For Discussion
on 14 November 2008

FCR(2008-09)43

ITEM FOR FINANCE COMMITTEE

HEAD 181 – TRADE AND INDUSTRY DEPARTMENT
Subhead 700 General non-recurrent
New Item "Special Loan Guarantee Scheme for Small and Medium Enterprises"

Members are invited to approve under Head 181 – Trade and Industry Department a new loan guarantee commitment of $7 billion with an expected maximum expenditure of $700 million for the Government to provide guarantee under a Special Loan Guarantee Scheme for Small and Medium Enterprises and to meet contingent liabilities arising from this guarantee.

PROBLEM

Small and medium enterprises (SMEs) are facing serious liquidity problem in the current global financial crisis. On top of the existing SME Loan Guarantee Scheme (SGS), we need to provide further support to facilitate them in obtaining immediate cashflow relief from the commercial lending market.

PROPOSAL

2. The Director-General of Trade and Industry, supported by the Secretary for Commerce and Economic Development (SCED), proposes to set up a time-limited Special Loan Guarantee Scheme for Small and Medium Enterprises (SpGS) with a total loan guarantee commitment of $7 billion at any particular time while the Scheme is in operation, and an expected maximum expenditure of $700 million, for the Government to provide up to 70% guarantee for loans taken out by eligible SMEs from participating lending institutions (PLIs).

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JUSTIFICATION

3. SMEs constitute 98% of the business establishments in Hong Kong and provide about 50% of the total employment in the private sector. They are the backbone of Hong Kong's economy. In recent months, tightening of credit in the commercial lending market amidst the current global financial market crisis has presented serious liquidity problems for SMEs. While welcoming various enhancement measures to the existing SGS approved by the Finance Committee (FC) on 28 October 2008, the trade has pointed out that many SMEs would still encounter problems when the PLIs are unwilling to grant loans and shoulder 50% of the risk in respect of individual applications under the existing SGS. There are calls for the Government to increase the guarantee ratio. We expect the SpGS, with the offer of 70% government guarantee, will help provide SMEs with another avenue to gain accessibility to credit facilities, at this time when the financial market is volatile and confidence is put under severe test.

4. We consider that the SpGS will be particularly helpful to SMEs with good track record and reasonable business prospects in obtaining financing for them to carry on their business and tide over the current difficult situation due to the global financial crisis. Depending on the actual loan size, some 10 000 to 15 000 SMEs are expected to benefit from the Scheme.

THE PROPOSED SCHEME

Guiding principles

5. The operation of the SpGS will be guided by the following principles –

(a) Market driven

Similar to existing and previous government loan guarantee schemes for SMEs, the operation of the SpGS will be market driven. The intention is to help SMEs which are creditworthy, have a good track record and can demonstrate reasonable business prospects but are unable to obtain adequate financing from lending institutions due to the credit crunch. We will rely on the PLIs to exercise their usual prudential professional judgement in assessing the SMEs' loan applications. We will sign a deed with each PLI setting out the rights and obligations of either party.

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(b) *Risk sharing*

The risk of default will be shared between the PLI and the Government, so that the former will exercise financial prudence in vetting the loan applications.

(c) *Time-limited*

The SpGS will be a separate, time-limited scheme to address the immediate credit crunch problem, to supplement the existing SGS.

Major features

6. Based on the above principles, we propose that the SpGS should have the following major features –

(a) the Government's loan guarantee commitment will be capped at $7 billion at any particular time while the SpGS is in operation;

(b) the Government will provide 70% guarantee to the loans granted by PLIs[1]. The maximum amount of guarantee for each SME is $700,000 for a term loan. In other words, the maximum amount of loan that each SME may obtain from the PLI under the SpGS is $1 million. With Government assuming a larger share of default risk, we expect PLIs to be more forthcoming in granting credit facilities to SMEs while remaining professional and prudent in vetting and processing the loan applications. As the SpGS is a special, time-limited scheme to help SMEs tide over immediate cashflow difficulties, we propose to provide more flexibility without setting any indicative guarantee exposure ceiling for individual PLIs;

(c) an SME may obtain from the PLI a revolving credit line[2] of up to $500,000, within the maximum amount of approved loan at $1 million. Subject to the maximum loan guarantee ratio at 70% of

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1 All "authorised institutions" under the Banking Ordinance, including banks, restricted licence banks and deposit-taking companies, are eligible to participate in the SpGS.

2 Under a revolving credit line, an SME may use the credit repeatedly up to a certain limit as long as payments are made. It may include overdraft facilities, revolving letters of credit line in support of trade finance, etc. A revolving credit line has an advantage over a term loan in that, other than a commitment or arrangement fee, interest is not usually charged on the unused part of the credit line, and that the borrower may draw on the credit line at any time that it needs to. Banks usually structure a revolving credit line as a demand loan, which means that any outstanding balance will have to be paid immediately upon request.

the approved loan, the Government's maximum amount of guarantee for an SME in respect of this revolving credit line is $350,000[3] or 70% whichever is lower. The provision of such a credit line will provide greater flexibility and help inject more liquidity into the market to meet the needs of SMEs;

(d) subject to the safeguards in paragraph 7 below, all SMEs[4] registered and with substantive business in Hong Kong are eligible to apply. There is no restriction to any specific industry or type of business;

(e) the application is open for six months starting from the date of implementation, which may be extended subject to review;

(f) a grace period of six months will be allowed, during which the borrower may repay the interest only. Thereafter, the loan should be repaid over a maximum of 24 months. As such, the maximum guarantee period for each loan, including both the term loan and the revolving credit line facility, should be 30 months after first drawdown, or up to 31 December 2011, whichever is earlier; and

(g) the interest rate will be determined by individual PLIs in accordance with commercial principle.

Safeguards Against Abuse

7. Given the higher guarantee ratio provided by Government, we consider it necessary to put in place adequate safeguards to ensure that only SMEs with genuine need and a reasonable business prospect would benefit from the proposed Scheme. In particular, we propose to build in the following requirements in the SpGS –

(a) personal guarantee is required of the SME owner or, in the case of a limited company, shareholders together holding more than 50% of the equity interest of the SME[5];

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3 A lower sub-ceiling is proposed for the revolving credit line in view of the higher risk involved, as the loan exposure would not diminish towards maturity.

4 "SMEs" is defined as any manufacturing businesses which employ fewer than 100 employees in Hong Kong; or any non-manufacturing businesses which employ fewer than 50 employees in Hong Kong.

5 It is considered reasonable to require SME owners to pledge confidence in their business with a personal guarantee when the Government now proposes to assume a higher default risk by providing 70% guarantee for the loans they take out from PLIs.

(b) the SME must have been in operation for at least one year on the date of implementation of the SpGS[6];

(c) the SME must have no default[7] in other banks; and

(d) the loans should not be used for repaying, restructuring or repackaging other loans[8].

FINANCIAL IMPLICATIONS

8. The setting up of the SpGS will require a total loan guarantee commitment of up to $7 billion. With an assumed default rate of 10%[9] for planning purpose, the expected maximum expenditure on the part of the Government is estimated at $700 million, likely to spread over two or more financial years starting from 2010-11. For the sake of financial prudence, except with Members' further approval, we would not provide loan guarantee beyond the $7 billion commitment or when expenditure for settling default claims from PLIs is about to reach $700 million, whichever happens first.

9. Any additional staffing requirement to implement the proposed measures will be absorbed by the Trade and Industry Department (TID) within its existing resources.

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6 This is to ensure that SMEs would not be set up solely for the purpose of obtaining loans under the SpGS.

7 "Default" here is defined as failure to make repayment in accordance with the terms and conditions of the approved credit facilities with a lapse of more than 60 days after the due date. In the interest of financial prudence and public accountability, we consider that Government should not provide loan guarantee for SMEs with a less than satisfactory credit history.

8 This provision is to forestall existing bad debts or classified loans from being off-loaded onto the Government through the SpGS, an important safeguard already put in place in the existing SGS pursuant to Director of Audit's recommendations made in respect of the special loan guarantee scheme launched in 1998.

9 The default rates for existing or previous government loan guarantee schemes are as follows –

(a) 5.7% for the special loan guarantee scheme during the Asian financial crisis in 1998 (with 70% Government guarantee for SMEs in all business sectors);

(b) 4.9% for the special loan guarantee scheme during SARS in 2003 (with 100% Government guarantee for enterprises in four specific sectors); and

(c) 2.8% for the existing SGS (with 50% Government guarantee for SMEs in all business sectors).

In view of the uncertainties, both over economic outlook and SMEs' behaviour or business performance, it is considered not imprudent to assume a 10% default rate for the SpGS.

10. The proposal has no implication for the fees and charges of services provided by TID.

IMPLEMENTATION PLAN

11. Subject to Members' approval of the recommendations set out in paragraph 2 above and completion of necessary procedures and legal documentation, the SpGS is expected to come into operation in December 2008.

PUBLIC CONSULTATION

12. SCED convened an SME Summit on 23 October 2008, which was attended by more than 40 participants including Legislative Councillors, representatives of various trades, major chambers of commerce and SME associations. The trade in general hoped that the Government would assist SMEs in obtaining credit, particularly by increasing the Government's loan guarantee ratio. We also consulted some PLIs of the SGS, which reacted positively to the proposal.

13. We sought Members' views on how the Government might provide further support for SMEs, and heard deputations, at the meetings of the Legislative Council Panel on Commerce and Industry on 21 and 27 October 2008 respectively. The SME Committee was also consulted on 6 November 2008.

14. We consulted the Panel on the proposed SpGS on 12 November 2008. Members were supportive of the proposal. To address Members' concerns on lending institutions' readiness to grant loans to SMEs under the SpGS, the time taken to process loan applications and the interest rates to be applied to approved loans, we are following up with the Hong Kong Monetary Authority and the Hong Kong Association of Banks. Members also sought further clarification on the safeguard measures to be built in to prevent abuse. Additional information in this regard is now provided in footnotes 5 to 8.

BACKGROUND

15. TID currently administers the SGS to help SMEs obtain loans from the commercial lending market. Under the SGS, the Government acts as guarantor for up to 50% of the approved loans. The maximum amount of loan guarantee for each SME is $6 million (i.e. each SME can borrow up to $12 million from the PLIs). As at end October 2008, the Government has approved more than 20 000 applications under the SGS, involving a total guarantee of $10.36 billion.

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16. We obtained the FC's approval on 28 October 2008 to introduce the following enhancement measures to the SGS, with a view to providing greater support and flexibility for SMEs in obtaining and repaying loans –

(a) to remove the sub-ceilings for the Business Installations and Equipment Loan and Working Capital Loan, while maintaining the overall maximum amount of guarantee for each SME at $6 million;

(b) to allow each SME to recycle the guarantee once after it has fully paid up the loan backed up by the guarantee (i.e. each SME will be able to obtain a maximum amount of guarantee of $12 million in its lifetime); and

(c) to increase the indicative ceiling of guarantee exposure for each PLI from $1.25 billion to $1.5 billion to provide more "quota" for the PLIs in granting loans.

We have also extended the maximum guarantee period for Working Capital Loans from two years to five years. All the enhancement measures were implemented on 6 November 2008.

17. The Government introduced two special finance schemes in 1998 and 2003 respectively to provide assistance to the trade in obtaining loans during the Asian financial crisis and SARS. The two schemes have a guarantee ratio of 70%[10] and 100% respectively.

Commerce and Economic Development Bureau
Trade and Industry Department
November 2008

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[10] The initial guarantee ratio was 50% when the scheme was first introduced, and was later increased to 70%.