For discussion on 12 November 1999 **FCR(1999-2000)45**

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 raise the commitment from $2.5 billion to $5 billion so as to increase the number of guarantee loans under the Special Finance Scheme for Small and Medium Enterprises and to approve two refinements to the terms and conditions of the Scheme.

PROBLEM

The existing approved commitment of $2.5 billion provided under the Special Finance Scheme for Small and Medium Enterprises (the Scheme) has been fully committed by the end of August 1999.

PROPOSAL

2. We propose -

(a) to increase the approved commitment for the Scheme from $2.5 billion to $5 billion so that we can guarantee loans up to $5 billion in total under the Scheme;

(b) to increase the maximum amount of guarantee to be provided by individual participating lending institutions (PLI) under the Scheme from $200 million to $400 million; and

(c) to cease to provide to PLIs deposits to match the amount guaranteed.

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JUSTIFICATION

Financing for Small and Medium Enterprises

3. The Scheme was intended to provide relief for small and medium enterprises (SMEs) in face of the severe liquidity crunch problem in 1998 which has now eased. However, despite the much improved liquidity position of the banks, many SMEs still face great difficulty in obtaining financing. We consider that the main problem is twofold: the banks and the SMEs. On the part of the banks, there is a general lack of experience/expertise in assessing SME loans. In addition, our banks tend to rely heavily on collateral and are not well disposed to vetting business proposals on their merits. On the part of SMEs, many have difficulty in preparing business plans and financial statements. This in turn makes the banks' assessment even more difficult.

4. At this early stage of economic recovery, we need to continue to be sensitive to SME's difficulties. However, we consider that the ongoing need for financing by SMEs cannot for long rely on what was introduced as a a special relief measure.

Short Term Consideration

5. We have considered the option of allowing the Scheme to continue to run its natural course, that is, applications will only be processed as and when funds are returned from discharged guarantees. As the Scheme is limited by the approved commitment, the amount of funding available will shrink over time, because there will inevitably be non-performing loans and hence claims against the Scheme. In addition, as the bulk of the guarantees were approved in the past six months and the guarantee period is two years[1], the rate of guarantee discharge in the coming few months is likely to be low. The two factors combined would mean that many applications will have to be put on hold in the coming months.

6. We therefore propose to double the total amount of guarantees that can be granted under the Scheme by raising the approved commitment to $5 billion. To date, the default rate under the Scheme is relatively low (about 2.2%). Given that the Scheme has only operated for about one year and many loans guaranteed have not yet matured, it is too early to arrive at a definitive conclusion on the future pattern of defaults. We have endeavoured, therefore, to draw reference from the experience of banks in commercial lending. We have gathered informally from

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[1] The Finance Committee approved, amongst other things, the increase of the maximum guarantee period from one year to two years in considering changes to the Scheme in April 1999.

some leading banks that the default rates for SMEs could range from 1.2% to 8.9%[2]. Accepting that loans guaranteed by the Scheme may carry a higher default rate, there should still be scope to allow at least a doubling of the total guarantee ceiling without a significant risk to Government incurring expenditure over and above the $2.5 billion already approved. This will enable more SMEs to benefit from the Scheme. Technically, however, in order to comply with the requirements under the Public Finance Ordinance concerning guarantees, an increase in the approved commitment to $5 billion is necessary to cover the very remote possibility that all the loans that the Government has underwritten under the Scheme became non-performing.

7. We intend to keep the maximum cumulative expenditure under the Scheme to the $2.5 billion originally approved last year. To this end, we will keep the take-up and default situation under close review. Should there be an indication that the overall default rate is increasing at an abnormal rate, for example, we will stop processing any new applications for guarantees even if the commitment ceiling has yet to be reached. More important, we will terminate the Scheme eventually (see paragraph 14 below). It should nonetheless be noted that despite all these measures, there is a possibility that the actual outlay from the Scheme would exceed $2.5 billion. This is because all claims against the Scheme's guarantees would have to be honoured should there be loan defaults.

8. We have also reviewed the terms and conditions of the Scheme in the light of the high take-up in the past six months. We propose that the following underlying principles of the Scheme be re-affirmed -

(a) Market driven

The operation of the Scheme must be market driven. We will therefore continue to rely on the authorized lending institutions to vet the loan applications.

(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 loan 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.

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[2] The definitions of SMEs differ among banks.

(d) Administrative simplicity

The Scheme should be simple and easy to administer.

9. We have considered the option of revising the risk-sharing ratio between Government and the PLIs from 70:30 to 60:40 to ensure better sharing of risks. However, the increase of the Government's share to 70% was made in response to strong public demand and after all, we do not intend the Scheme to operate on a permanent basis. Thus, on balance, we consider that the present split should remain.

10. As regards other terms and conditions of the Scheme, we consider that they should remain largely unchanged. Nonetheless, we propose the following two refinements.

11. First, as a result of the increase in the ceiling of the total amount of guarantees under the Scheme, we propose to correspondingly increase the ceiling on the guarantee amount of individual PLI from $200 million to $400 million. The ceiling was introduced when the Scheme was launched in August 1998 as a measure to ensure better risk management and more equitable distribution of funds.

12. Secondly, under the original design of the Scheme, the Government will deposit with the licensed banks (but not restricted licensed banks and deposit-taking companies), upon the latter's request, an amount equivalent to that of the guarantee, as a measure to ease the then tight liquidity of the banking system. Since the liquidity problem of banks has much improved and the demand for deposits has remained at a very low level, we consider that this arrangement is no longer necessary. We therefore propose to cease providing deposits to back up our guarantees.

Longer Term Consideration

13. In the light of the problems faced by the banks and SMEs in processing loan proposals, what is required in the long term is therefore a change in the business culture of the banking sector as well as that of SMEs themselves. As regards the former, the Government will implement a series of market reforms and liberalization initiatives to enhance the banks' competitiveness and risk management and assessment capabilities. These reforms and initiatives should help foster changes in the banks' attitude to extending SME loans in the long run. As regards the latter, both the Government and various industrial support organisations such as the Trade Development Council and the Hong Kong

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Productivity Council have all along been working to nurture a more professional management culture among local SMEs. We will continue and strengthen our support in this regard. We will explore various possibilities, such as new activities like mentor schemes with the participation of successful SME businessmen.

14. We have also considered carefully if there is an economic case for a general long-term financing scheme for SMEs. The conclusion is in the negative. Any general financing scheme to help SMEs on a long-term basis is unlikely to be feasible, given the large number of companies involved. It would also be at odds with our well-established free-market and prudent public finance principles. Indeed, when there are clear indications of the economy on a firm course of recovery, the rationale for special relief measures falls away. For the longer term, therefore, we intend to terminate the Scheme as soon as circumstances permit while taking into account the needs of SMEs. The exact timing will depend on a number of factors such as the default trend and SMEs' financing situation in general.

FINANCIAL IMPLICATIONS

15. In order to allow the Government to contractually underwrite $5 billion of loans under the Scheme, we need to increase the approved commitment from $2.5 billion to $5 billion. In the highly unlikely event that all loan recipients under the Scheme default in repayment, we will have to pay the PLI the full amount guaranteed, up to $5 billion.

16. In reality, the ultimate financial outlay for the Government is likely to be far lower than $5 billion, and indeed the original commitment of $2.5 billion, as it will amount only to the cumulative value of actual default cases. The total of such cases will depend upon a number of factors such as the general economic conditions and the duration of the Scheme as repayments received are recycled in the form of new guarantees and, therefore, the total involved in default cases will continually increase.

BACKGROUND INFORMATION

17. The Scheme was one of the economic relief measures announced in June 1998, with a view to easing the then liquidity crunch problem faced by SMEs.

18. On 31 July 1998, Finance Committee approved a commitment of $2.5 billion for the establishment of the Scheme. On 23 April 1999, Finance Committee approved changes to the Scheme, amongst others, by raising the Government's risk-sharing factor to 70% (from the previous 50%) and extending

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the maximum period of guarantees from one year to two years. Since these revisions, the take-up rate for the Scheme has increased considerably. By 31 August 1999, all the funds under the Scheme had been committed. Further applications have since been put on a waiting list and the processing of the cases is reactivated on a first-come-first-served basis as and when recycled funds are available from discharged and released guarantees.

19. As of 21 October 1999, there were 7 050 successful applications, with the cumulative guarantee and the loan involved amounting to $2,624 million and $4,424 million respectively. The number of applications on the waiting list stood at 2 452, which would require a guarantee amount of $662 million. A total of 29 cases have defaulted and the Government has paid out $27 million as compensation.

Trade and Industry Bureau
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