

**Consultation Paper
on the Establishment
of
the Film Guarantee
Fund**

Television and Entertainment
Licensing Authority

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Consultation Paper on the Establishment of the Film Guarantee Fund

Purpose

The Government proposes to set up a Film Guarantee Fund (FGF) on a pilot basis to assist local film production companies to obtain loans from local participating lending institutions (PLIs) for producing films. Comments on the proposal are hereby invited.

Background

Development in the Last Decade

2. The local film industry has been a vibrant and robust creative industry of Hong Kong for many years. It is characterized by a diverse range of players, with major production companies co-existing with a number of smaller ones with their own market niche. The industry has experienced its own ups and downs since the 1970s, but has been facing new challenges and difficulties since the late 1990s. In the early 1990s, the number of films released locally was around 200 a year. At its peak in 1993, a total of 234 local films were released and the local box office stood at \$1,132 million. And Hong Kong has been recognized as a major film production centre in the world. However, the number of films produced decreased significantly during the past five years due to the downturn of the local economy. In 2001, the number of local films released and box office were 126 and \$456 million respectively.

3. According to the Statistical Digest of the Service Sector 2002 compiled by the Census and Statistics Department, the number of local film industry establishments in the last decade largely remained at the level of 1 100 while the number of persons engaged fluctuated between 5 100 and 7 100. In 2001, there were over 6 000 persons in the industry. During 2000, the film industry generated a net output/value added of about \$1.6 billion, compared to \$1.3 billion in 1992. The details are at *Appendix A*. The economic value of the local film industry to Hong Kong is therefore important. Indeed, some studies carried out overseas reported that for every \$1 spent on film production, \$2.5 goes into the economy; and for every one person directly employed in film production, another 1.7 jobs are created in the local economy, benefiting ancillary services such as equipment rental, catering, transportation, etc. Moreover, many local productions are exhibited overseas and have gained wide recognition, showcasing Hong Kong to an international audience, and this has helped to generate many other economic benefits for Hong Kong, e.g. promoting tourism.

4. Many observers have attributed the decline of the local film industry to a number of factors. These include the decline in quality of the films, the high production costs, the proliferation of other forms of entertainment, the drop in box office receipts and revenue from overseas market which can be attributed to the existence of piracy and/or parallel imports. The economic problem brought on by

the Asian financial turmoil has aggravated the situation. This has led to the tightening of the traditional source of financing for film companies which hitherto have been mainly relying on distributor or equity financing. For the film industry to re-establish its leading position in the region, it has to improve its quality of production, to find ways to enhance its competitive edge, to explore new ideas and to develop new markets. At the same time, the film companies would need to identify new sources of funds to finance their film projects.

Film Financing in Hong Kong

5. In the last two decades, the majority of the Hong Kong films are financed by either distributor financing or equity financing. By “distributor financing”, a film production company obtains funds through pre-sale agreements with distributors and exhibitors on the distribution rights of a film. As for “equity financing”, the common modes in Hong Kong are –

- (a) single-project investment – a proprietor group provides funds for a film project. Sometimes overseas investors are involved, e.g. investors of Southeast Asian countries;
- (b) joint venture – parties with different active roles to play in the production, distribution or management of a film project contribute to the capital for the film; and
- (c) co-production with foreign investors – foreign film companies provide capital for a film project and participate in the production. Very often, the project will include location shooting in the home country of the foreign investor.

6. However, largely due to economic factors, these two traditional sources of financing have tightened. There was a decrease in the number of investors, and the absolute amount that the film production companies could obtain from each investor had also reduced. As a result, local film production companies are facing a problem of cash-flow and have to look for new source of funding for film production.

7. To address the concerns of the film industry in film financing, the Government commissioned a consultant in 2000 to study appropriate means to improve the opportunities of film financing. Having studied the current film financing practice in the US, Japan and the UK, and the suitability of adaptation of different modes of financing in Hong Kong, the consultancy report recommended, inter alia, the wider use of lender financing as a major source for funding local film production, which is a common financial tool in the US for financing film productions. It is estimated to account for about 25% of film financing there, and is the mode preferred by independent filmmakers. More details of the film financing arrangement in the US are set out in paragraph 11 below.

8. As filmmaking is a commercial activity, it should remain a private-sector enterprise. To a large extent, film financing may not be a pressing problem for large productions as there are avenues for financing these productions. However, it has become a pressing problem for the smaller-budget productions, which constitute the majority of the local film productions, to secure financing in this economic climate. We need to find ways to assist these productions in overcoming the problem of cash-flow as they play a key part in the development of a healthy and dynamic film industry in Hong Kong.

9. Due to the lack of knowledge and experience in assessing film-financing proposals, local banks have considerable concerns about the exposure to risks and the management of such risks in providing loans for film production, particularly to the smaller production companies, notwithstanding that local banks need to explore new outlets for funds under existing market situation. On the other hand, local film production companies are unable to offer sufficient collateral to underwrite the lenders' risks, although they may be able to produce evidence that there could be a steady return in film investments. Thus local film production companies are indeed facing the same problem as many local small and medium enterprises (SMEs) in obtaining financing from the market. We hold the view that it would be conducive to the long term and healthy development of the local film industry, and to the benefit of the economy, if we could devise a scheme to stimulate the establishment of a lender financing infrastructure and culture for film production in Hong Kong.

10. With Hong Kong's position as a financial centre and at the same time a major film exporter in the region, there are inherent favourable factors for the development of a film-financing infrastructure locally. Through the building of a proper lender financing infrastructure for film production, local production companies will be able to obtain loans from banks more easily and their cash-flow position will improve. This will in turn boost local film production. The establishment of such an infrastructure would also give the local banking sector wider exposure to the entertainment industry and thus open up more business opportunities for the banks, not only confining to Hong Kong but may also be extending to other Asian countries where the film industry has started to grow.

Film Financing in the United States

11. The existence of a comprehensive and efficient film-financing infrastructure in the US is one of the fundamental factors contributing to the prosperity of its film industry. Banks engaged in film financing accept film companies' asset and pre-sale agreements as collateral. For additional security, they may require the involvement of completion bond companies to assess the loan applications, oversee the progress of production and to ensure that the projects will not deviate from their pre-set budgets. When there is a completion bond, the banks can insure against any loss caused by delay or other contingencies. The banks therefore assess and manage their exposure to lending risks through the monitoring work of completion bond companies. A completion bond company normally charges a fee of 3% of the budget, depending on the risk level and the size of the

budget, which is on top of the insurance premium of about 1.5%. It is worth noting that the size of films to be bonded is normally not less than US\$2 million, which is much higher than a small and medium size film produced in Hong Kong.

Consideration

12. Drawing on the experience in the US, we consider it feasible to establish a lender financing infrastructure locally with the involvement of local banks, complemented by a customized completion arrangement. While we agree that completion bond provides the best security against non-completion risks, the premium involved can be an obstacle for low-budget productions. The fact that there is so far only one overseas company established to provide completion bond in Hong Kong also indicates that the market may not be as mature as that in the US. Nonetheless, this should not be a reason for us not to put forward proposals which would help create an environment that would be conducive to the development of such an infrastructure. We understand from the local film industry that cases of non-completion are few in Hong Kong. Hence, local lending institutions may be prepared to accept a form of completion arrangement that is applicable in the local context.

The Proposal

Introduction

13. To help build the film-financing infrastructure, we propose that the Government should set up a Film Guarantee Fund (FGF) and provides, on a pilot basis, a loan guarantee to PLIs which will offer loan facilities for film production with the support of film completion arrangement¹. The pilot scheme will initially operate for a period of two years on a revolving basis, i.e. loan guarantee discharged by PLIs will be ploughed back into the FGF for providing guarantee to new applications.

14. This is a loan guarantee scheme to help create a conducive environment for the development of a film financing infrastructure in Hong Kong. The Government has no intention to invest or take part in film production.

Source of Funding

15. We propose to set aside \$50 million from the Film Development Fund for the establishment of the FGF. The \$100 million Film Development Fund was set up in 1999 for a period of five years. There is a current balance of about \$62 million.

¹ Film completion arrangement may either be completion bond or any other acceptable measures to ensure the completion of the film in question.

Eligibility for Guarantee

16. It is essential that those which stand to benefit from this scheme are local productions. Moreover, there is a need to put a cap on the production cost so as to achieve the aim of benefiting the smaller-budget productions.

17. As a starting point, we propose that all film production companies registered in Hong Kong that have produced at least three films in the past five years for commercial theatrical release in Hong Kong are eligible under the scheme. In case of a newly formed company with no track record, it is eligible if the producer or the director of the film in question has produced or directed at least three films in the past five years for commercial theatrical release in Hong Kong. This serves as a safeguard to ensure that the film under guarantee will be up to a standard for commercial theatrical release. The FGF will provide guarantee to film production proposals which satisfy the following criteria –

- (a) at least 50% of the major cast and film crew² are Hong Kong permanent residents;
- (b) the budget³ of the film does not exceed \$7.5 million; and
- (c) the film is a feature film for commercial theatrical release in Hong Kong.

18. To avoid possible conflict of interest, the film production company cannot be a related company of the PLI or the company engaged to provide the completion arrangement. No film production company may at any time have loan guarantee for more than one of its films. This seeks to enable the scheme to benefit as many film production companies as possible.

Conditions of Loan Guarantee

19. Loan guarantee will be provided by the FGF on the following conditions –

- (a) the film production company must have secured an in-principle approval of loan from a PLI;
- (b) the film production company bears at least 30% of the budget and the PLI provides a loan of not more than 70% of the budget;

² The major cast and film crew include the following production roles – i) director; ii) screenwriter; iii) leading actor; iv) leading actress; v) supporting actor; vi) supporting actress; vii) producer; viii) cinematographer; ix) editor; and x) art director.

³ Budget includes all costs of production, promotion, distribution, printing of copies and engagement of completion arrangement.

- (c) the FGF will guarantee 50% (i.e. the risk-sharing ratio between the FGF and the PLI) of the loan provided by the PLI, i.e. a maximum of 35% of the budget, or \$2.625 million at the maximum;
- (d) the film production company must have secured a film completion arrangement for the film prior to applying for the loan guarantee;
- (e) the film production company bears the cost of the film completion arrangement and this cost may be included in the budget; and
- (f) the guarantee may be offered for a term loan or in the form of a new credit line for a maximum period of two years, counting from the date when the facility is made available to the film production company. Under normal circumstances, a loan guaranteed by the Government under the scheme will have to be activated within 90 days from the date of Government's approval of the guarantee.

A diagram setting out the key features of the proposed loan guarantee arrangement for illustration purpose is at *Appendix B*.

Application

20. All authorised institutions under the Banking Ordinance (Cap. 155) will be invited to participate as PLIs in the pilot scheme.

21. Applications for the loan guarantee will be submitted to the Government through the PLIs and will be considered by the Government on a first-come-first-serve basis.

22. Only applications that have secured film completion arrangement and obtained in-principle loan agreement from PLIs will be considered by the Government. A flow chart setting out the procedures for processing loan guarantee applications is at *Appendix C*.

Film Completion Arrangement

23. As a means of risk management against non-completion, it is necessary for the film production company to satisfy the PLI concerned that sufficient arrangement has been made to ensure completion of the film project. It would be an acceptable arrangement for the film production company to engage an independent agent to monitor the progress of production of the proposed film on behalf of the PLI concerned, and to take over the production when necessary in case of cost overrun, non-completion, or in case the production deviates from the implementation plan. The agent should also underwrite the risks of non-completion.

24. The film completion arrangement will minimize the risk of the PLIs in providing the loan as well as that of the Government in providing the loan guarantee.

Role of a PLI

25. The participation of a lending institution in this scheme is entirely on a voluntary basis. The Government will invite all eligible lending institutions to join the scheme and will publish a list of PLIs when the scheme is launched. The list will be updated continuously. The responsibilities of a PLI are –

- (a) to verify that an application made under the scheme satisfies all requirements as set out in paragraphs 16 to 19 above;
- (b) to exercise prudent professional judgment and proper due diligence in assessing an application based on the financial soundness and the commercial viability of the business proposal;
- (c) to seek the Government's agreement of providing guarantee under the scheme to the loan approved in principle by the PLI;
- (d) to establish and maintain a separate account or sub-account for the exclusive purpose of handling all loan payment to and repayment from the film production company; and
- (e) to exercise proper due diligence in securing repayment of the loan from the film production company; and in case of default, to provide justification and documentary proof for demonstrating to the Government that proper due diligence and prudent professional judgment have been exercised in approving the loan and in securing repayment before a call is to be made to the FGF on the loan guarantee.

Form of Loan Guarantee

26. The loan guarantee will be in the form of an agreement between the PLI offering the loan and the Government, setting out the rights and obligations of each party as well as the relevant arrangements and requirements.

Interest Rate of the Loan

27. The interest rate of the loan is a commercial issue to be decided between the film production company and the PLI concerned. The Government will not take part in the process.

Default Cases

28. In case of default, the PLI and the Government will co-own the copyright of the film in question until –

- (a) the film production company repays all of the outstanding loan under the conditions set by the PLI; or
- (b) the copyright of the film is publicly auctioned, with the revenue less administrative costs shared between the PLI and the Government according to the risk-sharing ratio of the loan guarantee as proposed in paragraph 19(c) above.

29. The PLI will provide all evidence and justifications to the Government in calling guarantee from the latter. The amount of guarantee that the Government has to pay will be determined by the risk-sharing ratio as proposed in paragraph 19(c) above. On default, any amount eventually recovered from the film production company will be shared between the Government and the PLI according to the risk-sharing ratio.

Target

30. The minimum number of films that can be guaranteed under the proposed \$50 million loan guarantee scheme will be 19 at any one time, with a budget of \$7.5 million for each film. The total budget of the films guaranteed can be over \$140 million. The actual number of films that can benefit from the scheme will be greater as not all films which receive the loan guarantee would have a budget of \$7.5 million and any loan guarantee discharged could be immediately ploughed back to the FGF to support new applications.

Theme or Content

31. The FGF will provide the loan guarantee if the criteria set out in paragraphs 16 to 19 above are met. The FGF will not look into the theme or content of the film, which will eventually have to be classified under the three-tier film classification system before exhibition is approved in Hong Kong.

Reference

32. The proposed scheme is drawn up with reference to the former Special Finance Scheme launched to support SMEs, and the Business Installations and Equipment Loan Guarantee Scheme for SMEs currently in operation.

Public Consultation

33. We welcome views from all quarters of the community on the proposal outlined in this consultation paper. Please forward your views and comments by completing and returning the proforma at *Appendix D* to us **on or before 6 November 2002** in the following manner –

- **by post:** Film Services Office, 40/F, Revenue Tower,
5 Gloucester Road, Wan Chai, Hong Kong
- **by fax:** 2824 0595

Views and comments can also be sent to the Film Services Office by e-mail at info@fso-tela.gov.hk.

34. The Government may publish all or part of the views and comments received and disclose the identity of the source in such manner as considered appropriate, unless the party submitting the views and comments requests any part of the views and comments and/or its identity be treated in confidence.

35. Copies of the consultation paper are available at the Television and Entertainment Licensing Authority at 39/F, Revenue Tower, 5 Gloucester Road, Wan Chai and the Information Technology and Broadcasting Branch of the Commerce, Industry and Technology Bureau at 2/F, Murray Building, Garden Road, Central. The paper can also be accessed on the Internet at the following addresses –

- <http://www.info.gov.hk/itbb>
- <http://www.info.gov.hk/tela>

36. For enquiries, please contact the Film Services Office of the Television and Entertainment Licensing Authority at 2594 5729.

Television and Entertainment Licensing Authority
October 2002

Appendix AStatistics of the Hong Kong Film Industry

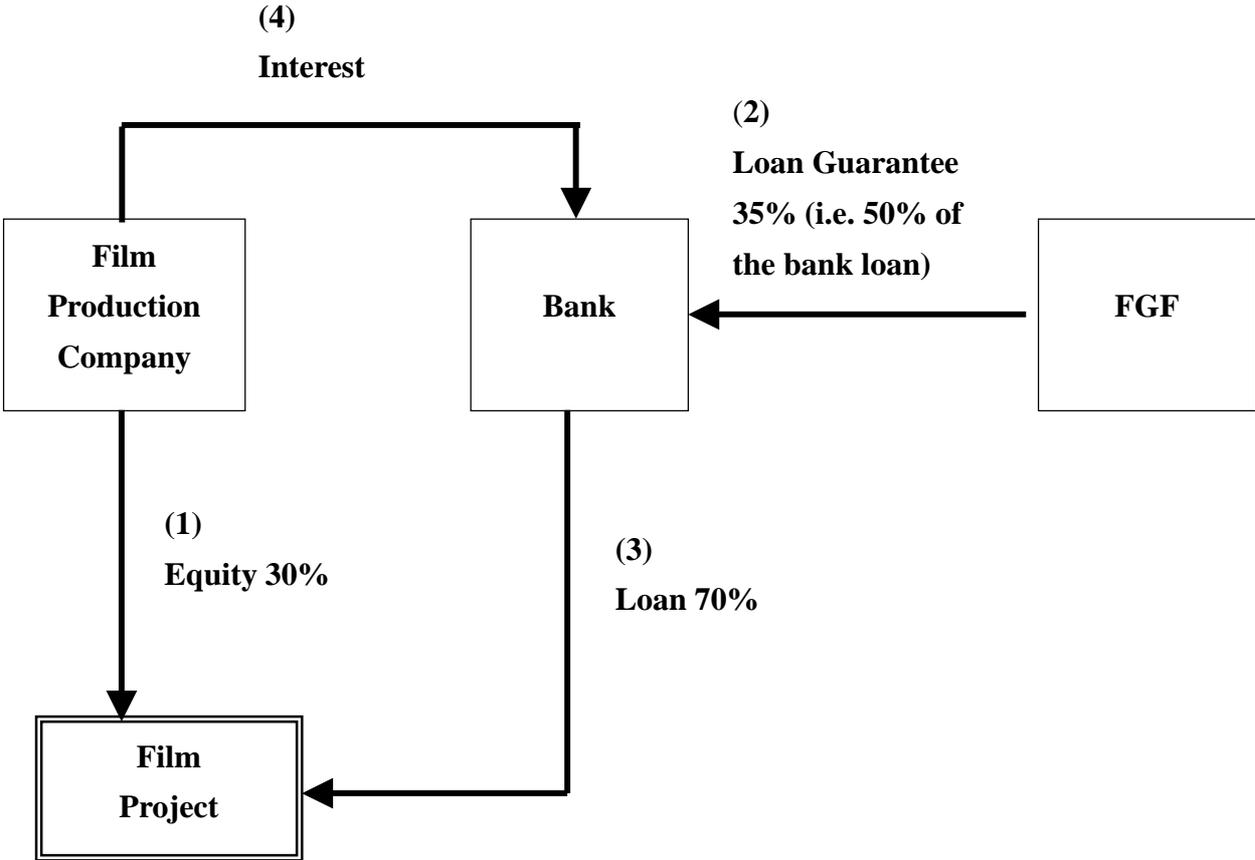
Year	No. of local films released⁽¹⁾	Local box office takings⁽¹⁾ (\$ million)	No. of establishments⁽²⁾	No. of persons engaged⁽²⁾	Net output/ Value added⁽²⁾⁽³⁾ (\$ million)
1992	138	1,239	1,057	6,428	1,351
1993	234	1,132	1,155	7,090	1,380
1994	190	957	1,301	5,851	1,929
1995	154	776	1,301	6,062	1,371
1996	116	659	1,168	6,406	1,458
1997	94	547	1,141	5,491	1,320
1998	92	421	991	5,129	1,109
1999	146	352	1,100	5,248	963
2000	151	382	1,112	5,535	1,648
2001	126	456	1,130	6,101	N.A.

Notes

- (1) Source: Hong Kong Kowloon & New Territories Motion Picture Industry Association Ltd.
- (2) Source: Statistical Digest of the Services Sector 2002 published by the Census and Statistics Department.
- (3) These are rough estimates which are compiled based on limited data. They may be subject to considerable revisions when more data become available. Special care should be taken when interpreting them.

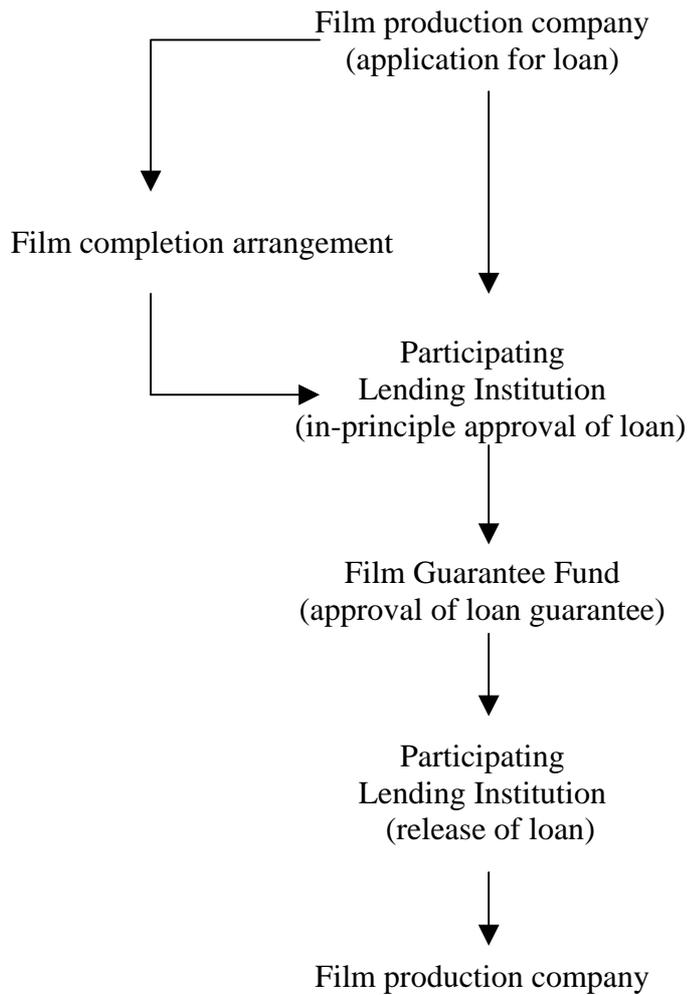
Appendix B

Key Features of the Loan Guarantee Proposal



Appendix C

Flow Chart for FGF Application Procedure



Appendix D

To : Film Services Office,
Television and Entertainment Licensing Authority
Fax : 2824 0595

**Consultation Paper on the Establishment of
the Film Guarantee Fund**

I / we have the following views on the proposal of setting up the Film Guarantee Fund :

The proposal is supported.
Comments:

The proposal is not supported.
Comments:

Other suggestions

I request that my comments and/or my identity be treated in confidence.

Signature : _____ Name : _____

Organisation/
Company : _____ Contact tel. no. : _____
(if applicable)