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LEGISLATIVE COUNCIL BRIEF

SPECIAL FINANCE SCHEME FOR SMALL AND MEDIUM ENTERPRISES

INTRODUCTION

At the meeting of the Executive Council on 21 July 1998, the Council ADVISED and the CHIEF EXECUTIVE ORDERED that:

(a) subject to the provision of funds by the Finance Committee of the Legislative Council, a $2.5 billion Special Finance Scheme should be set up to provide funding and guarantees for loans for Small and Medium Enterprises (SMEs); and

(b) the Credit Guarantee Scheme (CGS) launched on 3 June 1998 should be merged with the Special Finance Scheme.

BACKGROUND AND ARGUMENT

General Background

2. In February 1998, the Finance Committee of the Provisional Legislative Council agreed to the financial implications for setting up a $500

million pilot Credit Guarantee Scheme (CGS) to help SMEs involved in exports to obtain finances from lending institutions by providing guarantees for their loans. The CGS was launched on 3 June 1998. It is confined to pre-export financing and its beneficiaries are confined to those companies engaged in export of goods and services.

3. On 22 June 1998, the Government announced a package of special relief measures to ease Hong Kong's economic adjustment. One of these measures is to help SMEs to obtain loans from lending institutions. Whilst the prevailing credit crunch problem is affecting all companies, SMEs are particularly hard hit. Despite their credit worthiness, good track record and business prospects, some SMEs are unable to obtain loans from banks or have their credit line cut. With their relatively low start-up costs and greater adaptability to changing business environment, SMEs are a significant force in reviving the economy and creating employment opportunities. We therefore proposed to set up a new $2 billion scheme modelled on the CGS to help SMEs to cope with the liquidity crunch problem and to secure bank loans to meet genuine commercially viable business needs.

4. In designing the details of the new Scheme, we have listened to the views of the SME Committee, the banking sector and other interested parties. Taking into account these views, we have designed the Special Finance Scheme as described in the following paragraphs.

Proposed Scheme

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 creditworthy, have a good track record and can demonstrate business prospect but are unable to obtain adequate financing from lending institutions due to the credit crunch.

(b) Risk sharing

The risk of default and late repayment 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.

6. Under the proposed Scheme, the Government will act as the guarantor for SMEs' loans approved by lending institutions. The maximum amount of the guarantee in each case is $2 million or 50% of the approved loan, whichever is the less. In addition, subject to the exception mentioned in para 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 applicants' credit worthiness. To ensure equitable distribution of available facilities, 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 the 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 and 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. Director of Accounting Services will be responsible for the

administration of the Scheme on the part of Government and will be the Vote Controller of the Scheme. 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 para 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. 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. Appropriate steps will be taken 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. The Special Finance Scheme will also be reviewed 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 should be able to support 1,250 firms for the first year. The applications will be processed on a first come first served basis. As the Scheme is of a revolving nature and not all applicants will require a guarantee up to the ceiling and for the maximum period of 365 days, the actual number of beneficiaries is likely to exceed 1,250 SMEs.

FINANCIAL AND STAFFING IMPLICATIONS

20. Taking into account the $500 million grant under the CGS, the new Scheme will be a facility with a commitment of $2.5 billion. 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.

21. The administration cost on the part of the Government will be absorbed by the Director of Accounting Services.

ECONOMIC IMPLICATIONS

22. The Scheme could help SMEs secure finance and enhance working capital. This could help ease the financial difficulties faced by SMEs amidst the current tight credit situation.

PUBLIC CONSULTATION

23. The SME Committee, the banking sector and the Trade and Industry Panel of the Legislative Council have been consulted. The proposal has received their general support.

PUBLICITY

24. A press release will be issued on 24 July 1998. A spokesman will be available for answering media and public enquiries.

ENQUIRIES

25 Any enquiries on this brief shall be directed to Mr Bobby Cheng, Principal Assistant Secretary for Trade and Industry, tel : 2918 7460 or fax 2869 4420.

Trade and Industry Bureau

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