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LEGISLATIVE COUNCIL BRIEF

SPECIAL FINANCE SCHEME FOR SMALL AND MEDIUM ENTERPRISES

INTRODUCTION

At the meeting of the Executive Council on 26 October 1999, the Council ADVISED and the Chief Executive ORDERED that, subject to the approval of the Finance Committee of the Legislative Council, the approved commitment under the Special Finance Scheme (the Scheme) for Small and Medium Enterprises should be raised to $5 billion to increase the amount of guarantees under the Scheme; and the terms and conditions of the Scheme should be changed as set out in paragraphs 13 and 14 below. For the longer term, taking into account relevant factors such as the recovery of the economy and SMEs' financing situation in general, it is intended that the Scheme would be terminated when circumstances permit.

BACKGROUND AND ARGUMENT

Background

2. 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. The Government acts as the guarantor for SMEs' loans under this $2.5 billion scheme.

3. In May 1999, the Scheme was revised by raising the

Government's risk-sharing factor to 70% (from the previous 50%) and extending the maximum length 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.

4. As of 21 October 1999, there had been 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. There are also 40 possible default cases, involving $47 million of guarantees.

Short Term Considerations

5. 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.

6. At this early stage of economic recovery, we need to continue to be sensitive to SME's difficulty. At the same time, the Scheme was intended to provide relief for the severe liquidity crunch problem in 1998 which has now eased.

7. We have considered whether to allow the Scheme to continue to run its natural course, i.e., applications will only be processed as and when funds are returned from discharged guarantees.

As the Scheme is not an interest-earning one, 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 take-up only occurred in the past six months, when the maximum guarantee period was increased from one year to two years, 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.

8. We propose instead to double the ceiling of guarantee which can be granted under the Scheme 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 some leading banks that the default rates for SMEs could range from 1.2% to 8.9%[*]. 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 guarantee ceiling within the maximum commitment of $2.5 billion already approved and hence enable more SMEs to benefit from the Scheme. Technically, however, in order to comply with the requirements of the Public Finance Ordinance, an increase in the approved commitment to $5 billion is necessary to cover for the very remote possibility that all the loans that the Government has underwritten under the Scheme became non-performing.

9. 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 funding is still available. More important, we will terminate the Scheme eventually (see paragraph 17 below). It should nonetheless be noted that despite all these measures, there is a possibility that the actual outlay from the Scheme would

[*] The definitions of SMEs differ among banks.

exceed $2.5 billion – all claims against the Scheme's guarantees would have to be honoured should there be loan defaults.

10. We have also reviewed the terms and conditions of the Scheme. 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 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 Scheme should be simple and easy to administer.

11. We have considered whether to revise the risk-sharing ratio between Government and the participating lending institutions from 70:30 to 60:40 to slow down the take up. However, the increase of the Government's share to 70% was made in response to strong public demand. We consider that the present split should remain.

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

13. As a result of the increase in the ceiling of the guarantee amount, we propose to increase correspondingly the $200 million ceiling on the guarantee amount of individual participating lending institutions 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.

14. Under the original design of the Scheme, the Government has to 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 deposit has remained at a very low level, we consider that this arrangement is no longer necessary. We therefore propose to revoke the deposit option.

Longer Term Considerations

15. The root of the SME financing problem is the lack of expertise of local banks in assessing non-collateral-based lending and the inadequacies of SMEs themselves in modern financial management. A recent consultancy study indicates that there is a high concentration of asset-based lending in the local banking sector. We also understand that banks often encounter difficulties in obtaining from SMEs the basic requisite information for credit assessment. This gives rise to a situation where lenders are not willing or able to assess the viability of an SME business and that SME borrowers cannot put up a decent business plan or even a financial statement.

16. 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

organizations such as the Trade Development Council and the Hong Kong 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.

17. 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 need to take into account a number of factors such as the default trend and SMEs' financing situation in general.

FINANCIAL AND STAFFING IMPLICATIONS

18. In order to allow the Government to contractually underwrite \$5 billion of loans under the Scheme, we need to seek the Finance Committee's approval to an increase in the approved commitment from \$2.5 billion to \$5 billion. In the highly unlikely event that all loan recipients default, the full \$5 billion of guarantees would have to be made good.

19. In reality, the Government's ultimate financial commitment is likely to be far lower than \$5 billion as it will amount only to the 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.

20. The proposal has no additional staffing implications.

ECONOMIC IMPLICATIONS

21. In the shorter term, the proposed change to the Scheme could help more SMEs in obtaining loans from lending institutions. But when the overall economic situation and bank liquidity conditions gradually return to normal, SMEs should not continue to rely on Government guarantee support in obtaining general commercial credit.

PUBLIC CONSULTATION

22. The Small and Medium Enterprises Committee was informed of the progress of the Scheme after the funds had been fully committed. A member of the Committee raised an idea similar to increasing the guarantees with the existing funding.

PUBLICITY

23. A press release will be issued on 29 October 1999. A spokesman will also be available for answering media and public enquiries.

ENQUIRIES

24. 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
29 October 1999