

ITEM FOR FINANCE COMMITTEE

LOAN FUND

HEAD 257 - EMPLOYEES COMPENSATION ASSISTANCE FUND

Subhead 101 Bridging loan to Employees Compensation Assistance Fund Board

Members are invited to approve an increase in the approved commitment from \$60 million to \$280 million to provide an additional loan of \$220 million to the Employees Compensation Assistance Fund Board.

PROBLEM

The Employees Compensation Assistance Fund Board (the Board) needs funds to tide over its cash flow problem aggravated by substantial liabilities arising from the insolvency of two of the local subsidiaries of the HIH Group of insurance companies in April 2001.

PROPOSAL

2. The Commissioner for Labour, with the support of the Secretary for Education and Manpower (SEM), proposes an increase in the approved commitment from \$60 million to \$280 million under Head 257 Subhead 101 of the Loan Fund to provide an additional loan of \$220 million to the Board to help it tide over its cash flow problem so that it could provide assistance to eligible applicants, including employers who had taken out employees' compensation (EC) insurance with the insolvent insurers.

/JUSTIFICATION

JUSTIFICATION

Financial predicament of the Board

3. The Board is financed by a levy on the premium of EC insurance. At present, a levy at 5.3% of the premium of EC insurance is collected by the Employees' Compensation Insurance Levies Management Board for distribution to three entities: the Board (1%), the Occupational Safety and Health Council (2%) and the Occupational Deafness Compensation Board (ODCB) (2.3%). The levy rate for the Board has been maintained at 1% since its inception in 1991.

4. In recent years, the Board has faced a number of applications for assistance involving common law damages that resulted in payouts of more than \$10 million for each application. At the same time, the levy income of the Board has declined because of a reduction in premium income from the construction industry arising from the completion of major infrastructure projects and the charging of lower insurance premiums due to keen competition in the insurance industry. As a result, the Board has been incurring annual operating deficits since 1996-97.

5. A table showing the annual income and expenditure of the Board from 1991 up to 31 May 2002 is at Enclosure 1.

Encl. 1

Bridging loan provided to the Board in 2001

6. The Administration saw a need to resolve the structural imbalance between the income and expenditure of the Board and started to review the Employees Compensation Assistance Scheme (the Scheme) in 1999. While we were formulating a reform package for the Scheme, the accumulated reserves of the Board dropped to a very low level in early 2000. On 16 June 2000, Members approved a bridging loan of \$60 million to the Board to help it tide over its cash flow problem until end-July 2001 when the reform package for the Scheme was expected to take effect (ref. FCR (2000-01)30). The Board drew down the loan in July 2001 and subsequently repaid the first instalment of \$10 million in accordance with the loan agreement. The outstanding balance of the bridging loan stands at \$50 million.

/Insolvency

Insolvency of the HIH Group

7. In April 2001, three local subsidiaries of the HIH Group of insurance companies went into provisional liquidation because of the insolvency of its Australian parent company. Two of them were active players in the EC insurance market in Hong Kong. Under the Employees Compensation Assistance Ordinance (ECAO), the Board has to indemnify employers against the default of insurers who have become insolvent.

8. Based on the information provided by the provisional liquidators of the HIH Group, it is estimated that the total liabilities accruing from the employment-related injury claims under the EC policies underwritten by the insolvent insurers would amount to about \$371.7 million. When the affected employers have paid the statutory compensation and common law damages to injured employees, they would submit applications to the Board for assistance. Having regard to the number of such applications already received by the Board, we expect that the Board will have to settle the bulk of these applications for assistance from employers within the coming few years.

9. Up to 31 May 2002, the Board has already paid out \$22.8 million for applications arising from the HIH insolvencies.

Reform of the Scheme

10. With a view to restoring the long-term financial viability of the Scheme, the SEM introduced the Employees Compensation Assistance (Amendment) Bill 2002 (the Amendment Bill) into the Legislative Council on 27 February 2002 to reform the Scheme. The proposed reform measures include -

- (a) introducing relief payment in lieu of assistance for common law damages;
- (b) revising downwards the interest rate for the payment of employees' compensation;
- (c) empowering the Board to join in legal proceedings to defend the claims with a view to protecting the interests of the Fund;

/(d)

- (d) revising the procedures of filing applications to the Board;
- (e) imposing surcharge on uninsured employers;
- (f) increasing the levy rate on EC insurance premium by one percentage point and crediting in full the additional levy income arising from this one percentage point increase to the Board (i.e. the rate of levy going to the Board will increase from 1% to 2% of the EC insurance premium); and
- (g) re-distributing part of the levy income from ODCB to the Board

The Second Reading debate of the Amendment Bill will be resumed on 26 June 2002.

11. As regards paragraph 10(g), in order to enhance the Board's capacity to cope with the tight cash flow arising from the HIH insolvencies over the next few years without the need to further increase the levy rate on EC insurance premium, we have proposed in the Amendment Bill that the levy rate for the ODCB should be adjusted downwards from 2.3% to 1.8% on a long-term basis and the saving of 0.5 percentage point to be re-distributed to the Board. In addition, we have proposed in the Amendment Bill that a further 0.6 percentage point of levy rate for the ODCB be redistributed to the Board for a period of five years from 2002 to 2007. Subject to the passage of the Amendment Bill, the levy rate for the Board will increase to 3.1% with effect from 1 July 2002 until 30 June 2007 and reduce to 2.5% from 1 July 2007 onwards.

Need for a further loan

12. Notwithstanding the proposed reform measures in paragraph 10 above, the Board would not have sufficient funds to meet the potential liabilities in the coming few years because of a significant increase in claims as a result of the HIH insolvencies. In the last few months of 2001-02, claims arising from the HIH insolvencies have caused the Board's reserves to drop rapidly. As at 31 May 2002, the Board held a reserve of \$18.7 million. At the rate it is going, and in the absence of further assistance, the reserves of the Board will probably be depleted by mid-2002.

13. Without sufficient funds to meet its liabilities, the Board would be required to make payments in accordance with a queuing mechanism as laid down in section 26 of the ECAO. In such event, the eligible applicants would be entitled to an interest at a relatively high rate on the outstanding amount payable. This would in effect further drain the reserves of the Board. Moreover, invoking the queuing mechanism would also cause inconvenience and possible hardships to the eligible applicants. Therefore, an additional loan is required to help the Board tide over its cash flow problem in providing assistance to eligible applicants, including the employers who could not be indemnified by default of their insurers.

Proposed terms of the additional loan

14. Having carefully assessed the projected requirements, we propose to provide an additional loan of \$220 million to the Board. In arriving at this proposal, we estimate that the potential liabilities arising from the HIH insolvencies will materialise within the next four years, of which 60% will mature for payment in the first two years beginning 2002-03 and the remaining 40% due within the next two years. As the liabilities will spread over several years for payment and the Board will have a higher levy income based on a levy rate of 3.1% for five years from July 2002 to June 2007, the proposed additional loan will be sufficient to cover the total HIH liabilities for the Board. An illustrative cash flow projection of the Board taking into account the levy increase and levy adjustment, as set out in paragraphs 10 and 11 above, and the granting of the proposed additional loan is at Enclosure 2.

Encl. 2

15. It is proposed that the additional loan of \$220 million to the Board will be subject to the following terms –

(a) **Drawdown period:**

the additional loan would be drawn down by instalments as and when necessary by 31 March 2005;

(b) **Repayment terms:**

the loan will be repaid by equal annual instalments (covering loan principal and interest) beginning on 1 April 2006, calculated on an annuity basis for a period of 10 years. The Board may repay the loan in whole or in part at any time ahead of the repayment schedule. In case the Board has unexpected cash flow problems to repay the loan, it may amend the repayment schedule or extend the loan repayment period with the prior approval of the Financial Secretary; and

/(c)

(c) **Interest rate:**

interest will be charged against the loan from the date of drawdown at Government's "no-gain-no-loss" interest rate¹. Interest accrued up to and including 31 March 2005 will be capitalised.

16. We propose that the interest rate for the additional loan should be set at the Government's "no-gain-no-loss" rate, in line with the principle that the responsibility to pay compensation should rest with employers. This is also the case for the bridging loan of \$60 million approved by this Committee.

17. As the Board would not be able to repay the outstanding balance of \$50 million of the current bridging loan in accordance with the existing loan agreement, the repayment of this outstanding loan balance will be rescheduled in line with the repayment terms of the proposed additional loan as set out in paragraph 15(b) above.

18. According to the cash flow projection at Enclosure 2, the Board will be able to fully repay the Government loan and interest by 2015-16. This projection is built on the premises that the measures to restore the viability of the Board as set out in paragraphs 10 and 11 will come into effect later this year, and that there will be no major incidents leading to sudden upsurges in claims or sharp decline in levy income over the loan repayment period.

FINANCIAL IMPLICATIONS

19. The proposal to grant an additional loan at Government's "no-gain-no-loss" interest rate will not have additional financial implications for Government.

/BACKGROUND

¹ The Government's "no-gain-no-loss" interest rate is set at 2% below the average best lending rate of the note-issuing banks. .

BACKGROUND INFORMATION

20. The Board was established on 1 July 1991 under the ECAO to administer the Employees Compensation Assistance Fund for the benefits of persons eligible for payment under the ECAO. Under the Ordinance, injured employees or family members of deceased employees who are unable to receive employees' compensation or damages from their employers or insurers after exhausting legal and financially viable means of recovery may apply for payment from the Fund. The ECAO also protects employers against default of their insurers who become insolvent.

21. We consulted the Legislative Council Panel on Manpower on 15 November 2001 and 20 December 2001 on the rescue package for the Scheme which includes extending an additional government loan of \$220 million to the Board. Members generally supported the proposed measures.

Education and Manpower Bureau
June 2002

**Employees Compensation Assistance Fund Board
Income and expenditure account**

	91/92 (1.7.91 - 31.3.92)	92/93	93/94	94/95	95/96	96/97	97/98	98/99	99/2000	00/01	01/02	02/03 (as at 31.5.02)
No. of Cases Approved												
<i>Non-HIH Cases</i>	27	12	12	20	18	19	23	28	35	28	24	0
<i>HIH Cases</i>	0	0	0	0	0	0	0	0	0	0	205	0
Total income	\$16.7m	\$15.7m	\$21.8m	\$33.8m	\$31.7m	\$23.9m	\$28.5m	\$22.4m	\$21.5m	\$26.0m	\$29.8m	\$0.2m
<i>Levy income</i>	\$16.5m	\$15m	\$20.6m	\$31.3m	\$27.8m	\$20.9m	\$23.7m	\$20m	\$19.8m	\$25.2m	\$29.2m	\$0
<i>Interest and other income</i>	\$0.2m	\$0.7m	\$1.2m	\$2.5m	\$3.9m	\$3m	\$4.8m	\$2.4m	\$1.7m	\$0.8m	\$0.6m	\$0.2m
Total Expenditure ^A	\$2.6m	\$4.5m	\$23.8m	\$10.8m	\$11.2m	\$35.4m	\$49.7m	\$29.1m	\$40.5m	\$31m	\$64.5m	\$0.19m
<i>Non-HIH cases</i>	\$3.37m	\$4.29m	\$8.67m	\$10.42m	\$24.41m	\$34.16m	\$48.06m	\$26.51m	\$37.9m	\$28.07m	\$32.03m	\$0
<i>HIH cases</i>	---	---	---	---	---	---	---	---	---	---	\$22.77m	\$0
<i>Administrative Expense</i>	\$0.16m	\$0.4m	\$0.23m	\$0.43m	\$0.74m	\$1.2m	\$2.4m	\$2.55m	\$2.6m	\$2.9m	\$9.7m	\$0.19m
Surplus/Deficit	\$14.1m	\$11.2m	-\$2m	\$23m	\$20.5m	-\$11.5m	-\$21.2m	-\$6.7m	-\$19m	-\$5m	-\$34.7m	\$0.01m
Accumulated Fund	\$14.1m	\$25.3m	\$23.3m	\$46.3m	\$66.8m	\$55.3m	\$34.1m	\$27.4m	\$8.4m	\$3.4m	\$18.7m^B	\$18.7m

Notes

- A The total expenditure indicates the amount of assistance paid in a specific year and may cover the balance of unpaid items of cases assisted in the previous year(s). This total expenditure net of administrative expense may not tally with the breakdown by Non-HIH and HIH cases which reflects the amount of compensation assistance approved in the year.
- B This takes into account a bridging loan of \$60M provided by the Government and drawn down by the Board in July 2001, and the first repayment of \$10M to the Government later in the same financial year.

Employees Compensation Assistance Fund Board

Enclosure 2 to FCR(2002-03)25

Cash Flow Projection for 2002-03 to 2016-17

Cash flow (\$M)

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
Levy rate	3.1%	3.1%	3.1%	3.1%	3.1%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
Income															
Levy	59.450	89.900	89.900	89.900	89.900	81.200	72.500	72.500	72.500	72.500	72.500	72.500	72.500	72.500	72.500
Recoveries [1]	0.078	0.085	0.081	0.081	0.077	0.077	0.077	0.077	0.077	37.247	0.077	0.077	0.077	0.077	0.077
Surcharge [2]	1.500	1.500	1.500	1.500	1.500	1.500	1.500	1.500	1.500	1.500	1.500	1.500	1.500	1.500	1.500
Investment income	1.074	1.608	1.650	1.626	1.740	1.931	1.864	1.662	1.454	1.806	2.168	1.976	1.777	1.573	1.990
Total	62.102	93.093	93.131	93.107	93.217	84.709	75.941	75.740	75.532	113.053	76.246	76.053	75.854	75.650	76.067
Expenditure															
Payouts (statutory compensation)	(18.380)	(18.380)	(12.718)	(12.718)	(10.880)	(10.880)	(10.880)	(10.880)	(10.880)	(10.880)	(10.880)	(10.880)	(10.880)	(10.880)	(10.880)
Payouts (relief payment)	(20.600)	(24.200)	(27.800)	(27.800)	(27.800)	(27.800)	(27.800)	(27.800)	(27.800)	(27.800)	(27.800)	(27.800)	(27.800)	(27.800)	(27.800)
Payouts (HIH cases)	(104.670)	(104.670)	(87.225)	(52.335)	-	-	-	-	-	-	-	-	-	-	-
Administrative expenses	(4.270)	(4.424)	(3.987)	(3.289)	(2.663)	(2.663)	(2.663)	(2.663)	(2.663)	(2.663)	(2.663)	(2.663)	(2.663)	(2.663)	(2.663)
Total	(147.920)	(151.674)	(131.730)	(96.142)	(41.343)	(41.343)	(41.343)	(41.343)	(41.343)	(41.343)	(41.343)	(41.343)	(41.343)	(41.343)	(41.343)
Net operating cash flow	(85.818)	(58.581)	(38.599)	(3.035)	51.874	43.366	34.598	34.396	34.188	71.710	34.902	34.710	34.511	34.307	34.724
Further loans from Government	120.000	60.000	40.000	-	-	-	-	-	-	-	-	-	-	-	-
Repayment of loan and interest [3]	-	-	-	-	(41.227)	(41.227)	(41.227)	(41.227)	(41.227)	(41.227)	(41.227)	(41.227)	(41.227)	(41.227)	-
Net cash flow	34.182	1.419	1.401	(3.035)	10.647	2.138	(6.629)	(6.831)	(7.039)	30.483	(6.325)	(6.518)	(6.716)	(6.921)	34.724
Accumulated funds brought forward	18.700	52.882	54.301	55.702	52.667	63.313	65.452	58.823	51.992	44.953	75.436	69.111	62.593	55.877	48.956
Accumulated funds carried forward	52.882	54.301	55.702	52.667	63.313	65.452	58.823	51.992	44.953	75.436	69.111	62.593	55.877	48.956	83.680

Notes :

[1] The Employees Compensation Assistance Fund Board may be able to recover from the employers or insurers in respect of the amount already paid through subrogation.

[2] It is proposed under the Employees Compensation Assistance (Amendment) Bill 2002 that an employer who fails to take out employees compensation insurance shall be liable to pay a surcharge to the Board

[3] Assuming that the Government's "no-gain-no-loss" interest rate is 5.5% p.a.