,000 to $30,000. The grant will be on a dollar-to-dollar matching basis.

32. As a facilitating measure, we will allow SMEs to submit applications either before or after the commencement of the training courses. In the case of the latter, SMEs have to submit applications not later than the thirtieth calendar day after the completion of the training courses.

(III) <u>EMF</u>

33. This scheme aims at helping SMEs expand their business through active participation in export marketing activities, such as trade fairs and study missions. The maximum amount of grant an SME may obtain from the EMF will be increased from $10,000 to $40,000. The grant will be on a dollar-for-dollar matching basis. There will be no limit on the number of export promotion activities an SME may apply for the EMF, as long as the ceiling of $40,000 is not exceeded. The maximum amount of grant for each successful application will be $20,000 or 50% of the total expenditure on fundable items of the approved export promotion activity, whichever is the less. The purpose of setting a sub-ceiling to each application is to encourage SMEs to make continuous efforts in export promotion activities, with a view to building a long-term customer network.

(IV) <u>SDF</u>

34. This scheme aims at subsidising projects to be carried out by eligible support organisations, trade and industrial organisations, professional bodies and research institutes to enhance the competitiveness of SMEs in general or SMEs in specific sectors. Having taken into account the feedback of various parties, the SMEC considers it not necessary to revise the SDF for the time being.

/SUMMARY .....

SUMMARY

Encl. 2

35. When the aforementioned improvement measures are implemented, the maximum amount of guarantee/grant an SME may receive under the schemes will be $4.07 million, compared with the current $1.025 million. Details are at Enclosure 2. These improvement measures will also apply to SMEs which are existing users of the schemes.

IMPLEMENTATION TIMETABLE

36. Subject to Members' approval of the various improvement measures, our aim is to implement the measures under the EMF and STF in February 2003, and start the SGS by end March 2003.

REVIEW AND MONITORING

37. We will, in consultation with the SMEC, closely monitor SMEs' response to the revised funding schemes, and review the scope for further improvement in future.

FINANCIAL IMPLICATIONS

38. The implementation of the SGS and the various improvement measures under the EMF and STF will not require any increase in the Government's total commitment and expected maximum expenditure under the four existing funding schemes, which are $7.5 billion and $1.9 billion respectively.

39. There will not be any revenue implications arising from the recommendations in this paper.

40. Any additional resource requirement that is needed to implement the improvement measures will be absorbed by the Trade and Industry Department from within its existing resources.

BACKGROUND INFORMATION

41. In his Policy Address in October 2001, the CE accepted all the recommendations made by the SMEC in its report on SME support, including the setting aside of $1.9 billion to establish four SME funding schemes with a total commitment of $7.5 billion.

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42. When the Government launched the four funding schemes, it undertook to conduct a comprehensive review of the schemes one year after their implementation. At the suggestion of the Government, the SMEC started the review in August 2002. It completed the review and submitted a report on means to further enhance the effectiveness of the schemes to the CE in December 2002. A copy of the report was issued to Members earlier.

43. We consulted the Legislative Council Panel on Commerce and Industry on the proposed improvement measures on 16 December 2002. Panel Members were in general supportive of the proposed measures. A few members urged the Administration to strengthen publicity for the schemes when launching the improvement measures, in particular to SMEs in the service sector. We will take appropriate publicity efforts to ensure that information of the revised schemes is disseminated widely to SMEs.

44. A few members requested the Administration to provide a projection on how long we will be able to operate the four funding schemes with the commitment of $7.5 billion, taking into account the improvement measures. We wish to emphasize that it is extremely difficult to make a reliable projection, as the lifespan of the four funding schemes will depend on a number of factors, including the responses of SMEs and the actual amount of guarantee/grant individual SMEs will secure. Also, the experience of the past 12 months or so may not be very relevant in view of the improvement measures to be made.

45. Notwithstanding the above, we have endeavoured to come up with a
Encl. 3 projection for Members' reference at Enclosure 3. However, it is likely that the actual spending pattern will differ from the projection.

46. We have consulted a number of lending institutions on the proposed SGS. They welcome the proposals and are of the view that the SGS will be useful in helping SMEs address their financing needs, in particular, their working capital needs.

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47. When suggesting the improvement measures, we have also taken into account the recommendations of the Audit Commission in the value-for-money review on the Special Finance Scheme for SMEs, such as spelling out clearly our policy intentions in the Deed to be signed with PLIs, and adopting measures to prevent the offloading of bad loans by PLIs to the Government. These points have been duly taken on board as illustrated in paras 8 and 14.

Commerce, Industry and Technology Bureau
January 2003

Enclosure 1 to FCR(2002-03)53

Funding position of the four SME funding schemes
(as at end December 2002)

	Business Installations and Equipment Loan Guarantee Scheme	SME Export Marketing Fund	SME Training Fund	SME Development Fund	Total
Approved commitment	$6.6 billion (Expected maximum expenditure: $1 billion)	$300 million	$400 million	$200 million	$7.5 billion (Expected maximum expenditure: $1.9 billion)
Amount of guarantee/grant issued	$1.1 billion	$32 million	$22 million	$46 million	$1.2 billion

Enclosure 2 to FCR(2002-03)53

The amount of guarantee/grant an SME may receive before and after the introduction of the proposed improvement measures

	SME Business Installations and Equipment Loan Guarantee Scheme	**SME Export Marketing Fund**	**SME Training Fund**	**Total**
Maximum amount per SME under existing SME funding schemes	business installations and equipment loan guarantee: $1m (With $1m government guarantee, lending institutions can provide not less than $2m loan to SME.)	$10,000	$15,000 [Employees' training : $10,000 Employers' training : $5,000]	$1.025m
Maximum amount per SME under new SME funding schemes	$4m : • business installations and equipment loan guarantee: $2m • associated working capital loan guarantee: $1m • accounts receivable loan guarantee: $1m (With $4m government guarantee, lending institutions can provide not less than $8m loan to SME.)	$40,000	$30,000 [Employees' training : $20,000 Employers' training : $10,000]	$4.07m

Enclosure 3 to FCR(2002-03)53

Projection on the use of funds for the four funding schemes

	The year when funds are projected to be used up	Basis of projection
SGS	2004/05	• About 5 000 approved cases in a year for business installations and equipment loan guarantee (i.e. an increase of 50% when compared with the BIG) and associated working capital loan guarantee. Each approved case will receive guarantee of $600,000 on average ($400,000 for business installations and equipment, and $200,000 for associated working capital). • About 2 500 approved cases for accounts receivable loan guarantee in a year, each with a guarantee amount of about $500,000 on average. • Matured guarantee will not be recycled.
EMF	2006/07	• About 4 600 approved cases in a year (i.e. an increase of 50% when compared with the existing EMF), each with a grant of $14,000 on average (the average amount of grant per application is $10,000 under the existing EMF).
STF	2007/08	• About 16 500 approved cases in a year (i.e. an increase of 50% when compared with the existing STF), each with a grant of $5,000 on average (the average amount of grant per application is $2,500 under the existing STF).
SDF	2004/05	• About $37.5 million will be allocated for projects approved under SDF under each tranche, on average $1.5 million for an approved project.