

Research Paper

Exploration of a market-based solution for sustainable SME financing

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INTRODUCTION

1 The Bauhinia Foundation Research Centre (“BFRC”) is an independent policy think tank established in March 2006. Its research focus is on Hong Kong’s long-term competitiveness and socioeconomic well-being.

2 Given the very significant role of SMEs in the city’s economy, the BFRC recommended increasing the guaranteed credit for small and medium enterprises (“SMEs”) to 80%, as part of its policy submissions to the Chief Executive of HKSARG in November 2008, to help mitigate the credit crunch caused by the financial tsunami. The Government subsequently introduced the Special Loan Guarantee Scheme (“SpGS”) on top of its existing SME Loan Guarantee Scheme (“SGS”).

3 As from 1 January 2011, the Trade and Industry Department (TID) will cease to accept new applications under the SpGS. In view of the significant usage of the SpGS, we consider it important to explore whether and in what form the market can offer alternative guarantee arrangements to help sustain bank lending to small and medium enterprises (“SMEs”) in Hong Kong.

4 As part of the BFRC’s independent study into the subject, this paper considers relevant overseas experience and reviews the local conditions to examine the features of a market-based solution that can operate as a supplement to SGS.

EXISTING SME GUARANTEE SCHEMES IN HONG KONG

5 The Government launched the SGS in December 2001 to help SMEs to secure loans for acquiring business installations and equipment and meeting working capital needs. The overall objective is to assist SMEs to enhance their productivity and competitiveness in the rapidly changing global business environment.

6 Under the SGS, the Government provides guarantee on 50% of the approved loan granted by the participating lending institutions (“PLIs”) to the SMEs, subject to a maximum guarantee amount of HK\$6 million for each SME. As at 9 August 2010, 36 lending institutions have joined the SGS. The SGS currently has a limit of HK\$20 billion for loan guarantee commitment.

7 On 15 December 2008, amid the credit crunch associated with the global financial tsunami, the Government introduced the SpGS with a limit of HK\$100 billion on the total loan guarantee commitment. The SpGS was a short-term stimulus package on top of the SGS to mitigate the impact of the credit crunch. Initially, the SpGS provided 70% guarantee for loans granted by the PLIs to non-listed enterprises, and each enterprise could obtain a maximum loan of HK\$6 million, within which HK\$3 million could be used for a revolving credit line.

8 In light of the exceptional severity of the global financial crisis, the Government enhanced in June 2009 the SpGS by increasing its guarantee ratio from 70% to 80% and doubling the maximum amount of loan guarantee for each enterprise to HK\$12 million, within which HK\$6 million could be used for revolving credit

facilities. The maximum guarantee period for each loan was also extended from three years to five years, or up to 31 December 2015, whichever is earlier.

9 As the market gradually recovered, the Government announced in April 2010 that the SpGS would stop receiving new applications from 1 January 2011 while the guarantee period would be extended up to 31 December 2015. On the other hand, the SGS will remain in place to guarantee SME loans up to HK\$6 million with a maximum guarantee period of five years. More details of the SGS and the SpGS are at Annex A.

10 Given the uncertain outlook associated with the global economic environment, there are suggestions that local enterprises will still need certain support on top of the SGS to help them obtain financing from PLIs.

OVERSEAS EXPERIENCE

11 We have done a quick review of the corporate loan guarantee programmes in Asia, including Malaysia, Korea, Singapore, Taiwan, and Shanghai. Such programmes are often operated by organisations associated with the government and carry features suited to the local circumstances (summary at Annex B). In general, they aim to provide guarantee on loans to SMEs with coverage ranging from 50% to 100%. While some only guarantee non-revolving loans, some also cover term loans. The guarantee fee ranges from zero to 6% p.a. and there is differentiation between unsecured and secured loans. For some schemes, the low or no guarantee fee is apparently associated with a certain cap on the interest rate charged on the SME loans.

12 It is expected that Hong Kong's market-based scheme ("the New Scheme") should generally have due regard to the general norm among these overseas schemes. However, due regard should also be given to the operation of the SGS in Hong Kong, the phasing out of the SpGS in the coming few years, the local economic environment and prospect and the economic ecology involving the lending institutions and the SMEs.

POSSIBLE MARKET-BASED SOLUTION IN HONG KONG

Objectives

13 With a view to extending support to enterprises in obtaining financing from PLIs upon the cessation of SpGS, a market-based solution can be explored with the following objectives:

- (a) Involving no subsidy from taxpayers;
- (b) Providing banks or lending institutions with an additional risk-mitigating tool that would encourage them to sustain their scale of financing for SMEs in Hong Kong; and

- (c) Supporting enterprises in developing their businesses in Hong Kong in the long run.

14 Against the above objectives, the following sections outline the key features of a possible Hong Kong market-based solution for discussion.

Positioning of the New Scheme

15 The SpGS was a short-term solution offered by the Government in response to the 2008 financial crisis and the abrupt turn in market that caused a severe liquidity shortage. While there are still economic uncertainties facing the SMEs, market liquidity has recovered considerably along with healthy competition in the lending market. The New Scheme would not be a replacement for the SpGS as such. But it should be a commercially viable scheme designed to foster long-term sustainability of SME financing. In particular, it should help the lending institutions to manage their risk exposure to SME financing in such a way as to encourage lending institutions to continue to be strongly supportive of the SME sector for a greater variety of enterprises as far as possible. The New Scheme should properly balance the interests of all concerned stakeholders such as lending institutions, corporate borrowers and guarantors.

Target Segment

16 While the SGS covers SMEs only, the SpGS coverage extends to all non-listed enterprises satisfying certain eligibility criteria (details in Annex A). The New Scheme would preferably have a broad coverage to maintain a comparable eligibility window. The eligibility criteria could be adjusted over time to fine-tune the balance between the need of the enterprises and the possible exposure of the lending institutions and guarantors to excessive risks.

Facility Type

17 The SGS in essence covers only term loans whereas the SpGS expands to cover also revolving facilities to broaden the support to SMEs. To provide sufficient flexibility and incentive for the corporate borrowers, it is desirable for the New Scheme to maintain a similar coverage. Where possible, probably at a later stage when more experience is gathered on the operation of the New Scheme, there may be some room to improve the coverage beyond that of SGS and SpGS to assist the SMEs in their financing.

Underwriting/Coverage

18 Underwriting is essential to the proper classification and pricing of risk in any guarantee or insurance business. With the segmentation of the guaranteed loans into different risk classes, appropriate guarantee fees would be imposed to establish a self-sustained commercially viable business model. Initially, in order that the New Scheme would not be exposed to excessive risks or very high-risk loans, certain high-risk segments may have to be excluded from the coverage. Such exclusion would enable the New Scheme to maintain a guarantee fee structure at a more affordable level.

Otherwise, the guarantee fee may have to be set at a very high level to cater for the excess risks. More discussion is covered in the next section on Guarantee Fee Structure.

19 The SGS and SpGS operated by the TID rely entirely on the underwriting by banks on the premise that the banks are better placed and informed to make the credit judgement. However, the full delegation of the underwriting and credit assessment to the banks has its own drawback – when a claim arises, this will require a full-scale validation that inevitably lengthens the claims process. Dispute over claims and potential claims rejection are more likely to arise in the validation process. Physical tracking of loan documents, as well as staff turnover in banks, may also cause further complications in the validation process, although it is understood that the situation has improved with the SpGS.

20 In order to expedite the claims process without compromising the integrity of validation (at least within a generally acceptable degree), the guarantor may consider performing high-level checking on the due process of the banks in the underwriting activities to obtain sufficient comfort. Alternatively, the guarantor may also consider performing part of the underwriting and credit assessment, instead of solely relying on the banks. There may however be practical and operational constraints on how to achieve more optimality in this approach.

21 On balance, there may be advantages for the New Scheme to continue to rely on underwriting by banks, at least initially. However, in the long run, when the guarantor becomes involved in the underwriting process, it will lead to better understanding of the SME risks and provide room for better assessment and pricing of the SME loan guarantee fees. This is a move that can be contemplated in due course.

Operations & Claims Arrangement

22 Timely claims payment reinforces the confidence of the banks and SMEs in the effectiveness of the guarantee scheme. Reference can be made to the existing claims arrangement of the HKMC's Mortgage Insurance Programme (MIP) in which a clear workflow of claims procedure is set out to minimise any unnecessary delay in the claims payment. Allowance will however have to be made for the fact that the MIP loan underwriting is in fact done by the HKMC for all loans. There are therefore certain savings in the subsequent MIP claims processing/verification process.

23 In this case, when the underwriting is done by the banks rather than by the guarantor, as discussed in the preceding section, the claims processing will inevitably have to consume more time and efforts. As the underwriting is not done by the guarantor, it will be difficult for the New Scheme to provide an "unconditional" guarantee as such. Nevertheless, the design of the New Scheme should attempt to streamline the claims processing and provide more assurance on the effectiveness of the guarantee arrangement.

Risk-sharing Arrangement with Banks

24 Under the SpGS introduced in late 2008 to tide enterprises over the liquidity crunch triggered by the global financial tsunami, the SpGS provides a government/bank risk-sharing ratio of 80/20, i.e. the government and bank will respectively bear 80% and 20% of any default loss on a pari passu basis. This is in contrast to the 50/50 risk sharing under the SGS.

25 Under a fee-paying SME loan guarantee scheme, even though banks would generally still adhere to the prevailing credit assessment standards and procedures, the question of adverse selection would inevitably arise, simply as a corollary to the need for risk management. For the New Scheme, the guarantee fee level would need to be pitched at a sufficiently high level for the scheme to be commercially viable. Ironically, the higher the guarantee fee, the more intense would be the adverse selection issue.

26 There are suggestions that moral hazard might also arise in the underwriting of SME loan applications that are borderline cases, and this situation would arise in particular when the guaranteed portion is as high as 80%. There is therefore the question whether the 80/20 risk-sharing ratio would be a viable option in the New Scheme.

27 The next tiers of risk-sharing to be considered would be 70/30 and 60/40. While the SGS will continue to remain in place with 50/50 risk-sharing ratio, it is conceivable that the 50/50 tier in the New Scheme would still be a useful option for those enterprises that are not eligible for SGS or have exhausted their guarantee limit.

28 In sum, it would be reasonable for the New Scheme to consider guarantee coverage on the basis of 50/50, 60/40 and 70/30 risk-sharing ratio. The viability of 80/20 risk-sharing would need to be considered further in light of the pricing level, risk concentration and potential adverse selection.

Guarantee Fee Structure

29 The potential default loss and other costs associated with the New Scheme will need to be covered by a guarantee fee, which should be equitable and affordable. In order for the New Scheme to be viable, it would be essential to have a guarantor of solid financial strength and preferably high credit rating, together with a sufficiently large pool of guaranteed loans to achieve scale economy and risk diversification.

30 The guarantee fee level should be sufficient to properly reflect the underlying credit risk of the corporate borrowers. As the intention is that the guarantor should rely on the lending banks to underwrite the loans, the guarantee fee under the New Scheme would have to be benchmarked to an appropriate risk indicator for the loan in question. In general, the loan interest rate can be taken as a close proxy to the default risk associated with the loan/borrower, even though the interest rate level can be affected by other factors such as overall banking relationship, cross-sell potential and market competition in SME financing.

31 In using the SME loan interest rate as the risk benchmark, the guarantee fee to be charged is expressed as a proportion of the interest rate level of the loan (i.e. the fee factor). It is for consideration whether the fee factor should be a constant multiple or there should be several fee factors to correspond to different segments of interest rate. That is, the fee factor should not be linearly related to the interest rate level but should be scaled appropriately for higher interest rate level to reflect the likelihood of higher default risk.

32 Another dimension that needs to be considered is the risk-sharing ratio, i.e. a higher guarantee fee factor should apply for a higher risk-sharing. The loan size may also come in as another dimension, as larger loans would represent a higher concentration risk. The end-result in such a case would be a two- or three-dimension matrix of guarantee fee factors.

Guarantee Limit for an Enterprise & Guarantee Period

33 The SGS specifies a limit on the maximum guarantee amount (that is, 50% of the loan size or HK\$6 million, whichever is less). The SpGS specifies a limit on the maximum loan amount of HK\$12 million, in which up to HK\$6 million is for a revolving credit line. With the 80/20 risk-sharing ratio under the SpGS, an enterprise can receive a maximum guarantee of HK\$9.6 million for term loans, out of which HK\$4.8 million may be for revolving loans. For an enterprise eligible under the SGS, it can receive a total loan guarantee of HK\$15.6 million on its bank financing (from both SGS and SpGS).

34 For the New Scheme, it might be argued that, prima facie, there should be no ceiling on the guarantee amount, as this is a fee-paying scheme. However, for risk management reasons, a limit applicable to each enterprise should still be necessary under the New Scheme. Depending on the structure of the New Scheme, the limit might be in terms of maximum loan amount or maximum guarantee amount.

35 A related question is how the existing utilisation of SGS and SpGS for an enterprise should be considered against the limit under the New Scheme. Again, for risk management considerations, it appears that there should be certain netting of existing guarantee usage to contain the total exposure in respect of the enterprise.

36 Regarding the maximum guarantee period, both the SGS and the SpGS provide a maximum guarantee period of 60 months (for the SpGS, 60 months or up to 31 December 2015, whichever is earlier). The New Scheme may adopt a similar limit. Consideration may be given to varying guarantee period under the New Scheme as this can be one factor that can lower the guarantee factor.

Way Forward

37 We consider that a market-based solution to SME financing is a commercially viable scheme that can foster long-term sustainability of SME financing. With the termination of SpGs in December 2010, we need to put in place the New

Scheme sooner rather than later to help the lending institutions to manage their risk exposure to SME financing and to encourage lending institutions to continue to be strongly supportive of the SME sector for a greater variety of enterprises as far as possible.

Annex A - Corporate Guarantee Schemes in Hong Kong

	SME Loan Guarantee Scheme (SGS)	Special Loan Guarantee Scheme (SpGS)
Launch Date	14 Dec 2001	15 Dec 2008
Guarantee Commitment	HKD 20bn	HKD 100bn
Purpose	(i) For acquiring business installations and equipment, and (ii) For meeting working capital needs	Meeting general business needs to tide over corporate liquidity problem during Global Financial Tsunami
Target Segment	Small and medium enterprises (SMEs)	Corporate (excluding listed companies)
Eligibility Criteria	Manufacturing business < 100 staff in HK; non-manufacturing business < 50 staff in HK	Established ≥ 1yr on 15 Dec 2008 Personal guarantee from shareholders (≥ 50% share of equity interest) No outstanding default in any Authorized Institution
Risk Sharing (pari passu)	50% borne by TID	80% borne by TID
Types of Facility	Non-revolving loan	Non-revolving loan and revolving facility
Maximum Guarantee Amount	50% of total facilities or HKD 6mn, whichever is lower. No cap on total facility amount granted by banks. Recycle use of guarantee amount can be arranged one more time upon fully repaid the facility and it is subject to a maximum amount of \$6 million.	Total facility amount granted by banks capped at HKD 12mn, within which revolving limit up to HKD 6mn
Maximum Guarantee Period	60 months after the first drawdown date of each loan.	60 months after the first drawdown date of the loan/facility or up to 31 Dec 2015, whichever is earlier
Guarantee Fee	Nil	Nil

Annex B - Corporate Guarantee Schemes in Other Countries

Country/ Scheme Features	<i>Malaysia</i> Small Entrepreneur Guarantee Scheme ("SEGS") ¹ Old Scheme	<i>Malaysia</i> SmallBiz Express Scheme ("SBE") ¹ Replacement Scheme from Oct 2010	
Guarantee Fee	Unsecured portion - 3.50%p.a. Secured portion - 3.00%p.a. 100% Refund Policy is available if the notification of cancellation is received from the Bank within three months of the anniversary date / date of Letter of Guarantee	Unsecured portion - 6.0%p.a. Secured portion - 4.8%p.a. No Refund Policy	
Guarantee Coverage	80% for Non-Bumiputera ² of the facility 100% for Bumiputera ² of the facility (loan amount: RM10,000 to RM50,000 ~ HKD 24,698 to HKD123,490) <u>Maximum Aggregate Exposure</u> SMEs can only have <u>one</u> (1) financing under CGC guarantee	Up to 80% (loan amount: RM20,000 to RM50,000 ~ HKD49,396 to HKD123,490) <u>Maximum Aggregate Exposure</u> SMEs can have more than one financing under CGC guarantee with an aggregate exposure < RM250,000 (~ HKD 617,450) per SME. Multiple guarantees can be parked up to <u>five</u> (5) different FIs only (inclusive of new applications).	
Types of Facility	Non-revolving loan and revolving facility	Non-revolving loan	
Maximum Guarantee Period	5 years	5 years	
Interest Rate	Capped at Best Lending Rate ("BLR") + 1.5%p.a.	Guarantee cover	Interest rate cap
		≤50%	N/A
		>50%-60%	BLR + 2%p.a.
		>60%-70%	BLR+1.75%p.a
		>70%-80%	BLR+1.25% p.a.
Collateral	Lower guarantee fee for secured loan	Lower guarantee fee for secured loan	
Sources of Funds / Shareholders	Bank Negara Malaysia (79.3%) and commercial banks (20.7%)	Bank Negara Malaysia (79.3%) and commercial banks (20.7%)	
Administrator	Credit Guarantee Corporation Malaysia Berhad ("CGC")	Credit Guarantee Corporation Malaysia Berhad ("CGC")	
Underwriting	N/A	N/A	

Notes:

1. SEGS will be terminated in Oct 2010 tentatively and replaced by SBE.
2. Bumiputera' is a Malay word meaning 'son of the soil'. It is an official definition widely used in Malaysia, embracing ethnic Malays as well as other indigenous ethnic groups such as the tribal peoples of Peninsular Malaysia and in Sabah and Sarawak.

Country/ Scheme Features	<i>Malaysia</i> Direct Access Guarantee Scheme ("DAGS")
Guarantee Fee	Unsecured portion - 0.75% to 5.75%p.a. Secured portion - 0.50% to 3.60%p.a. 100% Refund Policy is available if the notification of cancellation is received from the Bank within three months of the anniversary date / date of Letter of Guarantee 50% Refund Policy is available only for superceding, renewal and unmaterialised cases if the notification of cancellation is received from the Bank between 3 to 6 months from anniversary date / date of Letter of Guarantee Processing Fee : RM300 ~ HKD 741 (for every successful application) Annual Fee: RM150 ~ HKD370
Guarantee Coverage	Up to 100% (loan amount: RM50,000 to RM3 mn ~ HKD 123,490 to HKD 7.4 mn)
Types of Facility	Non-revolving loan (including term loan and tradelines) and revolving facility
Maximum Guarantee Period	5 years
Interest Rate	Capped at Best Lending Rate ("BLR") p.a.
Collateral	Lower guarantee fee for secured loan
Sources of Funds / Shareholders	Bank Negara Malaysia (79.3%) and commercial banks (20.7%)
Administrator	Credit Guarantee Corporation Malaysia Berhad ("CGC")
Underwriting	N/A

Scheme Features	<i>Singapore</i> Local Enterprise Finance Scheme (LEFS)	<i>Singapore</i> Bridging Loan Programme (BLP) *on temporary basis*
Guarantee Fee	NIL	NIL
Guarantee Coverage	70% (loan amount: SGD15 mn ~ HKD86 mn)	50% (loan amount : SGD2mn ~ HKD11.5mn)
Types of Facility	Non-revolving loan	Non-revolving loan
Maximum Guarantee Period	General purpose - 2 years Machinery Loan - 8 years Factory Loan - 10 years	2 years
Interest Rate	<4 year = 5.5% or above >4 years = 6% or above	Minimum 5.5%p.a.
Collateral	For equipment/asset financing, the asset purchase under the loan would taken as collateral.	For equipment/asset financing, the asset purchase under the loan would taken as collateral.
Sources of Funds / Shareholders	Government	Government and Bank
Administrator	SPRING Singapore	SPRING Singapore
Underwriting	Financial Institutions	Financial Institutions

Scheme Features	Korea Credit Guarantee Services	China (Shanghai) 上海市中小企業擔保基金 (上海市普陀區)										
Guarantee Fee	0.5% to 3% p.a. of the outstanding guarantees varied according to the credit rating. Large enterprises are charged 0.5% higher fee than SMEs with a same rating.	<table border="1"> <thead> <tr> <th><u>Loan Amount</u></th> <th><u>GF p.a.</u></th> </tr> </thead> <tbody> <tr> <td><RMB 0.5mn</td> <td>0.8%</td> </tr> <tr> <td>>RMB 0.5 - 1.5mn</td> <td>1.0%</td> </tr> <tr> <td>>RMB 1.5 - 3.5mn</td> <td>1.1%</td> </tr> <tr> <td>>RMB 3.5 - 5.0mn</td> <td>1.2%</td> </tr> </tbody> </table>	<u>Loan Amount</u>	<u>GF p.a.</u>	<RMB 0.5mn	0.8%	>RMB 0.5 - 1.5mn	1.0%	>RMB 1.5 - 3.5mn	1.1%	>RMB 3.5 - 5.0mn	1.2%
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>RMB 1.5 - 3.5mn	1.1%											
>RMB 3.5 - 5.0mn	1.2%											
Guarantee Coverage	Tenor ≤ 10 years: maximum 85% Tenor > 10 years: maximum 80%	High-tech Sectors ³ : 90% Others: 85%										
Types of Facility	Non-revolving loan and revolving facility	Non-revolving loan										
Maximum Guarantee Period	N/A	1 year										
Interest Rate	No information	No information										
Collateral	N/A	Case-by-case basis; Must have collateral for loan amount >\$RMB2mn (~HKD2.29mn)										
Sources of Funds / Shareholders	Government (71%), financial institutions and enterprises	China National Investment and Guaranty Co., Ltd. and The Shanghai Municipal Finance Bureau										
Administrator	Korea Credit Guarantee Fund (KODIT)	China National Investment and Guaranty Co., Ltd.										
Underwriting	Korea Credit Guarantee Fund (KODIT)	China National Investment and Guaranty Co., Ltd.										

3. 對於高新技術成果轉化項目和高新技術企業的貸款

Scheme Features	<i>Taiwan</i> Regular Credit Guarantee Program - General Purpose Loans/ Small-amount Handy Loans
Guarantee Fee	<u>General Purpose Loans (loan size ≥ TWD5 mn ~ HKD1.22 mn)</u> 0.75% to 1.5% p.a. of guaranteed amount <u>Small-amount Handy Loans (loan size <TWD5 mn ~ HKD1.22 mn)</u> 0.85% to 1.60% p.a. of guaranteed amount
Guarantee Coverage	Maximum 80%
Types of Facility	Non-revolving loan and revolving facility
Maximum Guarantee Period	5 years
Interest Rate	No information
Collateral	For equipment/asset financing, the asset purchase under the loan would taken as collateral.
Sources of Funds / Shareholders	Government (80.29%), contracted financial institutions (19.12%), other fund (0.58%)
Administrator	Small and Medium Enterprise Credit Guarantee Fund of Taiwan
Underwriting	Financial Institutions in general cases ⁴

4. Under General Purpose Loans, Small and Medium Enterprise Credit Guarantee Fund of Taiwan (“SMEG”) will underwrite the case with loan size exceeding TWD10million ~HKD2.44 million. Under Small-amount Handy Loans, SMEG will underwrite the case with loan size exceeding TWD5million ~ HKD 1.22 million.