For discussion
on 23 April 1999

FCR(1999-2000)5

ITEM FOR FINANCE COMMITTEE

LOAN FUND
HEAD 275 - SMALL AND MEDIUM ENTERPRISES
Subhead 101 Special finance scheme for small and medium enterprises

Members are invited to approve changes to the Special Finance Scheme for Small and Medium Enterprises.

PROBLEM

We have reviewed the operation of the Special Finance Scheme for Small and Medium Enterprises (the Scheme). We need to decide whether to implement the changes recommended in the review.

PROPOSAL

2. We propose to adopt the recommendations made in the review of the Scheme as summarized in paragraph 5 below.

JUSTIFICATION

The Review

3. The Government has been closely monitoring feedback on the Scheme since its launch in August 1998. In December 1998, we embarked on a comprehensive review to assess the feedback and to examine ways to improve the operation of the Scheme. As part of the review, we have conducted three surveys to gather the views of successful applicants, participating lending institutions (PLIs) and Small and Medium Enterprises (SMEs) which have not made use of the Scheme or have failed to obtain credit facilities under the Scheme. We have

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also consulted the major political parties as well as a number of bankers. The detailed findings of the review and our recommendations are set out in the report
Encl. 1 at Enclosure 1.

4. In general, we have found that, for successful SME applicants, the Scheme has achieved its objective of helping them obtain loans from lending institutions. Although the liquidity problem has eased in the past few months, the need for financing assistance remains strong because of the recession. However, it seems that PLIs tend to remain over-cautious, thus making it very difficult for many SMEs to obtain financing under the Scheme. There are calls to revise the Scheme to induce the PLIs to lend to SMEs more readily.

5. The review report has made the following recommendations -

(a) the operation of the Scheme should continue;

(b) the four existing underlying principles, viz., market-driven basis, risk-sharing, risk-capping and administrative simplicity, should continue to apply;

(c) the assessment of applications should continue to be conducted by the PLIs;

(d) the risk-sharing ratio between the Government and the PLIs should be revised from the present 50:50 split to 70:30;

(e) the maximum guarantee limit of $2 million should remain unchanged;

(f) the current one-year maximum guarantee period should be extended to two years;

(g) the requirement for the PLIs to declare that the applicant has not missed loan repayments to the PLIs for more than 60 days after the due date in the past 12 months should be removed; and

(h) additional injection into the Scheme is unlikely given the temporary nature of the Scheme. The longer term question of assistance for SMEs should be dealt with separately.

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Consideration

6. As regards the *continued operation of the Scheme*, we have from the beginning made it clear that the Scheme will not be a permanent measure. Nonetheless, while the liquidity problem of the banks may have eased, for many firms the difficulty of obtaining financing has remained due to the overall economic climate and the drastic decrease in collateral values. There is therefore a need for the Scheme to continue for the time being. In keeping with the short-term nature of the Scheme, the current *underlying principles*, with the *PLIs assessing the applications*, should remain in place.

7. As regards the *risk-sharing ratio*, the overwhelming majority of the SMEs and other parties consulted consider the current ratio of 50:50 as the single most important impediment to the PLIs extending loans to SMEs. At the same time, we are aware of the concern that we should not increase the Government's share of the risk only to benefit the PLIs. We need to strike a balance between encouraging lending to SMEs and safeguarding the proper use of public money. We believe that the proposed 70 (Government) : 30 (PLIs) ratio would not excessively tilt the balance. The PLIs would still have to look after their own share of the risk. With the new risk-sharing ratio, the maximum guarantee limit of $2 million will effectively cap the maximum loan available to SMEs at $2.86 illion ($2 million being 70% of $2.86 illion) compared with the current effective cap of $4 million[1]. However, in view of the relatively small size of the Government guarantee required so far for the successful applications (less than $1 illion on average), we believe that the *maximum guarantee limit* of $2 million would remain sufficient even when the risk-sharing ratio is changed.

8. As regards the *maximum guarantee period*, we have received many representations that it is too short. While extending the guarantee period could lead to a reduction in the number of beneficiaries under the Scheme, we consider that the change would enable the Scheme to expand its scope of assistance to cover those SMEs requiring loans of longer duration. On balance, we recommend that the maximum guarantee period be extended to two years to provide greater flexibility.

9. The *60-day declaration requirement* has been introduced as a means to discourage the PLIs from off-loading bad loans on to the Scheme. As the Deed between the Government and the PLIs already requires the latter to assess the

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[1] There is no Government-imposed cap on the loan size.

applications on a prudent basis, this declaration requirement is no more than an information-gathering device. So far, except for one case, we have approved all cases declared by the PLIs under the 60-day declaration requirement. It is therefore doubtful whether this requirement serves any useful purpose. More importantly, it is clear from the representations we have received that this requirement has become a disincentive for the PLIs to make full use of the Scheme. We therefore suggest to remove this requirement.

10. Given the temporary nature of the Scheme, additional funding is unlikely in the near future. Government's commitment under the Scheme should remain at $2.5 billion. Nonetheless, we are looking into various possibilities to provide assistance to SMEs on a longer term basis. We shall consult interested parties when more concrete proposals are available.

11. We believe that the proposed changes outlined above should make the Scheme more user-friendly and provide a greater incentive for the PLIs to extend loans to SMEs while still upholding the market driven principle.

FINANCIAL IMPLICATIONS

12. The proposed changes to the Scheme will involve no additional funding or staffing requirement. The proposed increase in the risk-sharing ratio could induce more PLIs to extend loans to SMEs, thus increasing the rate at which the funding of the Scheme is drawn down. In the event of default payment by approved SME borrowers, the Government would have to meet larger claims arising from the proposed increase risk-sharing ratio.

BACKGROUND INFORMATION

13. As part of the package of special relief measures announced by the Government on 22 June 1998, the Scheme aims to help SMEs to cope with the liquidity crunch problem and to secure bank loans to meet genuine commercially viable business needs. On 31 July 1998, this Committee approved a financial commitment of $2.5 billion for the establishment of the Scheme. The Scheme was launched on 24 August 1998. Under the Scheme, the Government acts as the guarantor, in respect of each approved loan, for up to 50% of the approved loan or $2 illion, whichever is the less, for up to 365 days.

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14. As of 8 April 1999, we received a total of 1 335 applications under the Scheme. All except one was approved. However 21 applicants subsequently withdrew their applications. Three default cases was registered. The cumulative guarantee and the loan involved amounted to $777 million and $1,585 million respectively. The detailed statistics showing the various aspects of the performance of the Scheme as of 8 April 1999 are set out at Enclosure 2.

Encl. 2

Trade and Industry Bureau
April 1999

<u>Note by Clerk, PAC</u>: Enclosures 1 and 2 not attached.