

Chapter 3

Special Finance Scheme for small and medium enterprises

On 24 August 1998, the Government launched the Special Finance Scheme for small and medium enterprises (the Scheme) to help small and medium enterprises (SMEs) which were creditworthy, had a good track record and were able to demonstrate business prospects to obtain adequate financing from lending institutions. Under the Scheme, the Government acts as a guarantor for loans to SMEs approved by participating lending institutions (PLIs). On default of the guaranteed loans, the Government makes payments to the PLIs to honour the guarantees. The Director of Accounting Services is responsible for the administration of the Scheme.

2. Audit conducted a review on the implementation of the Scheme to examine whether:

- there were adequate safeguards to ensure that the granting of guarantees to SMEs was consistent with the objective of the Scheme and whether the Government's interest had been adequately protected; and
- the existing arrangement for writing off irrecoverable guarantee payments was satisfactory.

No safeguard against the offloading of loans onto the Scheme

3. Paragraph 1.5 of the Audit Report stated that upon commitment of all the funds available for the Scheme in March 2000, the Government had stopped offering new guarantees. Paragraph 1.6 revealed that as at 29 August 2002, the Default Rate for Expired or Released Guarantees was 7.6%. The Treasury had processed claims for 548 defaulted guaranteed loans and was processing the claims which the PLIs had submitted for 1,446 defaulted guaranteed loans. According to paragraph 2.40, the Director of Accounting Services agreed with Audit's recommendation that the Treasury should examine claims being processed and re-examine claims already paid, to ascertain whether the PLIs concerned had breached any requirement stipulated in the deed signed between the Government and the PLI (the Deed).

4. Against this background, the Committee enquired about the default position as at 6 December 2002 and the actions that the PLIs concerned had taken to recover the defaulted guaranteed loans.

5. **Mr SHUM Man-to, Director of Accounting Services**, in his letter of 17 December 2002 in *Appendix 40*, provided the information, as follows:

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Default Rate for Expired or Released Guarantees :	7.54%
Number of defaulted guaranteed loans	
paid	574
being processed	<u>1,351</u>
	1,925
	=====
Total amount of guaranteed payments (\$million)	
made to PLIs	\$277.9
less amount recovered	<u>16.4</u>
	\$261.5
	=====

The Director also said that, after receiving the Government's compensation, the PLIs were required to continue their recovery actions, including legal actions where necessary, against the SMEs concerned. Any money recovered by the PLIs was shared between the PLIs and the Government according to the agreed risk-sharing factor.

6. **Mr TSANG Chi-hung, Assistant Director of Accounting Services**, said that:

- there were another 80 to 90 guarantee cases in which the PLIs concerned might submit claims if the loans were in default. Thus, there would be a total of 2,000 cases of defaulted guaranteed loans at the most; and
- the Treasury would examine or re-examine all the claims for such loans and, if necessary, seek professional advice from the Department of Justice and the Hong Kong Monetary Authority (HKMA). It would take about one year to complete the examination of the more than 1,300 cases being processed. However, in the course of examination of each claim, if the Treasury had doubts about the circumstances relating to the case, it would request the PLI concerned to provide the relevant details. If the Treasury considered that the PLI had breached any requirement in the Deed, it would inform the PLI that the Government would not make the guarantee payment. In this case, the PLI would normally argue with the Treasury over the decision.

7. Referring to the claims for the more than 1,300 defaulted guaranteed loans being processed by the Treasury, the Committee enquired:

- about the number of the SMEs concerned which had been declared bankrupt or had applied for liquidation; and

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- whether the PLIs had foreseen in their assessment of the creditworthiness of the SMEs that the guaranteed loans to these SMEs would eventually become defaulted loans.

8. In his letter of 17 December 2002, the **Director of Accounting Services** informed the Committee that:

- under the Deed, a PLI could submit to the Government a claim for compensation when an SME had failed to repay a loan on maturity, irrespective of whether or not the SME had become bankrupt or liquidated. After receiving compensation from the Government, the PLI was required to continue its pursuit of repayments from the SME until further recovery efforts against the SME were considered futile, e.g. when the SME had become bankrupt, liquidated or untraceable. As the 1,351 claims as at 6 December 2002 had not yet been paid by the Government because they were being checked or additional information was being sought from the PLIs concerned, the Treasury did not have the record yet of the number of SMEs out of these 1,351 cases which had been or would be declared bankrupt or had applied for liquidation; and
- the Treasury was not aware of any PLIs which had foreseen in their assessments of creditworthiness that their loans to the SMEs concerned would eventually become defaulted loans. However, in reply to a standard questionnaire designed by the Trade and Industry Department, some PLIs had indicated that they would not have approved the loans in the absence of a guarantee from the Government.

9. In response to the Committee's request, the **Director of Accounting Services** provided a copy of the Deed and a list of the PLIs associated with the defaulted guaranteed loans vide his letter of 17 December 2002.

10. Upon the Committee's further request, the **Director of Accounting Services** provided further information on the PLIs associated with the defaulted guaranteed loans, showing:

- the total number of loans granted by each PLI against the total number of guaranteed loans granted under the Scheme and the total amount of such loans granted by each PLI;

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- the percentage of the total amount of defaulted loans of each PLI against its total amount of the guaranteed loans under the Scheme; and
- the PLIs which belonged to the same group of companies.

11. Based on the above further information, it appeared to the Committee that among the few PLIs which had granted a large number of guaranteed loans under the Scheme, the ratio of the defaulted amount of the loans was high. The Committee therefore enquired with the Chief Executive, HKMA about the industry norm for the default rate of loans granted by lending institutions, specifically the average default rate and the range of such default rate.

12. The **Head (Banking Development), HKMA** advised in his letter of 31 December 2002, in *Appendix 41*, that:

- the HKMA did not have statistics on “default rate” of loans granted by lending institutions. One alternative indicator was the level of non-performing loans of retail banks in Hong Kong, which was 4.13%, 4.41% and 5.03% for the quarters of September, June and March 2002 respectively; and
- the HKMA was unable to provide the figures relating to the range of “non-performing loans” to the Committee because this would involve disclosure of information of individual banks, which was prohibited under section 120 of the Banking Ordinance.

13. The Committee noted from paragraph 2.32 of the Audit Report that to ascertain whether the PLIs had approved guaranteed loans to SMEs which did not satisfy all the three criteria of being creditworthy, having a good track record and being able to demonstrate business prospects, to repay existing loans granted by them, Audit had selected from the Treasury’s records a number of cases for study. The Committee asked the Director of Audit about the total number of cases selected and how the cases had been selected.

14. **Mr Dominic CHAN Yin-tat, Director of Audit**, replied that Audit had selected 100 defaulted guaranteed loan cases at random. It found that in 11 cases, the PLIs had offloaded bad loans onto the Scheme. The six cases illustrated in the Audit Report were examples of Audit’s findings.

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15. Noting the findings of Audit's study of the six cases, the Committee asked whether the Treasury had detected in the defaulted guaranteed loans irregularities similar to those indicated in Audit's findings.

16. The **Director of Accounting Services** informed the Committee in his letter of 17 December 2002 that:

- the Treasury had noticed other cases where borrowers were reported to be in financial difficulties similar to those described in the six cases. There were also cases where the PLIs had transferred existing loans to the Scheme. The Treasury had previously referred many such cases to the Department of Justice, the Commerce, Industry and Technology Bureau (CITB) and the HKMA for consideration. However, as pointed out in paragraph 2.33 of the Audit Report, the Government placed complete reliance on a PLI in the assessment of the creditworthiness of a borrower and there was no restriction in the Deed on the use of the guaranteed loans, including repaying other loans granted by the PLIs; and
- apart from Case study 2 and Case study 3 quoted in the Audit Report, the Treasury had not so far noticed any cases where a guaranteed loan was granted before the date of the Treasury's notification of the result of application.

17. Regarding Case study 2 and Case study 3, the Committee asked whether:

- the granting of the guaranteed loans to the SMEs before the date of the Treasury's notification of the result of application was in breach of the Deed; and
- legal advice had been sought.

18. The **Director of Accounting Services** advised in his letter of 17 December 2002 that the PLI in these two cases had now confirmed in writing that one of the loans concerned was granted on the date of the Treasury's notification of the result of application and the other five days afterwards. The Treasury was seeking further clarification from this PLI. If there was evidence of the practices reported in paragraph 2.32 of the Audit Report, the Treasury would certainly seek legal advice.

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19. The Committee understood from Audit's case studies that in the six cases, the PLIs had not had strong justifications for supporting their assessments at the time of the borrowers' applications for the guaranteed loans that the SMEs were creditworthy. Noting that the objective of the Scheme was to help creditworthy SMEs, the Committee questioned whether there was a departure from the objective in the six cases and enquired about the follow-up actions.

20. The **Secretary for Commerce, Industry and Technology** explained in his letter of 30 December 2002, in *Appendix 42*, that:

- the fundamental objective of the Scheme was to provide relief to SMEs in the face of the unprecedented liquidity crunch in 1998. It was commonly acknowledged that many SMEs were facing severe cashflow problems at the time when the Scheme was launched. Indeed, a lot of them were no longer able to make repayments to existing loans as scheduled. Under the circumstances, the Administration considered that allowing SMEs to restructure their loans was in line with the objective of the Scheme;
- SMEs with overdue repayments were not necessarily unworthy of credit. For the six cases in question, the Administration noted that the PLIs concerned decided to lend to the SMEs because their assessment was that the difficulties of these enterprises were only temporary in nature and could be relieved through loan restructuring. Indeed, a few of these SMEs had managed to repay part of the loan before they subsequently failed to continue doing so; and
- the Administration had made it clear from the start that the Government would rely on the PLI to exercise its usual prudent professional judgement in assessing whether an individual SME was creditworthy. PLIs were bound by the provisions of the Deed signed with the Government that set out the rights and obligations of each party. For the six cases in question, the Director of Accounting Services, in consultation with the Department of Justice, was reviewing them to ascertain whether the PLIs concerned had breached any requirements stipulated in the Deed. The same would also be done for all other claims for compensation under the Scheme. If a PLI was found to have breached the requirements of the Deed, the Government might seek to recover the amount from the PLI for a claim already paid or refuse to make payments for a claim being processed.

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21. Paragraph 2.10 of the Audit Report revealed that soon after the announcement on the launching of the Scheme in June 1998, there were concerns about the possible abuse of the Scheme by the PLIs through the offloading of loans onto the Scheme. From mid-1998 to the end of 1999, there were continuing discussions among bankers, government departments and bureaux, and the HKMA on the adequacy of the safeguards against such abuse.

22. Against the above background, the Committee asked:

- whether the Administration had taken measures to build in sufficient safeguards to prevent the PLIs from offloading bad loans onto the Scheme; and
- whether before the Scheme was launched, the then Trade and Industry Bureau (TIB) had given instructions to the Department of Justice on the drafting of the Deed regarding the prohibition of offloading bad loans onto the Scheme.

23. **Hon Henry TANG Ying-yen, Secretary for Commerce, Industry and Technology**, stated at the public hearing and in his letter of 19 December 2002, in *Appendix 43*, that:

- the Scheme was launched in 1998 when many SMEs were having their credit line cut by Japanese banks in the liquidity crunch following the Asian financial turmoil. The Government hoped to help those SMEs which could demonstrate business prospects to tide over their difficulties. The guaranteed loans under the Scheme were not intended for the repayment of existing loans granted by the same PLIs. Hence, the PLI was required to declare that the applicant had no overdue loan repayments to it for over 60 days in the 12-month period prior to the application. In 1999, the Government completed a review of the Scheme and found that it was difficult for many SMEs to obtain financing under the Scheme due to the “no overdue loan” declaration requirement. As a result, the review report recommended that the requirement be removed;
- he admitted that the SMEs were in financial difficulties at the time of their applications for guaranteed loans under the Scheme. The reason could be that the SMEs were facing the problem of delayed payments by their clients. On the other hand, if an SME had overdue loan repayments to lending institution A but was only allowed to obtain a guaranteed loan from lending institution B, lending institution A might apply to have the SME declared

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bankrupt. Another possible scenario was that if the SME was not allowed to use a guaranteed loan granted by lending institution A to repay an existing loan granted by the same lending institution, lending institution A would not continue to provide financing to the SME. Hence, SMEs would not be able to operate if they were not allowed to use new loans to repay existing loans;

- the operation of the Scheme had been based on four principles, namely market-driven, risk-sharing, risk-capping and administrative simplicity. It was close to an art to achieve a balance between these principles. Moreover, the Government needed to take into account three competing considerations, i.e. the prudent use of public money, the SMEs' facing financial difficulties and complete reliance on the PLIs to assess loan applications; and
- the CITB could find no written record of the TIB giving instructions to the Department of Justice on the drafting of the Deed regarding the prohibition of offloading bad loans onto the Scheme. As described in the Audit Report, the TIB had, however, explained to the relevant parties, including the HKMA and the Treasury, that it considered that the Deed need not be amended to include provisions disallowing the restructuring of loans.

24. In view of the above reply, the Committee asked the Secretary for Financial Services and the Treasury to comment on the offloading of bad loans onto the Scheme. **Hon Frederick MA Si-hang, Secretary for Financial Services and the Treasury**, responded that in order to prevent the borrowers from using new loans to repay existing loans granted by the same lenders when launching similar schemes in the future, a mechanism similar to that of a Chapter 11 Reorganisation provided in the bankruptcy legislation of the United States should be introduced in Hong Kong. Under the mechanism, when a company was in difficulties, its existing loans would be frozen. The operation of the company would only be financed by new loans. Hence, new loans were separated from existing loans.

25. In view of the Secretary for Financial Services and the Treasury's comments, the Committee pointed out that the Administration had introduced the Companies (Corporate Rescue) Bill into the Legislative Council (LegCo) on 23 May 2001. The Bill concerned the introduction of a corporate rescue procedure which would give companies in financial difficulties an opportunity to try to turn around. However, the scrutiny of the Bill had been held in abeyance since December 2001 to allow time for the Administration to act in respect of the concerns of the Bills Committee. The Secretary noted the Committee's observation.

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26. On the question of offloading of loans onto the Scheme, the **Director of Accounting Services** supplemented that in processing applications for the Government's guarantees under the Scheme, the Treasury had acted in accordance with the provisions of the Deed. The Treasury would not have granted guarantee of a loan if the PLI concerned had given any false, fraudulent or misleading information, or had acted in bad faith. Regarding the six case studies conducted by Audit, Audit considered that, at the time of the borrowers' applications for the guaranteed loans, the PLIs did not have strong justifications for supporting their assessments that the borrowers were creditworthy. As this was not in breach of the Deed, the Treasury could not reject the applications on such grounds.

27. Noting the consequences of the absence of a clear provision in the Deed to prohibit the offloading of bad loans onto the Scheme, the Committee asked whether, with hindsight, the Deed should have been revised to introduce additional safeguards against the possible abuse of the Scheme by the PLIs.

28. In his letter of 19 December 2002, the **Secretary for Commerce, Industry and Technology** stated that:

- at the time when the Scheme was devised, the SMEs in Hong Kong were facing severe cashflow problems and were unable to secure financing due to the liquidity crunch. Indeed, many were no longer able to make repayments to existing loans as scheduled. Had the Government stated in the Deed that loan restructuring was disallowed, lending institutions would simply recall the loans and a lot of SMEs would have been forced to wind up their businesses as a result. This would have been against the objective of setting up the Scheme which aimed at relieving the financial hardship of SMEs when Hong Kong was experiencing a particularly difficult time after the Asian financial crisis; and
- in view of the unique liquidity crunch at the time and judging from the encouraging outcome that more than 92% of the loans guaranteed under the Scheme were performing or were fully repaid, the Administration considered that it had made the right decision not to prohibit loan restructuring under the Scheme in the Deed. However, this did not mean that the Administration did not consider it necessary to provide additional safeguards for similar funding schemes when the circumstances were different. Indeed, when the Government launched the SME Business Installations and Equipment Loan Guarantee Scheme in 2001, it had included in the Deed provisions expressly disallowing borrowers and lenders to use the scheme for loan restructuring, partly because of the improved financing environment for SMEs as compared

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to 1998. The Government would continue to devise its SME funding schemes with the aim of striking the right balance between upholding fiscal prudence and providing necessary support to SMEs.

29. The Committee understood that the Government had found it difficult to balance the competing principles or considerations in operating the Scheme. It asked how the Government, when launching similar schemes in the future, could strike a balance between competing considerations relating to the schemes.

30. The **Secretary for Commerce, Industry and Technology** said in his letter of 19 December 2002 that:

- when launching similar schemes in the future, the Government would aim to strike the right balance between achieving the objectives of the schemes (including the market-driven principle), and building in the necessary safeguards to avoid abuse of the schemes. It would also consult widely before deciding on the means that would maximise the usefulness of the schemes while ensuring that public money would be used properly;
- a case in point was the SME Business Installations and Equipment Loan Guarantee Scheme which aimed at helping SMEs obtain loans to acquire business installations and equipment for enhancing their competitiveness. To achieve this objective and ensure that public money was properly spent, the Government had made it clear that SMEs were not allowed to use the scheme to refinance business installations and equipment already in their possession or in the possession of their associates. The Deed signed with the PLIs also expressly disallowed borrowers and lenders to use the scheme to repay, restructure or repack other loan facilities, including doubtful or bad loans;
- the Government would continue to maintain the right balance in implementing the latest recommendations of the SME Committee on enhancing the effectiveness of the SME Business Installations and Equipment Loan Guarantee Scheme; and
- after the launching of any loan guarantee scheme, the Government would continue to closely monitor the performance and effectiveness of the scheme and, if necessary, make adjustments to ensure that it was indeed striking the right balance between competing considerations.

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31. The Committee further enquired about the monthly amount of guarantee offered by the Government in the period leading to the review of the Scheme in December 1998.

32. The **Secretary for Commerce, Industry and Technology** informed the Committee in his letter of 19 December 2002 that:

- the review had recommended, among other things, that :
 - (a) the risk-sharing ratio between the Government and PLIs should be revised from 50:50 to 70:30;
 - (b) the maximum guarantee period should be extended from one year to two years; and
 - (c) the “no overdue loan” declaration should be removed;
- revisions to the Scheme had been endorsed by the Finance Committee (FC) of the LegCo and put in place in late April 1999;
- for the nine months from August 1998 to April 1999, the amount of guarantee approved was about \$856 million. The entire amount of the initial commitment of \$2.5 billion was used up by the end of August 1999, i.e. four months after the implementation of the aforementioned revisions; and
- the monthly breakdown of the number of approved cases and the amount of guarantee approved during the period from August 1998 to April 1999 were as follows :

	Number of approved cases	Amount of guarantee approved
August 1998	0	0
September 1998	93	about \$88 million
October 1998	201	about \$138 million
November 1998	240	about \$161 million
December 1998 (The review was conducted)	196	about \$116 million
January 1999	186	about \$106 million
February 1999	127	about \$57 million
March 1999	228	about \$91 million
April 1999	245	about \$99 million
Total	1,516	about \$856 million

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33. The Committee further enquired about the total number of applications for guaranteed loans under the Scheme during the same period. The **Secretary for Commerce, Industry and Technology** stated in his letter of 31 December 2002, in *Appendix 44*, that during the period from August 1998 to April 1999, the Treasury had received 1,535 applications involving total guarantee amounting to about \$866 million. The monthly breakdown of the number of applications received and the amount of guarantee sought were as follows:

	Number of applications received	Amount of guarantee sought
August 1998	0	0
September 1998	93	about \$88 million
October 1998	201	about \$138 million
November 1998	240	about \$161 million
December 1998 (The review was conducted)	197	about \$117 million
January 1999	188	about \$107 million
February 1999	131	about \$58 million
March 1999	234	about \$93 million
April 1999	251	about \$104 million
Total	1,535	about \$866 million

34. The Committee noted from the discussion paper for the FC meeting held on 23 April 1999, in *Appendix 45*, that the TIB had stated that the 60-day declaration requirement had become a disincentive for the PLIs to make full use of the Scheme. Furthermore, the Secretary for Commerce, Industry and Technology said in his letter of 30 December 2002 that allowing SMEs to restructure their loans was in line with the objective of the Scheme. It appeared to the Committee that under the circumstances, the PLIs had granted guaranteed loans to SMEs more readily, but they had not demonstrated that they had strong justifications for supporting their assessment that the borrowers were creditworthy when they applied for the guaranteed loans. As a result, among the few PLIs which had granted a large number of guaranteed loans, the ratio of the defaulted amount of the loans was high, even when compared to the level of non-performing loans of retail banks for the quarters of September, June and March 2002, i.e. 4.13%, 4.41% and 5.03% respectively.

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35. Against the above background, the Committee enquired whether the Administration had informed the FC of the expected default rate of the guaranteed loans under the Scheme. The **Secretary for Commerce, Industry and Technology** replied that the Administration had made an assumption of a 25% default rate when seeking the FC's funding approval for the Scheme.

36. The Committee was aware that the Administration had submitted three discussion papers on the Scheme to the FC for its meetings held on 31 July 1998, 23 April 1999 and 12 November 1999, in *Appendices 46, 45 and 47* respectively. The Administration had informed the FC vide the paper for the meeting on 31 July 1998 that there was a possibility of the capital commitment for the Scheme not being recovered, in part or in whole. However, it appeared to the Committee that the assumption of a 25% default rate had not been mentioned in any of the three FC papers. The Committee was concerned whether the Administration had revealed all relevant information when seeking the LegCo's funding approval. The **Secretary for Commerce, Industry and Technology** responded that according to his understanding, the 25% default rate had been stated in public.

37. **Mr Raymond YOUNG, Deputy Secretary for Commerce, Industry and Technology**, added that as stated in paragraph 7 of the Administration's paper for the FC meeting held on 12 November 1999, "despite all these measures, there was a possibility that the actual outlay from the Scheme would exceed \$2.5 billion". In other words, the default rate of the guaranteed loans might be as high as 50%.

38. The Committee further enquired whether:

- the Administration had submitted to the LegCo other papers on the Scheme in question; and
- the default rate of 25% had been mentioned in any of those papers.

39. In his letter of 17 December 2002, in *Appendix 48*, the **Secretary for Commerce, Industry and Technology** informed the Committee that the Administration had used the SME Committee's assumption of a 25% default rate of the guaranteed loans under the Scheme in assessing the amount of money to be recouped from the Scheme when the Administration sought the funding approval of the FC for the establishment of four SME funding schemes in October and November 2001. The letter therefore confirmed that the Government's internal assumption of a 25% default rate of the guaranteed loans under the Scheme had not been revealed to the LegCo when it sought funding approval for the Scheme in question.

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40. The Committee understood from Audit's observations in paragraph 2.33(e) of the Audit Report that the Treasury, the HKMA and the Financial Services and the Treasury Bureau had seen the need and made suggestions to prohibit the PLIs from offloading bad loans onto the Scheme. However, the CITB did not agree to add a clause in the Deed prohibiting the offloading of bad loans. The Committee noted from the minutes of the FC meeting held on 23 April 1999, in **Appendix 49**, that during the discussions on the recommendations made in the review of the Scheme, a LegCo Member had expressed concern that some PLIs might use the Scheme to offset other loans acquired by the beneficiaries. In response, the then Director-General of Industry had advised that "as details of the agreement on loan facility was made between PLIs and applicants of the SFS¹, the Administration would not be in a position to know if the guarantee had been used to offset other loans. Nevertheless, the Administration would not provide the necessary guarantee if there was clear evidence indicating that this was the case". The Committee questioned why, despite the LegCo Member's direct question, the then Director-General of Industry had not revealed the numerous concerns raised by the various parties about such possible abuse.

41. The **Secretary for Commerce, Industry and Technology** responded that the then Director-General of Industry had neither hidden the truth on purpose nor been dishonest. The Administration could not have made it clear that it was aware of the possibility of being taken advantage of by the PLIs. As a matter of fact, the default rate of the guaranteed loans under the Scheme was 7.5%. In contrast, the default rate of loans granted by banks normally ranged between 1.2% and 8.9%. This indicated that the Government had managed to strike a balance between competing considerations relating to the Scheme.

42. The Committee pointed out that the crux of the matter was that the Administration, when seeking funding approval from the LegCo, should be frank and honest about all the considerations leading to its decisions. In the present case, the Administration should have made clear to the LegCo that the Administration had put up its recommendations after taking into account all the concerns expressed by the various parties about possible abuse of the Scheme. The **Secretary for Commerce, Trade and Industry** responded that the Administration would make reference to the Committee's views in future.

¹ SFS is the abbreviation of the Special Finance Scheme for small and medium enterprises.

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43. Conclusions and recommendations The Committee:

No safeguard against the offloading of loans onto the Special Finance Scheme for small and medium enterprises (the Scheme)

- expresses dismay that:
 - (a) despite the repeated concerns expressed by some bankers, the Hong Kong Monetary Authority (HKMA), the Treasury and the Financial Services and the Treasury Bureau from mid-1998 to the end of 1999 about the possible abuse of the Scheme by the participating lending institutions (PLIs) through the offloading of bad loans onto the Scheme and the adequacy of the safeguards against such abuse, no specific provisions to restrict such offloading were added to the deed signed between the Government and a PLI (the Deed);
 - (b) the Administration had been economical with the truth when seeking funding approval by the Legislative Council (LegCo), as evidenced by the following:
 - (i) despite a LegCo Member's direct question at the Finance Committee (FC) meeting held on 23 April 1999 about the possibility of some PLIs using the Scheme to offset other loans acquired by the applicants, the then Director-General of Industry did not reveal in his response the concerns of various parties about such possible abuse; and
 - (ii) when seeking the FC's funding approval for the Scheme in 1998, the Administration only informed the FC of the possibility that the capital commitment of the Government under the Scheme would not be recovered, in part or in whole; but it did not reveal the Government's internal assumption of a 25% default rate of the guaranteed loans under the Scheme, which was the default rate assessed by the Small and Medium Enterprises (SME) Committee;
 - (c) the Administration cannot produce any evidence to show that, despite the gravity of the issue and the numerous concerns raised by the various parties, it had taken positive measures to address the issue of offloading bad loans onto the Scheme by including provisions against such offloading in the Deed; and

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- (d) the PLIs had not demonstrated that they had strong justifications for supporting their assessment that the borrowers were creditworthy when they applied for the guaranteed loans, as indicated by the fact that among the few PLIs which had granted a large number of guaranteed loans under the Scheme, the ratio of the defaulted amount of the loans was high, even when compared to the level of non-performing loans of retail banks for the quarters of September, June and March 2002, i.e. 4.13%, 4.41% and 5.03% respectively;
- notes:
 - (a) that for the nine months from August 1998 to April 1999, the amount of guarantee approved by the Government was about \$856 million, and the entire amount of the initial commitment of \$2.5 billion for the Scheme had been used up by the end of August 1999, i.e. four months after the removal of the “no overdue loan” declaration requirement; and
 - (b) the Administration’s views that:
 - (i) the “no overdue loan” declaration requirement was a disincentive for the PLIs to make full use of the Scheme; and
 - (ii) allowing the SMEs to restructure loans was in line with the objective of the Scheme;
- considers that allowing SMEs to restructure their loans is not equivalent to allowing the borrowers to use new loans to repay existing loans granted by the same PLIs;
- acknowledges:
 - (a) the Secretary for Financial Services and the Treasury’s statement that in order to prevent the borrowers from using new loans to repay existing loans granted by the same lenders when launching similar schemes in the future, a mechanism similar to that of a Chapter 11 Reorganisation provided in the bankruptcy legislation of the United States should be introduced in Hong Kong;
 - (b) that for future similar schemes under which the Government acts as a guarantor for loans granted to the private sector, the Secretary for Commerce, Industry and Technology and the Director-General of Trade and Industry have agreed to critically assess the risks of abuse by lenders through methods such as offloading bad loans onto the schemes;

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- (c) that when the Government launched the SME Business Installations and Equipment Loan Guarantee Scheme in 2001, it had included in the Deed provisions expressly disallowing borrowers and lenders to use the scheme for loan restructuring;
 - (d) that the Director of Accounting Services, in consultation with the Department of Justice, is reviewing the claims for compensation in respect of the six guaranteed loans examined by Audit, to ascertain whether the PLIs concerned have breached any requirement stipulated in the Deed, and the same will also be done in respect of all other claims for compensation under the Scheme; and
 - (e) the Secretary for Commerce, Industry and Technology's undertaking that if a PLI was found to have breached the requirements of the Deed, the Government might seek to recover the amount from the PLI for a claim already paid or refuse to make payments for a claim being processed;
- urges the Administration to act expeditiously in respect of the concerns of the Bills Committee on Companies (Corporate Rescue) Bill whose scrutiny of the Bill has been held in abeyance since December 2001 to allow time for the Administration to act;
- recommends that for future similar schemes under which the Government acts as a guarantor for loans granted to the private sector, the Director-General of Trade and Industry should:
 - (a) in conjunction with the Secretary for Commerce, Industry and Technology and on the basis of the results of the risk assessment, decide whether the Government should allow the borrowers to use new loans to repay existing loans granted by the same lenders; and
 - (b) require the lender to provide to the Government essential credit information about the borrower if the Government allows the borrower to use the new loan to repay existing loans granted by the same lender, so that the Government can conduct a thorough credit assessment of the borrower before approving the guarantee;

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Need to review the writing-off authority of the Director of Accounting Services

- expresses concern about the large number of write-off cases (estimated to be about 1,200 in January 2002), the significant amount of irrecoverable guarantee payments (estimated to be about \$430 million in January 2002) to be written off and the fact that it was the Treasury which approved the applications for the guarantees in the first place;
- acknowledges that the Secretary for Financial Services and the Treasury has agreed to review the current delegation to the Director of Accounting Services of the authority to approve personally the write-off of irrecoverable guarantee payments each exceeding \$0.5 million under the Scheme;

Granting of guaranteed loans of \$50,000 not restricted

- expresses concern about the high default rate of guaranteed loans of \$50,000 each under the Scheme;
- acknowledges that the Secretary for Commerce, Industry and Technology and the Director-General of Trade and Industry have agreed to critically assess the need of setting a minimum loan amount if a similar scheme is launched in the future; and

Follow-up actions

- wishes to be kept informed of:
 - (a) the details of the Director of Accounting Services' review of all the claims for compensation under the Scheme, including:
 - (i) the explanations obtained from the PLIs;
 - (ii) the actions taken as a result of the review, e.g. the amount recovered from the PLIs for claims already paid and the number of such claims and, among the claims being processed, the amount and number that the Government refused to make payments; and
 - (iii) the improvement measures that will be adopted in future similar schemes; and
 - (b) the results of the review of the writing-off authority of the Director of Accounting Services.