CHAPTER 5

THE GOVERNMENT OF THE HONG KONG SPECIAL ADMINISTRATIVE REGION

LOAN FUND

GOVERNMENT SECRETARIAT

Commerce, Industry and Technology Bureau

Financial Services and the Treasury Bureau

GOVERNMENT DEPARTMENTS

Trade and Industry Department

Treasury

Special Finance Scheme for small and medium enterprises

Audit Commission
Hong Kong
15 October 2002

SPECIAL FINANCE SCHEME
FOR SMALL AND MEDIUM ENTERPRISES

Contents

Paragraphs

PART 4: GUARANTEED LOANS OF $50,000

SPECIAL FINANCE SCHEME FOR SMALL AND MEDIUM ENTERPRISES

Summary and key findings

Introduction

A. On 24 August 1998, the Government launched the Special Finance Scheme for small and medium enterprises (the Scheme) to help small and medium enterprises (SMEs) which were creditworthy, had a good track record and were able to demonstrate business prospects to obtain adequate financing from lending institutions. Under the Scheme, the Government acts as a guarantor for loans to SMEs approved by participating lending institutions (PLIs). On default of the guaranteed loans, the Government makes payments to the PLIs to honour the guarantees. The Government's maximum commitment, which was originally $2.5 billion, has been increased to $5 billion. The maximum amount of guarantee offered by the Government to assist each SME is the lesser of $2 million or 70% of the guaranteed loan (originally the lesser of $2 million or 50% of the guaranteed loan). The maximum guarantee period is 2 years (originally 1 year). The Director of Accounting Services is responsible for the administration of the Scheme. A deed signed between the Government and a PLI (the Deed) sets out the rights and obligations of each party and the appropriate mechanism for settling the transactions. Upon commitment of all the funds available for the Scheme in March 2000, the Government stopped offering new guarantees. The total number of guaranteed loans granted to the SMEs was 11,968. The Treasury calculates the Default Rate for Expired or Released Guarantees (DREG) to reflect the default situation of guaranteed loans. As at 29 August 2002, the DREG was 7.6% (paras. 1.2 to 1.6 and 1.8).

Audit review

B. Audit has conducted a review on the implementation of the Scheme to examine: (a) whether there are adequate safeguards to ensure that the granting of guarantees to SMEs is consistent with the objective of the Scheme and whether the Government's interest has been adequately protected; and (b) whether the existing arrangement for writing off irrecoverable guarantee payments is satisfactory (para. 1.9). Audit's findings are summarised in paragraphs C to K below.

No safeguard against the offloading of loans onto the Scheme

C. The Government places complete reliance on a PLI to assess an SME's application for a guaranteed loan. However, a PLI is not required to provide to the Treasury information on the creditworthiness of an SME. Normally, the Treasury notifies a PLI of the result of the application within one working day upon receipt of the duly completed application form (paras. 2.3 and 2.4).

D. The Deed is not an effective tool to protect the Government's interest. Under the Deed, a PLI is required to exercise its professional skill, judgement and care in processing an SME's application and to act in accordance with prevailing good banking practice. It is also required to refund guarantee payments to the Government if it has given any false, fraudulent or misleading information or has acted in bad faith. However, the Department of Justice has expressed the view that a PLI's culpability under the Deed requires an element of fault. It has also pointed out that the provisions for false, fraudulent or misleading information and for acting in bad faith are in connection with a PLI's claims for payment, instead of its conduct before a guarantee was granted (paras. 2.7 and 2.8).

E. There is no restriction on the use of the guaranteed loans, including repaying other loans granted by the PLIs. The Treasury, the Hong Kong Monetary Authority and the Financial Services and the Treasury Bureau saw the need and had made suggestions to prohibit the PLIs from offloading bad loans onto the Scheme. However, the Commerce, Industry and Technology Bureau did not agree to add a clause in the Deed prohibiting the offloading of bad loans. The Government cannot stop a PLI from offloading existing loans onto the Scheme, especially when the PLI knows that the SME might not be able to repay the existing loans. In the event of default afterwards, the Government cannot reject claims for compensation from the PLI (paras. 2.15, 2.18, 2.20 to 2.30 and 2.34).

F. In some cases, the PLIs did not have strong justifications for supporting their assessments that the SMEs were creditworthy, at the time of the borrowers' applications for guaranteed loans. Furthermore, in some cases, the PLIs granted guaranteed loans to SMEs before the date of the Treasury's notification of the result of application (para. 2.32).

G. Based on the findings of the case studies, Audit considers that the implementation of the Scheme is unsatisfactory for three reasons. First, granting guaranteed loans to SMEs which do not satisfy all the three criteria of being creditworthy, having a good track record and being able to demonstrate business prospects is contrary to the objective of the Scheme. Second, granting guaranteed loans to uncreditworthy SMEs will deprive other SMEs which satisfy all the three criteria of the opportunity to obtain funding to meet genuine commercially viable business needs. Third, in case of default of guaranteed loans granted to uncreditworthy SMEs, the PLI would be able to reduce its own loss because the Government would have to honour the guarantees (para. 2.34).

H. For future similar schemes, Audit considers that, in order to adequately safeguard the Government's interest, there is a need for the Government to critically assess the risks of lenders offloading bad loans onto a scheme. Based on the results of the risk assessment, the Government should decide whether it would allow borrowers to use the new loans to repay existing loans granted by the same lenders (para. 2.35).

I. In order to safeguard the proper use of public money, Audit considers that the Treasury needs to critically re-examine the claims for compensation in respect of the six guaranteed loans examined by Audit and all other similar claims to ascertain whether the PLI concerned has breached the Deed (para. 2.36).

Need to review the writing-off authority of the Director of Accounting Services

J. In February 2002, for the purpose of streamlining procedures and increasing efficiency, the then Secretary for the Treasury delegated to the Director of Accounting Services the authority to approve personally the write-off of irrecoverable guarantee payments each exceeding $0.5 million under the Scheme. Having regard to the large number of write-off cases, the significant amount of irrecoverable guarantee payments to be written off and the fact that the Treasury approved the applications for the guarantees in the first instance, Audit considers that there is a need to review the justifications for such delegation of authority (paras. 3.2 to 3.4).

Granting of guaranteed loans of $50,000 not restricted

K. In a review report submitted to the Finance Committee of the Legislative Council in April 1999, the Trade and Industry Department expressed its reservations about the granting of guarantees of small loans. However, no minimum loan amount had been set on the guaranteed loans under the Scheme. As at 29 August 2002, the DREG of 23.9% of guaranteed loans of $50,000 each was more than three times the DREG of 7.6% of all guaranteed loans. Audit considers that the Government should have set a minimum loan amount on the guaranteed loans under the Scheme (paras. 4.2, 4.7(c) and 4.8).

Audit recommendations

L. Audit has made the following major recommendations that:

No safeguard against the offloading of loans onto the Scheme

(a) for future similar schemes under which the Government acts as a guarantor for loans granted to the private sector, the Director-General of Trade and Industry should:

(i) in conjunction with the Secretary for Commerce, Industry and Technology, critically assess the risks of the schemes being abused by lenders through offloading bad loans onto the schemes and, based on the results of the risk assessment, decide whether the Government should allow the borrowers to use new loans to repay existing loans granted by the same lenders (para. 2.37(a));

(ii) if the Government allows a borrower to use the new loan to repay existing loans granted by the same lender, require the lender to provide to the Government essential credit information about the borrower so that the Government can conduct a thorough credit assessment of the borrower before approving the guarantee (para. 2.37(b)); and

(iii) if the Government does not allow a borrower to use the new loan to repay existing loans granted by the same lender and relies on the lender to conduct the credit assessment of the borrower:

— specify in the relevant legal documents the objectives of the scheme and the criteria of granting loans to borrowers;

— provide a clear definition of "bad loan"; and

— state clearly in the relevant legal documents that the lender is not allowed to offload bad loans onto the scheme (para. 2.37(c));

(b) the Director of Accounting Services should:

(i) re-examine the claims for compensation of the six guaranteed loans examined by Audit and all other similar claims to ascertain whether the PLI concerned has breached the Deed (para. 2.38(a)); and

(ii) if the PLI is found to have breached the Deed, recover the money from the PLI for a claim already paid and reject the claim for a claim being processed (para. 2.38(b));

Need to review the writing-off authority of the Director of Accounting Services

(c) the Secretary for Financial Services and the Treasury should:

(i) review the justifications for delegating to the Director of Accounting Services the authority to approve personally the write-off of irrecoverable guarantee payments each exceeding $0.5 million under the Scheme (para. 3.5(a)); and

(ii) based on the results of the review, decide whether the delegation should continue (para. 3.5(b)); and

Granting of guaranteed loans of $50,000 not restricted

(d) the Secretary for Commerce, Industry and Technology and the Director-General of Trade and Industry should, if a similar scheme is launched in future, critically assess the desirability of setting a minimum loan amount (para. 4.9).

Response from the Administration

M. The Administration generally agrees with Audit's recommendations.

PART 1: INTRODUCTION

Background

1.1 In June 1998, the Government announced that it would implement a package of special relief measures to ease Hong Kong's economic adjustment. One of the measures was to help small and medium enterprises (SMEs) obtain loans (Note 1) from lending institutions through the Special Finance Scheme for SMEs (the Scheme). The Trade and Industry Department (TID — Note 2) was responsible for coordinating the input from government departments concerned to formulate the design of the Scheme and for assisting in the implementation (e.g. promotion and publicity) of the Scheme.

1.2 In July 1998, the Finance Committee (FC) of the Legislative Council approved a commitment of $2.5 billion for the establishment of the Scheme. The objective of the Scheme is to help SMEs obtain adequate financing from lending institutions provided that they satisfy the following three criteria:

(a) being creditworthy;

(b) having a good track record; and

(c) being able to demonstrate business prospects.

In early August 1998, the Government invited all authorised institutions under the Banking Ordinance (Cap. 155) to join the Scheme. On 24 August 1998, the Government launched the Scheme.

1.3 Under the Scheme, the Government acts as a guarantor for loans (hereinafter referred to as guaranteed loans) to SMEs approved by participating lending institutions (PLIs). Other than those limitations on the use of the guaranteed loans which may be imposed by the PLIs, the Scheme does not impose limitations on the specific use of the guaranteed loans. On default of the guaranteed loans, the Government makes payments to the PLIs to honour the guarantees granted under the Scheme (hereinafter referred to as guarantee payments).

1.4 Since the launching of the Scheme in August 1998, the Government has made some changes to the Scheme, as summarised in Table 1 below.

Note 1: *In this report, the term "loan" refers to various kinds of credit facilities including term loans and overdraft facilities.*

Note 2: *Before the establishment of the TID on 1 July 2000, the Industry Department was responsible for providing general support for the industrial sector and SMEs.*

Table 1

Changes to the Scheme

	From August 1998 to March 1999	From April to October 1999	From November 1999
Government's maximum commitment	$2.5 billion	$2.5 billion	$5 billion
Maximum amount of guarantee offered by the Government to assist each SME	$2 million or 50% of the guaranteed loan, whichever is the less	$2 million or 70% of the guaranteed loan, whichever is the less	$2 million or 70% of the guaranteed loan, whichever is the less
Maximum guarantee period	1 year	2 years	2 years

Source: CITB's records

1.5 Upon commitment of all the funds available for the Scheme in March 2000, the Government stopped offering new guarantees. The total number of guaranteed loans granted to the SMEs was 11,968. The total amount of guarantees offered by the Government was $5.8 billion (Note 3).

1.6 The Treasury calculates the Default Rate for Expired or Released Guarantees (DREG) to reflect the default situation of guaranteed loans. The DREG is calculated as a percentage of the total amount of net claims to-date (i.e. the amount of claims less the Government's share of the amount recovered) to the total amount of guarantees which had expired or had been released. As at 29 August 2002 (the last Thursday in August 2002), 99.2% of the total amount of guarantees of $5.8 billion offered by the Government had expired or had been released and the DREG was 7.6%. The Treasury had processed claims for 548 defaulted guaranteed loans and had made guarantee payments of $237.3 million to the PLIs. The Treasury was processing the claims which the PLIs had submitted for 1,446 defaulted guaranteed loans (Note 4). The total amount of these claims was $199.8 million.

Note 3: *The total amount of guarantees granted was $5.8 billion. This had exceeded the approved maximum commitment of $5 billion because of the revolving nature of the Scheme. Guarantees were offered for new loans after the expiry or release of the guarantees previously granted.*

Note 4: *These included the claims for 1,141 defaulted guaranteed loans of $50,000 each, which amounted to $31.7 million (see para. 4.6(c) below).*

Design of the Scheme

1.7 In July 1998, in the paper seeking the FC's approval to launch the Scheme (the 1998 FC paper), the Commerce, Industry and Technology Bureau (CITB — Note 5) informed the FC that the design of the Scheme was based on four principles, namely:

(a) ***Market-driven.*** The operation of the Scheme must be market-driven. The intention was to help those SMEs which satisfied the three criteria of being creditworthy, having a good track record and being able to demonstrate business prospects, but which were unable to obtain adequate financing from lending institutions due to the credit crunch;

(b) ***Risk-sharing.*** The risk of default and late payment should be shared between the PLIs and the Government;

(c) ***Risk-capping.*** There should be an upper limit to the total amount of guarantees offered by the Government under the Scheme. There should also be a ceiling on the maximum amount of guarantee each SME might obtain from the Government; and

(d) ***Administrative simplicity.*** The Scheme should be simple and easy to administer.

Administration of the Scheme

1.8 The Director of Accounting Services is responsible for the administration of the Scheme and is the Vote Controller. All payments to, and repayments from, the SMEs are handled by the PLIs. A deed signed between the Government and a PLI (the Deed) sets out the rights and obligations of each party and the appropriate mechanism for settling the transactions.

Audit review

1.9 Audit has conducted a review on the implementation of the Scheme. The audit objectives were to examine:

(a) whether there are adequate safeguards to ensure that the granting of guarantees to SMEs is consistent with the objective of the Scheme and whether the Government's interest has been adequately protected; and

---

Note 5: *On 1 July 2000, the Trade and Industry Bureau was renamed the Commerce and Industry Bureau. With the implementation of the Accountability System, with effect from 1 July 2002, the CITB took over the statutory functions of the Commerce and Industry Bureau.*

(b) whether the existing arrangement for writing off irrecoverable guarantee payments to the PLIs is satisfactory.

Audit has found a number of areas where there is room for improvement and has made a number of recommendations to address the related issues.

General response from the Administration

1.10 The **Secretary for Commerce, Industry and Technology** and the **Director-General of Trade and Industry** welcome Audit's initiative of conducting the value for money audit on the Scheme and Audit's recommendations for improvement. They agree to bear Audit's recommendations in mind if similar schemes are to be launched in future. They have said that:

(a) the fundamental objective of the Scheme is to provide relief to SMEs in the face of the unprecedented liquidity crunch problem in 1998. Moreover, apart from the principle that loan guarantees should be granted to SMEs which are creditworthy, have a good track record, and can demonstrate business prospects, the operation of the Scheme is guided by four basic principles which are of equal significance, namely market-driven, risk-sharing, risk-capping, and administrative simplicity. These principles were endorsed by the FC in July 1998. In evaluating the cost-effectiveness of the Scheme, it is essential to appreciate fully the above background against which the Scheme was introduced, and give due consideration to the need to strike a balance between the objective of the Scheme and the principles which guide the operation of the Scheme;

(b) in approving the 1998 FC paper, the FC was fully aware that, under the risk-sharing principle, there was a possibility that the capital commitment of the Government under the Scheme would not be recovered, in part or in whole. In approving an increase in the Government's commitment from $2.5 billion to $5 billion in November 1999, the FC was informed that in the highly unlikely event that all loan recipients under the Scheme defaulted in repayment, the Government would have to pay the PLIs the full amount guaranteed of $5 billion; and

(c) as the fundamental objective of the Scheme is to provide relief to SMEs in the face of the severe liquidity crunch problem in 1998, it would make sense to assess whether the Scheme has achieved this objective. In this regard, 9,912 SMEs have benefited from the Scheme. As at 12 September 2002, the DREG was 7.6% and the PLIs had submitted claims in respect of guaranteed loans granted to 1,880 SMEs, amounting to $440 million. This means that more than 92% of the guaranteed loans are performing or have been fully repaid. The Scheme has also helped about 8,000 SMEs tide over the liquidity crunch problem.

PART 2: OFFLOADING OF LOANS ONTO THE SCHEME

Government's intention is to help creditworthy SMEs

2.1 As mentioned in paragraph 1.7(a) above, in the 1998 FC paper, the CITB informed the FC that the Government's intention of operating the Scheme was to help those SMEs which were creditworthy, had a good track record and could demonstrate business prospects but which were unable to obtain adequate financing from lending institutions due to the credit crunch.

Reliance on PLIs to assess loan applications

2.2 In the 1998 FC paper, the CITB stated that:

(a) the Government would rely on a PLI to exercise its usual prudent professional judgement in assessing the creditworthiness of the loan applicants; and

(b) loan applications were subject to the usual prudent scrutiny by a PLI.

2.3 Clause 7.8 of the Deed stipulates the PLI's obligation to assess loan applications, as follows:

> *"The Lender acknowledges that the Government places* ***complete reliance*** *on the Lender in its professional skill, judgement and care as a prudent lender. The Lender shall exercise professional skill, judgement and care in processing every Borrower's application for Facility and shall act in accordance with prevailing good banking practice for the banking sector." (Audit's emphasis)*

A PLI is not required to provide to the Treasury information on the creditworthiness of an SME to support the SME's application for a guaranteed loan.

Starting date of a guaranteed loan

2.4 Normally, the Treasury notifies a PLI of the result of the application within one working day upon receipt of the duly completed application form from the PLI. According to Clause 2.6 of the Deed, the starting date of a guaranteed loan shall fall within 14 days from the date of the notification of the result of application issued by the Treasury.

Government would not interfere with lending decisions of PLIs

2.5 Before the Scheme was launched, the Financial Secretary wrote to the PLIs in August 1998, stating that:

(a) a PLI would have a large degree of discretion in determining whether a loan should be granted to an SME under the Scheme;

(b) while the Government would not interfere with lending decisions of a PLI, it expected the PLI to make credit assessments in the usual way; and

(c) the Government would keep all administrative procedures to a minimum, relying principally on the professionalism of a PLI.

However, the Financial Secretary did not explicitly convey to the PLIs that the objective of the Scheme, as the FC had been informed, was to help those SMEs which were creditworthy, had a good track record and could demonstrate business prospects, to obtain adequate financing from lending institutions (see para. 1.7(a) above).

The Deed is not effective for protecting the Government's interest

2.6 The Government relies on a PLI to exercise its usual prudent professional judgement in assessing the creditworthiness of the loan applicants (see para. 2.2(a) above). According to the Deed, a PLI is required to exercise its professional skill, judgement and care in processing loan applications and to act in accordance with prevailing good banking practice (see para. 2.3 above). However, the Deed does not specify that a PLI should only grant guaranteed loans to SMEs which are creditworthy, have a good track record and can demonstrate business prospects.

2.7 In August 1998, the TID informed the CITB that several clauses had already been provided in the Deed to protect the Government's interest, as follows:

(a) Clause 7.4 stipulated that a PLI should promptly disclose to the Government all material facts and information which might affect the rights, interest, obligations or liabilities of the Government;

(b) Clause 7.8 stipulated that a PLI should exercise professional skill, judgement and care in processing every borrower's application and should act in accordance with prevailing good banking practice; and

(c) Clause 9.1 stipulated that if a PLI had given any false, fraudulent or misleading information, or acted in bad faith, the payment made by the Government should be refunded immediately.

2.8 However, Audit notes that the Deed is not an effective tool to protect the Government's interest. This is substantiated by the Department of Justice's comments in August 1998 on the safeguards in the Deed against possible abuse that:

(a) a PLI's culpability under both Clauses 7.8 and 9.1 required an element of fault. For example, a PLI had been negligent, reckless or fraudulent; and

(b) the provisions for false, fraudulent or misleading information and for acting in bad faith under Clause 9.1 were in connection with a PLI's claims for payment, instead of its conduct before a guarantee was granted.

Only creditworthy SMEs should be assisted

2.9 In January 1999, the TID produced a review report on the Scheme. The report was submitted to the FC in April 1999 when the CITB sought the FC's approval to implement some of the recommendations of the report. In the report, the TID stated that:

(a) the objective of the Scheme was to help those SMEs which were creditworthy, had a good track record and could demonstrate business prospects, to obtain adequate financing from lending institutions; and

(b) in view of the need to safeguard the proper use of public money, the TID maintained the view that only creditworthy and viable SMEs should be provided with assistance from the Scheme.

Concerns about possible abuse by offloading loans onto the Scheme

2.10 Soon after the announcement on the launching of the Scheme in June 1998, there were concerns about the possible abuse of the Scheme by the PLIs through the offloading of loans onto the Scheme. From mid-1998 to the end of 1999, there were continuing discussions among bankers, government departments and bureaux, and the Hong Kong Monetary Authority (HKMA) on the adequacy of the safeguards against such abuse.

2.11 During the discussions, different views were expressed on the adequacy of the safeguards against the offloading of bad loans (Note 6) onto the Scheme. The views expressed by various parties are detailed in paragraphs 2.12 to 2.28 below.

Some bankers suggested ways to prevent abuse of the Scheme in 1998

2.12 Soon after the announcement on the launching of the Scheme in June 1998, some bankers expressed concerns about the possible abuse of the Scheme by the PLIs through the offloading of bad loans onto the Scheme.

2.13 In early July 1998, a banker expressed concerns to the CITB that the Scheme could be abused if a PLI lent additional money under the Scheme to an existing customer of the PLI for repaying an existing loan granted by the PLI, especially when the PLI knew that the customer might not be able to repay the existing loan. This would reduce the PLI's loss because the Government would share half of the loss. It was therefore suggested that the Scheme should allow the PLIs to grant guaranteed loans to new customers only. Another banker expressed the view that the Government should double check the guaranteed loans granted under the Scheme to prevent banks from offloading bad loans onto the Scheme. It was suggested that guaranteed loans should not be granted to an SME which already had loans classified as substandard, doubtful or loss (see para. 2.14(c), (d) and (e) below).

HKMA's suggestions to prevent offloading of bad loans onto the Scheme

2.14 According to the guidelines issued by the HKMA, loans can be categorised (Note 7) as follows:

(a) ***Performing.*** A loan in this category refers to a loan, the borrower of which is current in meeting commitments and full repayment of interest and principal of which is not in doubt;

(b) ***Special mention.*** A loan in this category refers to a loan, the borrower of which is experiencing difficulties which may threaten the position of the lender. Ultimate loss is

---

Note 6: *The term "bad loan" is commonly used by the banking sector. According to the HKMA, the banking sector uses various terms, such as "bad loans", "non-performing loans" and "problem loans", interchangeably when making reference to unsatisfactory loans. These terms usually refer to: (a) loans which are overdue for more than three months; (b) restructured loans; (c) loans on which interest accrual has been suspended or ceased; and (d) classified loans.*

Note 7: *The guidelines are broad principles recommended by the HKMA and do not provide a legal definition of "loan quality".*

not expected at this stage, but can occur if adverse conditions persist. The borrower should be subject to special monitoring;

(c) ***Substandard.*** A loan in this category refers to a loan, the borrower of which is displaying a definable weakness which is likely to jeopardise repayment. A loan on which repayment of interest or principal is overdue for more than three months generally falls into this category. Restructured loans are also included in this category. A restructured loan refers to a loan which has been restructured or renegotiated, either because of a deterioration in the financial position of the borrower or because of the inability of the borrower to meet the original repayment schedule;

(d) ***Doubtful.*** A loan in this category refers to a loan, the collection of which in full is improbable and the lender of which expects to sustain a loss of interest or principal, after taking account of the net realisable value of collateral. Doubtful loans generally include loans on which repayment of interest or principal is overdue for more than six months; and

(e) ***Loss.*** A loan in this category refers to a loan which is considered uncollectable after all collection efforts have been exhausted.

Loans in the substandard, doubtful or loss categories are referred to as classified loans.

2.15 On 24 July 1998, the HKMA advised the TID that it was important to build in some safeguards to prevent the PLIs from offloading bad loans onto the Scheme. The HKMA suggested to include the following requirements in the Scheme:

(a) the proceeds which a borrower obtained from a guaranteed loan should not be used to repay an existing loan granted by the same PLI;

(b) a PLI was expected to conduct a proper credit assessment when approving a guaranteed loan; and

(c) a PLI should allow the Government to conduct due diligence assessments of the guaranteed loans from time to time.

2.16 On 27 July 1998, commenting on the HKMA's suggestions, the TID stated that there should not be too many safeguards in the Scheme because:

(a) the Scheme was operated on an honour system based on good faith. To include something to the effect that a PLI was expected to conduct a proper credit assessment when approving a guaranteed loan seemed superfluous;

(b) once the Government got into the specifics on the use and application of the guaranteed loans, the Government might get into a very tricky area. For example, the Government needed to explain why servicing of debts with another PLI using the guaranteed loan was allowed, while servicing of debts with the same PLI was disallowed; and

(c) any due diligence assessment conducted by the Government would essentially be checks on the assessment conducted by a PLI. In this area, professional and judgemental issues would cloud dishonest intent, if any, to offload bad loans onto the Scheme.

Removal of the "no overdue loan" declaration requirement in early 1999

2.17 After the Scheme was launched in August 1998, when submitting to the Government an SME's application for guarantee, the PLI was required to declare that the applicant had no overdue loan repayments to it for over 60 days in the 12-month period prior to the application. If the applicant had overdue loan repayments in that period, the PLI was required to provide to the Government detailed information on the overdue loan repayments. In January 1999, the TID suggested that the "no overdue loan" declaration requirement should be removed because:

(a) the declaration was intended to help the Government better ensure that the applicant had a good track record and reduce the possibility of a PLI offloading possible bad loans onto the Government. However, it seemed that the requirement had the effect of reinforcing the PLI's conservatism; and

(b) the overall design of the Scheme was to let a PLI exercise its professional judgement to assess the creditworthiness of the applicant. The Government was not supposed to conduct a second assessment.

2.18 On 3 March 1999, in response to the TID's suggestion to remove the "no overdue loan" declaration requirement, the Treasury suggested that in order to protect the Government's interest, a clause should be added to the Deed to prohibit a PLI from granting a guaranteed loan to an applicant if his indebtedness to the PLI was already classified as substandard, doubtful or loss (see para. 2.14 above) when applying for the guaranteed loan.

2.19 On 13 March 1999, the TID objected to the Treasury's suggestion on the grounds that:

(a) regarding loans classified as doubtful or loss, there were three clauses in the Deed which, in effect, prohibited a PLI from offloading such loans onto the Scheme. These clauses were Clause 7.4 on prompt disclosure of information which might affect the Government's interest, Clause 7.8 on professional judgement and good banking practice, and Clause 9.1 on the need to act in good faith. Offloading classified loans onto the Scheme would amount to acting in bad faith; and

(b) regarding substandard loans, if the Government were to prohibit the offloading of such loans onto the Scheme, the implication was that the Scheme would become more restrictive. It would not be able to help some SMEs which had suffered from the depreciation of the collateral following the financial turmoil.

2.20 On 17 March 1999, the CITB informed the Treasury that the "no overdue loan" declaration requirement should be removed and that the Treasury's suggestion to add a clause to the Deed would not be pursued. In late April 1999, the FC approved the removal of the "no overdue loan" declaration requirement. Since then, a PLI is no longer required to make a declaration to the Government that an applicant has no overdue loan repayments for over 60 days in the 12-month period prior to the application.

Treasury reiterated the need to prohibit offloading of bad loans in late 1999

2.21 On 15 October 1999, the Treasury reiterated the need to incorporate into the Deed a requirement prohibiting a PLI from offloading bad loans onto the Scheme. The Treasury stated that:

(a) the Deed required a PLI to act in accordance with good banking practice. However, the Deed was silent on the offloading of bad loans and did not give a definition of "bad loan". In addition, there was no mention in the Deed that offloading of bad loans (e.g. through restructuring of overdue loans) was against good banking practice; and

(b) without a clear provision in the Deed on the prohibition of offloading bad loans, it was difficult, if not impossible, to stop a PLI from offloading bad loans onto the Scheme or to reject a claim from a PLI for compensation in the event of default afterwards.

2.22 On 22 October 1999, the Financial Services and the Treasury Bureau (FSTB — Note 8) agreed with the Treasury that a clause should be added to the Deed to explicitly define "bad loan" and to prohibit the offloading of bad loans onto the Scheme.

Note 8: *With the implementation of the Accountability System, with effect from 1 July 2002, the FSTB took over the statutory functions of the Finance Bureau.*

2.23 On 27 October 1999, expressing its reservations on the Treasury's suggestion, the CITB stated that:

(a) any proposal of introducing additional safeguards or hurdles should be in line with the spirit underlying the principle that the Scheme should rely on a PLI to assess the loan applications; and

(b) it was not certain that the clause in the Deed requiring a PLI to act in accordance with good banking practice was as inadequate in preventing the offloading of bad loans onto the Scheme, as it had been suggested.

HKMA supported Treasury's suggestion

2.24 On 5 November 1999, expressing its views on the Treasury's suggestion, the HKMA stated that:

(a) the absence of a clause in the Deed prohibiting the offloading of bad loans and the removal of the "no overdue loan" declaration requirement might lead a PLI to think that:

(i) including overdue loans in the Scheme was allowed; and

(ii) such action did not contravene good banking practice as stipulated in the Deed; and

(b) the CITB might need to make clear whether including overdue loans in the Scheme was acceptable and did not contravene good banking practice.

2.25 On 8 November 1999, in response to the HKMA's comments, the CITB stated that:

(a) unless there was a clear definition of "classified loan", a PLI might become even more conservative than it would have been in normal commercial lending. This would defeat the purpose of the Scheme;

(b) without a clear definition of "classified loan", the Treasury might have practical difficulties in determining whether a specific application had contravened the proposed clause; and

(c) the additional clause might be seen as an administrative hurdle for an SME to obtain guarantee under the Scheme.

2.26 On 11 November 1999, in response to the CITB's comments mentioned in paragraph 2.25 above, the Treasury stated that:

(a) the Deed did not provide a definition of "bad loan". Unless the prevailing good banking practice as stipulated in the Deed was an adequate guide, the Government would leave to the discretion of a PLI to decide which categories of loans it should not offload onto the Scheme;

(b) if a definition of "bad loan" was clearly spelt out in the Deed and a clause prohibiting the offloading of bad loans was included in the Deed, the Treasury would require a PLI to confirm that it had complied with the Deed before its claim was paid; and

(c) the HKMA's guidelines could be used as a reference to derive a definition of "bad loan". Without such a definition, the Treasury would have difficulties in taking action against those PLIs which might have offloaded bad loans onto the Scheme.

2.27 On 15 November 1999, the HKMA advised the CITB that:

(a) one factor which generally indicated a deterioration in the repayment ability of a borrower was whether the borrower had overdue loan repayment records;

(b) in general, a bank would need to have strong justifications for granting facilities to a borrower who had overdue loan repayment records;

(c) the fact that there was no explicit requirement for a PLI to exclude overdue loans from the Scheme might give it an impression that including overdue loans in the Scheme was allowed;

(d) **the Treasury's suggestion of adding a clause in the Deed to prevent the offloading of bad loans appeared reasonable.** The HKMA further suggested to include in the Deed the explicit requirement that loans which were classified as substandard, doubtful or loss should not be included in the Scheme, in addition to the existing requirement of good banking practice. This was because the existing requirement of good banking practice left too much room for different interpretations; and

(e) a PLI should have no problem in understanding the definition of "classified loan" because it had been required to report to the HKMA the breakdown of the loan portfolio since 1994.

CITB expressed reservations about Treasury's suggestion

2.28 On 17 November 1999, the CITB expressed its reservations to the HKMA about the Treasury's suggestion, as follows:

(a) as the Scheme required that a separate account be maintained for a loan under the Scheme, in practice, at the point of granting the loan, the loan would not be substandard, doubtful or loss. These classifications would only arise at a later point, but not at the point of granting the loan. Therefore, there would be practical difficulties in requiring classified loans to be excluded from the Scheme;

(b) it would be difficult to distinguish offloading of classified loans from "provision of breathing space", which was arguably not incompatible with the purpose of the Scheme; and

(c) it would be difficult to devise the policing arrangements for preventing the offloading of classified loans while not breaching the principle of administrative simplicity.

2.29 **As it transpired, the Deed had not been revised to include a clause for prohibiting the offloading of classified loans onto the Scheme.**

No safeguard against offloading of loans onto the Scheme

2.30 In April 2002, in response to Audit's enquiry about the offloading of loans onto the Scheme, the Treasury informed Audit that:

(a) there was no restriction on the use of the funds under the Scheme, including repaying other loans granted by the PLIs. For this reason, in processing applications for the Government's guarantees under the Scheme, the Treasury had not instituted any measures or procedures against granting guarantees of loans which the PLIs might use to offset other loans granted by them, provided that all other requirements stipulated in the applications were met; and

(b) in processing the PLIs' claims for compensation for defaulted guaranteed loans, the Treasury would not refuse to pay compensation for guaranteed loans which the PLIs had used to offset other loans granted by them, provided that the provisions of the Deed had been followed by the PLIs.

2.31 In June 2002, the TID informed Audit that there were no specific restrictions on the offloading of bad loans onto the Scheme. However, the TID also stated that:

(a) Clause 7.8 of the Deed required a PLI to exercise its professional skills, judgement and care and to act in accordance with good banking practice in processing loan applications; and

(b) if a PLI was found to have failed to comply with its obligations under the Deed, the Government might refuse to pay compensation to it in the event of default of the guaranteed loan, and might also demand it to refund the Government any compensation already paid to it.

Audit's case studies of guaranteed loans

2.32 To ascertain whether the PLIs have approved guaranteed loans to SMEs which **do not** satisfy all the three criteria of being creditworthy, having a good track record and being able to demonstrate business prospects, to repay existing loans granted by them, Audit selected from the Treasury's records a number of cases for study. In carrying out the case studies, Audit took into consideration:

(a) the fact that the Government placed complete reliance on a PLI in the assessment of the creditworthiness of a borrower (see paras. 2.2 and 2.3 above); and

(b) the HKMA's views that one factor which generally indicated a deterioration in the repayment ability of a borrower was whether the borrower had overdue loan repayment records and that in general, a bank would need to have strong justifications for granting facilities to a borrower who had overdue loan repayment records (see para. 2.27(a) and (b) above).

The case studies indicate that, at the time of the borrowers' applications for the guaranteed loans, the PLIs did not have strong justifications for supporting their assessments that the borrowers were creditworthy. Furthermore, in two of the case studies (Case study 2 and Case study 3), the PLI granted a guaranteed loan to the SME before the date of the Treasury's notification of the result of application. Examples of Audit's findings are given below.

Case study 1

Case particulars

1. In mid-December 1999, PLI-1 submitted an application for guarantee of a loan of $2.9 million to be granted to Company A. On 15 December 1999, the Treasury approved a guarantee of $2 million of the loan and issued the notification of the result of application to PLI-1. On 28 December 1999, Company A drew down the guaranteed loan. In December 2000, PLI-1 informed the Treasury that Company A had failed to repay the loan, and requested the Treasury to pay $2 million to honour the guarantee. In May 2002, the Treasury paid PLI-1 $2 million.

2. Audit's examination of the case file revealed that PLI-1 had offloaded existing bad loans of Company A onto the Scheme. In December 1999, when applying for the guaranteed loan, Company A had an outstanding loan of $3.9 million and an outstanding overdraft of $1.6 million with PLI-1. Company A's repayments for the existing loan had been overdue for more than eight months. Company A failed to repay the instalments of the outstanding loan after making the last repayment on 25 March 1999. PLI-1 restructured the outstanding loan and the outstanding overdraft to the guaranteed loan of $2.9 million and another loan of $2.6 million not granted under the Scheme. When approving the guaranteed loan in December 1999, PLI-1 gave Company A a "substandard" rating in its credit assessment.

Audit comments

3. **Audit considers that at the time of Company A's application for the guaranteed loan, PLI-1 did not have strong justifications for supporting its assessment that Company A was creditworthy.**

Source: Treasury's records

Case study 2

Case particulars

1. In early August 1999, PLI-2 submitted an application for guarantee of a loan of $1.1 million to be granted to Company B. On 12 August 1999, the Treasury approved a guarantee of $0.8 million of the loan and issued the notification of the result of application to PLI-2. However, on 10 August 1999 (i.e. two days ***before*** the date of the Treasury's notification of the result of application), Company B drew down the guaranteed loan. In October 2000, PLI-2 informed the Treasury that Company B had failed to repay the loan, and requested the Treasury to pay $0.6 million to honour the guarantee of the loan. In July 2002, after consulting the Department of Justice, the CITB and the TID, the Treasury paid PLI-2 $0.5 million to honour the guarantee, taking account of the proceeds from the realisation of collateral for the guaranteed loan.

2. Audit's examination of the case file revealed that PLI-2 had offloaded an existing bad loan of Company B onto the Scheme. In August 1999, when Company B was applying for the guaranteed loan, PLI-2 was taking collection actions against Company B for an outstanding loan (with delinquency of 195 days) of $1.4 million. PLI-2 restructured the outstanding loan to the guaranteed loan of $1.1 million together with a repayment of $0.3 million from Company B. In September 1999, PLI-2 obtained a Consent Order whereby Company B and its other guarantors agreed to provide to PLI-2 a second legal charge on a property, in consideration of PLI-2's accepting a new repayment schedule. After making the first monthly repayment in September 1999, Company B failed to make subsequent monthly repayments on their due dates. In May 2000, Company B made the monthly repayment originally due in February 2000. Thereafter, no repayment was received from Company B.

Audit comments

3. **Audit considers that at the time of Company B's application for the guaranteed loan, PLI-2 did not have strong justifications for supporting its assessment that Company B was creditworthy. Furthermore, Company B's draw down of the guaranteed loan on 10 August 1999 (i.e. two days before the date of the Treasury's notification of the result of application) was in breach of the Deed.**

Source: Treasury's records

Case study 3

Case particulars

1. In May 1999, PLI-2 (the same PLI as in Case study 2) submitted an application for guarantee of a loan of $2.7 million to repay an existing mortgage loan extended to Company C. On 1 June 1999, the Treasury approved a guarantee of $1.9 million of the loan and issued the notification of the result of application to PLI-2. However, on 27 May 1999 (i.e. five days ***before*** the date of the Treasury's notification of the result of application), Company C drew down the guaranteed loan. In August 2000, PLI-2 requested the Treasury to pay $1 million to honour the guarantee of the loan. In September 2000, after consulting the CITB, the TID and the HKMA, the Treasury paid PLI-2 $1 million to honour the guarantee, taking account of subsequent repayments by Company C and the proceeds from the sale of the mortgaged property.

2. Audit's examination of the case file revealed that PLI-2 had offloaded an existing bad loan of Company C onto the Scheme as the guaranteed loan was used to repay an existing mortgage loan. In February 1999, PLI-2 had obtained a court judgement against Company C in respect of the mortgage loan. In May 1999, at the time of application for the guaranteed loan, Company C's existing mortgage loan with overdue repayments was outstanding at $2.7 million and a recent valuation of the mortgaged property revealed a potential shortfall of $1.2 million. In August 1999, PLI-2 informed the Treasury that Company C's repayment of the guaranteed loan had been overdue for more than 20 days. In October 1999, PLI-2 foreclosed the mortgaged property.

Audit comments

3. **Audit considers that at the time of Company C's application for the guaranteed loan, PLI-2 did not have strong justifications for supporting its assessment that Company C was creditworthy. Furthermore, Company C's draw down of the guaranteed loan on 27 May 1999 (i.e. five days before the date of the Treasury's notification of the result of application) was in breach of the Deed.**

Source: Treasury's records

Case study 4

Case particulars

1. In mid-January 2000, PLI-1 (the same PLI as in Case study 1) submitted an application for guarantee of a loan of $0.5 million to be granted to Company D. On 17 January 2000, the Treasury approved a guarantee of $0.3 million of the loan and issued the notification of the result of application to PLI-1. On 21 January 2000, Company D drew down the guaranteed loan. After making the first repayment, Company D failed to make the second repayment due in February 2000 and all subsequent repayments. In August 2000, the Treasury consulted the CITB, the TID and the HKMA whether PLI-1 had breached the Deed. In April 2002, the Treasury paid PLI-1 $0.3 million to honour the guarantee.

2. Audit's examination of the case file revealed that PLI-1 had offloaded a restructured loan of Company D onto the Scheme. According to the guidelines of the HKMA, a restructured loan is a substandard loan (see para. 2.14(c) above). In November 1998, Company D experienced difficulties in repaying a hire-purchase loan granted by PLI-1 and requested PLI-1 to restructure the loan to a short-term loan to be repaid by 24 monthly instalments. PLI-1 subsequently gave Company D a "high-risk" rating in its credit assessment. In January 1999, PLI-1 granted a short-term loan of $0.8 million to Company D to be repaid by 24 monthly instalments. In December 1999, when Company D requested PLI-1 to restructure again the short-term loan to the guaranteed loan with a lower monthly repayment so as to ease its tight cashflow, PLI-1 gave Company D a "high-risk" rating again in its credit assessment. Compared with the previous repayment schedule, Company D repaid $16,000 less a month.

Audit comments

3. **Audit considers that at the time of Company D's application for the guaranteed loan, PLI-1 did not have strong justifications for supporting its assessment that Company D was creditworthy.**

Source: Treasury's records

Case study 5

Case particulars

1. In early February 1999, PLI-3 submitted an application for guarantee of a loan of $4 million to be granted to Company E. On 4 February 1999, the Treasury approved a guarantee of $2 million of the loan and issued the notification of the result of application to PLI-3. On 5 February 1999, Company E drew down the guaranteed loan. After making the first repayment due in March 1999, Company E failed to make the second and all subsequent repayments. In March 2002, the Treasury paid PLI-3 $2 million to honour the guarantee of the loan.

2. Audit's examination of the case file revealed that PLI-3 had offloaded an existing loan onto the Scheme. The guaranteed loan granted to Company E was used to repay an existing loan granted by PLI-3 to Company F. The repayments of the existing loan had been overdue for more than two months. Company E and Company F were closely related. Company F was 51% owned by a Mr. X (who was also the sole owner of Company E) and 49% owned by his close relatives. In August 1996, PLI-3 granted a loan of $6.1 million to Company F. In January 1999, when Company F's outstanding loan balance was $3.8 million, Mr. X informed PLI-3 that Company F's business was extremely difficult due to the poor general market conditions. Mr. X requested PLI-3 to restructure the outstanding loan. Mr. X also requested PLI-3 to use the name of Company E as the borrower of the restructured loan as Company E was the owner of the collateral (which was a production machine located in the Mainland).

Audit comments

3. **In view of the close relationship between Company E and Company F, Audit considers that at the time of Company E's application for the guaranteed loans, PLI-3 did not have strong justifications for supporting its assessment that Company E was creditworthy.**

Source: Treasury's records

Case study 6

Case particulars

1. In July 1999, PLI-4 submitted an application for guarantee of a loan of $0.5 million to be granted to Company G. On 29 July 1999, the Treasury approved a guarantee of $0.3 million of the loan and issued the notification of the result of application to PLI-4. On 31 July 1999, Company G drew down the guaranteed loan. In June 2000, PLI-4 notified the Treasury that Company G failed to repay the loan. In September 2000, the Treasury consulted the CITB, the TID and the HKMA whether PLI-4 had breached the Deed. In October 2000, the Treasury paid PLI-4 $0.3 million to honour the guarantee of the loan.

2. Audit's examination of the case file revealed that PLI-4 had offloaded an existing bad loan onto the Scheme. The guaranteed loan was used to repay an existing mortgage loan granted by PLI-4 to two shareholders of Company G who had acquired the mortgaged property for investment purpose. In early 1999, the two shareholders admitted that they were in financial difficulties. In order to reduce the interest accrued on the mortgage loan, PLI-4 agreed to the disposal of the mortgaged property and to convert the shortfall between the proceeds from the sale of the property and the outstanding principal to a term loan. The purpose of granting the guaranteed loan was to help the two shareholders of Company G solve their cashflow problem so that they could continue their business.

Audit comments

3. **Audit considers that at the time of Company G's application for the guaranteed loan, PLI-4 did not have strong justifications for supporting its assessment that Company G was creditworthy.**

Source: Treasury's records

Audit observations on offloading of loans onto the Scheme

2.33 Audit has noted that:

(a) the objective of the Scheme is to help those SMEs which meet all the three criteria of being creditworthy, having a good track record and being able to demonstrate business prospects, to obtain adequate financing from lending institutions (see para. 1.2 above). However, the Deed does not specify that a PLI should only grant guaranteed loans to such SMEs (see para. 2.6 above);

(b) the Government placed complete reliance on a PLI to assess an SME's application for a guaranteed loan. However, a PLI was not required to provide to the Treasury information on the creditworthiness of an SME (see para. 2.3 above). From late April 1999, a PLI was no longer required to make a declaration to the Government that an SME had no overdue loan repayments for over 60 days in the 12-month period prior to the application (see para. 2.20 above);

(c) the Deed is not an effective tool to protect the Government's interest according to the legal opinion of the Department of Justice given in August 1998 (see para. 2.8 above);

(d) there was no restriction on the use of the guaranteed loans, including repaying other loans granted by the PLIs (see para. 2.30(a) above);

(e) the Treasury, the HKMA and the FSTB saw the need and had made suggestions to prohibit the PLIs from offloading bad loans onto the Scheme (see paras. 2.15, 2.18, 2.21, 2.22, 2.24, 2.26 and 2.27 above). However, the CITB did not agree to add a clause in the Deed prohibiting the offloading of bad loans because, among other reasons, it would be difficult to distinguish offloading of bad loans from "provision of breathing space", which was arguably not incompatible with the purpose of the Scheme (see para. 2.28(b) above). In the end, there are no specific provisions in the Deed to restrict the offloading of bad loans onto the Scheme (see para. 2.31 above);

(f) in some cases, the PLIs did not have strong justifications for supporting their assessments at the time of the borrowers' applications for guaranteed loans that the SMEs were creditworthy (see para. 2.32 above); and

(g) in some cases, the PLIs granted guaranteed loans to SMEs before the date of the Treasury's notification of the result of application (see para. 2.32 above).

2.34 In implementing the Scheme, the Government cannot stop a PLI from approving guaranteed loans to an SME which does not satisfy all the three criteria of being creditworthy, having a good track record and being able to demonstrate business prospects. Furthermore, the

Government cannot stop a PLI from offloading existing loans onto the Scheme, especially when the PLI knows that the SME might not be able to repay the existing loans. In the event of default afterwards, the Government cannot reject claims for compensation from the PLI. **Audit considers that the implementation of the Scheme is unsatisfactory because:**

(a) **granting guaranteed loans to SMEs which do not satisfy all the three criteria of being creditworthy, having a good track record and being able to demonstrate business prospects is contrary to the objective of the Scheme;**

(b) **granting guaranteed loans to uncreditworthy SMEs will deprive other SMEs which satisfy all the three criteria of the opportunity to obtain funding to meet genuine commercially viable business needs because of the Government's maximum commitment under the Scheme (see Table 1 in para. 1.4 above); and**

(c) **in case of default of guaranteed loans granted to uncreditworthy SMEs, the PLI would be able to reduce its own loss because the Government would have to honour the guarantees.**

2.35 **For future similar schemes, Audit considers that, in order to adequately safeguard the Government's interest, there is a need for the Government to critically assess the risks of lenders offloading bad loans onto a scheme, taking account of the lessons learnt from the Treasury's experience of handling guaranteed loans to SMEs under the Scheme. Based on the results of the risk assessment, the Government should decide whether it would allow borrowers to use the new loans to repay existing loans (including bad loans) granted by the same lenders.**

2.36 **In order to safeguard the proper use of public money, Audit considers that the Treasury needs to critically re-examine the claims for compensation in respect of the six guaranteed loans mentioned in paragraph 2.32 above and all other similar claims (including claims already paid and claims being processed), to ascertain whether the PLI concerned has breached any requirement stipulated in the Deed, particularly Clauses 2.6, 7.4, 7.8 and 9.1 (see paras. 2.4 and 2.7 above).**

Audit recommendations on offloading of loans onto the Scheme

2.37 **For future similar schemes under which the Government acts as a guarantor for loans granted to the private sector, in order to ensure that adequate safeguards are provided to protect the Government's interest, Audit has *recommended* that the Director-General of Trade and Industry should:**

(a) **in conjunction with the Secretary for Commerce, Industry and Technology:**

(i) **critically assess the risks of the schemes being abused by lenders through offloading bad loans onto the schemes, having regard to the lessons learnt from the Treasury's experience of handling guaranteed loans to SMEs under the Scheme; and**

(ii) **based on the results of the risk assessment, decide whether the Government should allow the borrowers to use new loans to repay existing loans granted by the same lenders;**

(b) **if the Government allows a borrower to use the new loan to repay existing loans granted by the same lender, instead of relying on the lender to assess the creditworthiness of the borrower, require the lender to provide to the Government essential credit information about the borrower so that the Government can conduct a thorough credit assessment of the borrower before approving the guarantee. Such information should include:**

(i) **whether the borrower is an existing customer of the lender and, if so, the repayment records of his existing loans, including whether he has overdue loan repayments for over 60 days in the 12-month period prior to the application;**

(ii) **the purpose of applying for the new loan and whether the loan will be used to repay existing loans; and**

(iii) **the total amount of outstanding debts vis-à-vis the total amount of assets of the borrower; and**

(c) **if the Government does not allow a borrower to use the new loan to repay existing loans granted by the same lender and relies on the lender to conduct the credit assessment of the borrower:**

(i) **specify in the relevant legal documents the objectives of the scheme and the criteria of granting loans to borrowers;**

(ii) **provide a clear definition of "bad loan" with reference to the guidelines on the classification of loans issued by the HKMA and taking account of the lessons learnt from the Treasury's experience of handling guaranteed loans to SMEs under the Scheme; and**

(iii) **state clearly in the relevant legal documents that the lender is not allowed to offload bad loans onto the scheme.**

2.38 **Audit has *recommended* that the Director of Accounting Services should:**

(a) **re-examine the claims for compensation of the six guaranteed loans mentioned in paragraph 2.32 above and all other similar claims, to ascertain whether the PLI concerned has breached any requirement stipulated in the Deed, including:**

(i) **the requirement that the PLI shall grant the guaranteed loan to the borrower with a starting date within 14 days from the date of issuing of the notification of the result of application by the Treasury (see para. 2.4 above);**

(ii) **the requirement that the PLI shall promptly disclose to the Government all material facts and information which might affect the rights, interest, obligations or liabilities of the Government under the Scheme (see para. 2.7(a) above);**

(iii) **the requirement that the PLI shall exercise its professional skill, judgement and care in processing the borrower's application and act in accordance with good banking practice (see para. 2.7(b) above); and**

(iv) **the requirement that the PLI shall not give any false, fraudulent or misleading information to the Government or act in bad faith (see para. 2.7(c) above).**

In doing so, the Director should seek the advice of the Department of Justice on legal issues and the advice of the HKMA on banking practices, where appropriate; and

(b) **if the PLI is found to have breached any requirement of the Deed, recover the money from the PLI for a claim already paid and reject the claim for a claim being processed.**

Response from the Administration

2.39 The **Secretary for Commerce, Industry and Technology** and the **Director-General of Trade and Industry** accept Audit's recommendations. They have said that:

Objective of the Scheme is to help creditworthy SMEs

(a) in view of Audit's concern, for future similar schemes, the CITB and the TID are prepared to consider issuing letters to the PLIs stating in more specific terms the

intention regarding the type of SMEs to benefit from these schemes. The CITB and the TID will also consider the option of including such terms in the Deed in consultation with the Department of Justice;

(b) the requirements that the PLIs should only grant guaranteed loans to SMEs which are creditworthy, have a good track record and can demonstrate business prospects, are conveyed to the PLIs through Clause 7.8 of the Deed. Clause 7.8 stipulates that the PLIs should exercise professional skill, judgement and care in processing every borrower's application and should act in accordance with prevailing good banking practice. The CITB and the TID believe that the PLIs which follow Clause 7.8 would, in practice, only grant guaranteed loans to SMEs which, in their professional views, are creditworthy and have a good track record and can demonstrate business prospects (Note 9);

(c) as advised by the Department of Justice in August 1998, the PLIs would be culpable under Clauses 7.8 and 9.1 if they are found negligent, reckless or fraudulent. Given that it was the Government's intention to place complete reliance on the PLIs in assessing loan applications and evaluating the creditworthiness of SMEs, the CITB and the TID consider it fair that an element of fault is required in order to hold a PLI culpable under these clauses;

Inclusion of provisions for preventing transfer of loans to the Scheme

(d) when launching similar schemes in future, the Government would critically assess the risks of the schemes being abused by lenders through offloading bad loans onto the schemes, and take the most appropriate measures to prevent abuse. As a matter of fact, this has been done in the past, and can be done in future without difficulty. However, the CITB and the TID would like to caution that it would not be easy for the Government to adopt Audit's recommendation that the Government itself should conduct thorough assessments on guarantee applications, rather than relying on the PLIs to do so. This would in effect require the Government to assume the role of the PLIs in assessing loan applications. In doing so, the CITB and the TID would need to identify extra resources as well as resort to outside expertise;

(e) it was the conscious decision of the Government not to explicitly prohibit the transfer of loans to the Scheme. The fundamental objective of the Scheme is to help SMEs secure financing during the liquidity crunch. As reflected by the business sector and acknowledged by the FC, one of the most common problems facing SMEs at that time was that many of them were facing severe cashflow problems. Indeed, many were no longer able to make repayments to existing loans, as scheduled. If the Scheme did not

---

Note 9: *The HKMA had advised the CITB that the requirement of good banking practice left too much room for different interpretations (see para. 2.27(d) above).*

allow for transfer of loans to the Scheme, the PLIs would simply recall the loans and a lot of SMEs would have been forced to wind up their businesses as a result. This would be in direct contradiction to the objective of providing breathing space to SMEs to relieve their liquidity crunch. Moreover, SMEs with overdue repayments during the liquidity crunch in 1998 were not necessarily credit-bankrupt in the conventional sense. Instead of excluding all of them from the Scheme, the CITB and the TID consider that it would be more appropriate for the Government to defer to the PLIs to decide whether they were creditworthy individually (Note 10);

(f) there are indeed quite a number of fully-repaid cases involving SMEs which had overdue repayments at the time of seeking the Government's guarantee under the Scheme. This shows that the CITB and the TID have adopted the right approach by placing complete reliance on the PLIs under the Scheme to decide which SMEs are creditworthy, and have struck a balance between financial prudence on one hand and administrative simplicity on the other hand; and

(g) the CITB and the TID note that Audit had reservations about the creditworthiness of the six guarantee cases it had examined in the report. It is worth noting that in all these cases, the PLIs decided to lend to the SMEs because they knew the SMEs well, and believed that their financial difficulties were temporary in nature and would be improved through loan restructuring.

2.40 The **Director of Accounting Services** agrees with Audit's recommendation that the Treasury should examine claims being processed and re-examine claims already paid, to ascertain whether the PLI concerned has breached any requirement stipulated in the Deed.

2.41 The **Chief Executive of the HKMA** generally agrees with Audit's recommendations, in particular the recommendation that adequate safeguards would need to be incorporated into future similar schemes to prevent abuse by lending institutions. The Chief Executive also agrees that the Treasury should examine claims being processed and re-examine claims already paid, to ascertain whether all these claims satisfy the terms for compensation stipulated in the Deed as this would help safeguard the proper use of public money.

Note 10: *It should be noted that the HKMA had advised the CITB about the risk of granting facilities to borrowers with overdue repayment records and that strong justifications were needed for granting facilities to such borrowers (see para. 2.27(a) and (b) above).*

PART 3: WRITE-OFF OF IRRECOVERABLE GUARANTEE PAYMENTS

Authority to approve write-off of irrecoverable guarantee payments

3.1 On default of guaranteed loans, the Government makes guarantee payments to the PLIs. Any amount recovered from an SME is shared between the Government and a PLI on a pro-rata basis, according to the ratio of the amount guaranteed by the Government to the amount of the guaranteed loan. As at 31 March 2002, the balance of guarantee payments to the PLIs was $184.9 million (see Appendix A), after deducting the Government's share of the total amount recovered from the SMEs and the amount of $10.6 million written off in 2001-02.

3.2 According to Financial Circular No. 6/2000 dated 5 June 2000, a Head of Department or a Controlling Officer can approve personally the write-off of a loss up to $0.5 million in each case or in respect of any one cause not involving fraud or negligence on the part of a public officer. In January 2002, based on the estimate that the total number of write-off cases would be about 1,200 and the total amount of irrecoverable guarantee payments to be written off would be about $430 million, the FSTB considered that:

(a) following the arrangements existing at that time, the Director of Accounting Services would have to seek the then Secretary for the Treasury's approval for write-off of irrecoverable guarantee payments each exceeding $0.5 million, of which there were many; and

(b) to streamline the procedures and to improve efficiency, it was more efficient for the Secretary for the Treasury to delegate to the Director of Accounting Services the authority to approve personally the write-off of irrecoverable guarantee payments each exceeding $0.5 million under the Scheme.

3.3 In February 2002, the Secretary for the Treasury delegated to the Director of Accounting Services the authority to approve personally the write-off of irrecoverable guarantee payments each exceeding $0.5 million under the Scheme. The Director of Accounting Services was required to submit a half-yearly return to the Secretary for the Treasury, indicating the details (including the reasons for write-off) of each irrecoverable guarantee payment written off under the delegated authority during the half-yearly period. In March 2002, the Director of Accounting Services approved the write-off of irrecoverable guarantee payments amounting to $10.3 million, which included seven payments ranging from $0.8 million to $1.9 million.

Audit observation on write-off of irrecoverable guarantee payments

3.4 **Having regard to the large number of write-off cases, the significant amount of irrecoverable guarantee payments to be written off (see para. 3.2 above) and the fact that the Treasury approved the applications for the guarantees in the first instance, Audit considers that there is a need to review the justifications for such delegation of authority.**

Audit recommendations on write-off of irrecoverable guarantee payments

3.5 **Audit has *recommended* that the Secretary for Financial Services and the Treasury should:**

(a) **review the justifications for delegating to the Director of Accounting Services the authority to approve personally the write-off of irrecoverable guarantee payments each exceeding $0.5 million under the Scheme; and**

(b) **based on the results of the review, decide whether the delegation should continue.**

Response from the Administration

3.6 The **Secretary for Financial Services and the Treasury** agrees to review whether the current delegation to the Director of Accounting Services of the authority to approve personally the write-off of irrecoverable guarantee payments each exceeding $0.5 million under the Scheme should continue.

PART 4: GUARANTEED LOANS OF $50,000

TID's views on small guaranteed loans

4.1 In August 1998, soon after the FC approved the Scheme, at a meeting with representatives of the SMEs, the TID stated that, after taking into consideration such factors as the complications in, and the costs of, the administration of guaranteed loans, the Government would not provide guarantees under the Scheme to those SMEs which needed only a small amount of financing.

4.2 In the TID's review report submitted to the FC in April 1999, it was stated that:

(a) there were suggestions that a simpler scheme with simpler application procedures be devised for small loans (say, up to $200,000 or $500,000) to help those SMEs which needed only a small amount of financing. However, it would be confusing if a two-tier system was devised with different eligibility criteria and application procedures;

(b) the application procedures for the guarantees on the part of the Government were already very simple;

(c) for small loans (say, up to $100,000), there were various personal credit facilities available in the market; and

(d) if an SME was unable to obtain a small loan from the financial institutions, its creditworthiness and business prospects seemed doubtful.

In the event, no minimum loan amount had been set on the guaranteed loans under the Scheme.

Large number of applications for guarantee of loans of $50,000 approved in 1999

4.3 Before 1999, no application for guarantee of loan of $50,000 each was received by the Treasury. During the period June 1999 to January 2000, the Treasury approved more than 4,400 applications for guarantee of loans of $50,000 each from two PLIs of the same banking group (PLI-5 and PLI-6). These two PLIs offered guaranteed loans of $50,000 each to SMEs as a standard banking product.

4.4 In late September 1999, the TID informed PLI-5 and PLI-6 that:

(a) the Treasury would not accept any new applications for guarantee of loans of $50,000 each; and

(b) the Treasury would continue to process the applications for guarantee of loans of $50,000 each already received.

4.5 In November 1999, the TID informed the Panel on Trade and Industry of the Legislative Council that:

(a) PLI-5 and PLI-6 had already stopped submitting to the Treasury applications for guarantee of loans of $50,000 each; and

(b) the Government would issue guidelines to the PLIs that guaranteed loans should be provided to SMEs in response to market demand, rather than the PLIs commercialising the guaranteed loans to attract potential customers.

High default rate of guaranteed loans of $50,000

4.6 As at 29 August 2002, in respect of guaranteed loans of $50,000 each, the guarantees for all of which had expired or had been released:

(a) the total amount of guarantees granted was $155.5 million;

(b) the total amount of net claims already paid by the Government (to PLI-5 and PLI-6) in respect of defaulted guaranteed loans was $5.5 million;

(c) the Treasury was processing the claims (which PLI-5 and PLI-6 had submitted), amounting to $31.7 million, for 1,141 defaulted guaranteed loans; and

(d) the DREG (see para. 1.6 above) was 23.9% (i.e. ($5.5 million + $31.7 million)/ $155.5 million).

Audit observations on guaranteed loans of $50,000

4.7 Audit has noted that:

(a) despite the TID's reservations about the granting of guarantees of small loans, no minimum loan amount had been set on the guaranteed loans under the Scheme (see paras. 4.1 and 4.2 above);

(b) during the period June 1999 to January 2000, the Treasury approved more than 4,400 applications for guarantee of loans of $50,000 each (see para. 4.3 above); and

(c) **as at 29 August 2002, the DREG of 23.9% of guaranteed loans of $50,000 each was more than three times the DREG of 7.6% of all guaranteed loans granted under the Scheme (see paras. 1.6 and 4.6(d) above).**

4.8 **Audit considers that the Government should have set a minimum loan amount on the guaranteed loans under the Scheme. This is because, as mentioned in the TID's review report submitted to the FC in April 1999:**

(a) **there are various personal credit facilities available in the market for small loans (say, up to $100,000); and**

(b) **if an SME is unable to obtain a small loan from the financial institutions, its creditworthiness and business prospects seem doubtful (see para. 4.2 above).**

Audit recommendation on guaranteed loans of $50,000

4.9 **Audit has *recommended* that the Secretary for Commerce, Industry and Technology and the Director-General of Trade and Industry should, if a similar scheme is launched in future, critically assess the desirability of setting a minimum loan amount, having regard to the availability of small loans in the market and the creditworthiness and business prospects of borrowers who are unable to obtain such loans from lending institutions.**

Response from the Administration

4.10 The **Secretary for Commerce, Industry and Technology** and the **Director-General of Trade and Industry** have said that:

(a) the CITB and the TID accept Audit's recommendation that the Government should, if a similar scheme is launched in future, critically assess the need of setting a minimum loan amount, in addition to a ceiling amount. Should such circumstances arise, the Government would take all relevant considerations into account in making the assessment;

(b) the CITB and the TID note Audit's concern about the relatively high default rate of guaranteed loans of $50,000 each;

(c) the meeting with SME representatives mentioned in paragraph 4.1 above took place before the launching of the Scheme, and when the Government was still working on the implementation details of the Scheme. The issue on small loans was probably being considered within the TID at that time. However, when the Scheme was subsequently launched, no threshold was set on the lowest amount of loan that would qualify for the Scheme. This shows that it was the Government's conscious decision not to pursue the proposal further;

(d) there are indeed good reasons not to set a minimum loan amount under the Scheme. In retrospect, while personal credit facilities for small loans up to $100,000 might be available in the market when the Scheme was launched, this does not necessarily mean that SME entrepreneurs could obtain them any easier than obtaining commercial loans at that time. As a matter of fact, the liquidity crunch had affected the entire lending market. Also, unlike individuals who are employees, SME entrepreneurs normally do not have ready proof of stable income and may therefore not be considered favourably for personal loans by lending institutions, particularly during the 1998 liquidity crunch; and

(e) the concern of the TID in respect of the applications for guarantee of loans of $50,000 each received from PLI-5 and PLI-6 was more about whether such loans could indeed help SMEs, and whether the PLIs had processed the applications of such standardised loan products in a prudent manner, rather than about the amount of loans per se.

Appendix A
(para. 3.1 refers)

Balance of guarantee payments as at 31.3.2002

	($'000)
Total amount of guarantee payments	206,107
Total amount recovered from SMEs	(10,685)
	195,422
Total amount of irrecoverable guarantee payments written off	(10,552)
Balance	**184,870**

Source: Treasury's records

Appendix B

Acronyms and abbreviations

CITB	Commerce, Industry and Technology Bureau
DREG	Default Rate for Expired or Released Guarantees
FC	Finance Committee
FSTB	Financial Services and the Treasury Bureau
HKMA	Hong Kong Monetary Authority
PLI	Participating lending institution
SME	Small and medium enterprise
TID	Trade and Industry Department