

For discussion
on 31 July 1998

ITEM FOR FINANCE COMMITTEE

LOAN FUND

NEW HEAD "SMALL AND MEDIUM ENTERPRISES"

New Subhead "Special finance scheme for small and medium enterprises"

Members are invited to approve the creation of a new Head "Small and Medium Enterprises" under the Loan Fund and, under the new Head, a new Subhead "Special finance scheme for small and medium enterprises" with a commitment of \$2.5 billion for the establishment of a special finance scheme for small and medium enterprises.

PROBLEM

Some small and medium enterprises (SMEs) have difficulties in obtaining loans from lending institutions or are having their credit line cut in the current liquidity crunch.

PROPOSAL

2. We propose to create a new Head "Small and Medium Enterprises" under the Loan Fund and under the new Head, a new Subhead "Special finance scheme for small and medium enterprises" with a commitment of \$2.5 billion for setting up a special finance scheme (the Scheme) to provide guarantees for loans or credit facilities extended by recognised lending institutions to SMEs.

JUSTIFICATION

3. The Hong Kong economy is experiencing a severe and abrupt downturn as a result of the regional financial turmoil. Due to the cutback of credit lines by international banks in Asia (including Hong Kong) and the concerns over the credit risk, many banks have tightened their lending policy.

4. Whilst the liquidity crunch is affecting all businesses, SMEs which constitute about 98% of enterprises in Hong Kong are particularly hard hit. Some SMEs have had their bank loans or credit facilities cut despite their credit worthiness, good track record and business prospects. We believe that there is a case to establish a scheme to provide guarantees for loans or credit facilities extended by recognised lending institutions to SMEs.

5. The design of the new Scheme is based on the following principles -

a. Market driven

The operation of the Scheme must be market driven. The intention is to help those SMEs which are credit worthy, have a good track record and can demonstrate business prospects but are unable to obtain adequate financing from lending institutions due to the credit crunch.

b. Risk sharing

The risk of default and late payment should be shared between the lending institutions and the Scheme.

c. Risk capping

There should be an upper limit to the total amount of credit guarantees offered by the Government under the Scheme. There should also be a ceiling for the maximum amount of guarantee each company may obtain from the Government.

d. Administrative simplicity

The new Scheme should be simple and easy to administer.

Details of the Scheme

6. Under the proposed Scheme, the Government will act as the guarantor for loans to SMEs approved by participating lending institutions. The maximum amount of the guarantee in each case is either \$2 million or 50% of the approved loan, whichever is the less. In addition, subject to the exception mentioned in paragraph 16 below, we will place with the lending institution, if it so requests, a deposit up to the amount of the guarantee so that its "loan to deposit" ratio will be maintained at a reasonably comfortable level whilst loans are extended to SMEs. We believe that this added feature would be welcome by lending institutions given the current tight liquidity of the banking system. The proposed framework of the Scheme is described below.

(A)Assessment of Applications

7. Government will rely on lending institutions to exercise their usual prudent professional judgement in assessing the credit worthiness of the applicants. To ensure equitable distribution of available resources, Government will implement a system to keep track of successful applicants so that no SME may at any one time enjoy a Government guarantee exceeding the ceiling of \$2 million under the Scheme.

(B)Eligibility

8. All companies registered in Hong Kong are eligible. However, the Scheme will not cover loan transactions between two lending institutions or loan transactions between a lending institution and any of its related companies. This is to avoid possible conflicts of interest on the part of the lending institutions.

(C)Use of Loans

9. Loan applications are subject to the usual prudent scrutiny by the lending institutions. Other than those limitations on the use of the loans which may be imposed by the lending institutions, the Scheme will not impose limitations on the specific uses of the loans.

(D)Ceilings

10. Each firm may apply, through a participating lending institution, for a guarantee from Government of up to \$2 million or an amount up to 50% of the loan offered by the lending institution, whichever is the less. The loan may be offered as a term loan or in the form of a new credit line.

11. For better risk management and for more equitable distribution of available resources, an indicative ceiling of \$200 million in guarantee will be imposed on each participating lending institution. We will monitor the situation closely and may revise the ceiling for individual institutions in the light of operational experience.

(E)Guarantee Period

12. The guarantee period is up to a maximum of 365 days.

(F)Interest

13. The lending institutions will determine the interest for the loans they offer to SMEs in accordance with their established principles. Government will not intervene in such commercial decisions. Since the lending institutions will undertake the administrative work associated with the assessment, day-to-day management and repayment of the loan and in view of the risk sharing arrangement which will dilute their share of the collateral, we consider a spread of 3% between the interest a bank charges a successful applicant and the interest it pays to the Government for the corresponding deposit reasonable.

(G)Administration

14. The Director of Accounting Services will be responsible for the administration of the Scheme on the

part of Government and will be the Vote Controller. All payment to and repayment from the borrower will be handled by the lending institutions. There will be an agreement between Government and the participating lending institutions setting out the rights and obligations of each party and the appropriate mechanism for settling the transactions.

(H)Arrangement for Default Cases

15. On default, any amount recovered from the SME including any amount recovered through the disposal of the collateral, if any, will be shared between Government and the lending institution on a pro-rata basis according to the ratio of the amount guaranteed by Government to the size of the total loan.

(I)Participating Lending Institutions

16. All authorised institutions under the Banking Ordinance will be invited to join the Scheme. The deposit arrangement as described in paragraph 6 above, however, will not be applicable to restricted licence banks and deposit-taking companies. This is because it has been the established practice of the Government to place its deposits only with licensed banks.

Impact on the Credit Guarantee Scheme

17. In February 1998, this Committee approved a grant of \$500 million to the Hong Kong Export Credit Insurance Corporation (HKECIC) for setting up a pilot credit guarantee scheme (CGS) to provide guarantees for loans on pre-shipment expenses by SMEs in Hong Kong. The CGS is confined to pre-export financing and its beneficiaries are confined to those companies engaged in export of goods and services. The launching of the CGS has coincided with the deepening of the liquidity crunch problem, which the CGS was not meant to address. There have been varying comments on the usefulness of the CGS. Nonetheless, since the CGS is not geared towards addressing the immediate liquidity crunch problem and to avoid possible confusion on the part of SMEs and participating lending institutions alike, we believe that there is a case to merge the CGS with the new Scheme. Upon the merging of the two schemes, we will take appropriate steps to honour those guarantees already entered into by the CGS.

Review and Monitoring

18. We will put in place a mechanism to track the performance, on an aggregate basis, of participating lending institutions. We will also review the Scheme regularly taking into account the overall economic climate and liquidity situation. When the liquidity situation improves, the need for the Scheme may no longer be there.

Number of Beneficiaries

19. Assuming that applicant SMEs will each seek the maximum guarantee of \$2 million for a period of 365 days, the new Scheme would be able to support 1 250 SMEs in the first year. We will process the applications on a first-come-first-served basis. As the funds available in the Scheme for providing guarantees are of a revolving nature and not all applicants will require a guarantee up to the ceiling or for the maximum period of 365 days, the actual number of beneficiaries is likely to exceed 1 250 SMEs.

FINANCIAL IMPLICATIONS

20. Taking into account that the CGS was set up with a grant of \$500 million and that we will now merge it with the new scheme, we propose to set up the present Scheme under the Loan Fund with a commitment of \$2.5 billion. It will be a facility of a revolving nature. The HKECIC will continue to be contractually responsible for liabilities on the guarantees undertaken in its name under the CGS until the expiry of such liabilities. It will repay the \$500 million grant under the CGS, together with the interest accrued thereon, into the General Revenue Account, less any payment for administrative expenses and default cases which may arise from its outstanding liabilities under the CGS.

21. Given the nature of the Scheme, there is an inherent risk that calls may be made on the guarantee which will have to be settled by payments from the approved commitment. There is thus a possibility of the capital commitment under the Loan Fund not being recovered, in part or in whole.

22. The administration cost, which is not expected to be significant, will be absorbed by the Director of

Accounting Services.

BACKGROUND INFORMATION

23. The Chief Executive announced on 22 June 1998 that the Hong Kong Special Administrative Region Government would implement a package of special relief measures to ease Hong Kong's economic adjustment. The measures underline the commitment of the Administration to help the community in the current economic adjustment. One of the measures is to help SMEs to obtain loans from lending institutions.

24. Subsequent to the announcement of the measures, the Administration has consulted various interested parties, including the Small and Medium Enterprises Committee and the banking sector. The proposal has received their general support. We have also consulted the Legislative Council Panel on Trade and Industry on the proposed Scheme at its meeting on 22 July 1998.

Trade and Industry Bureau
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