

ITEM FOR FINANCE COMMITTEE

LOAN FUND

NEW HEAD "PROTECTION OF WAGES ON INSOLVENCY FUND"

New Subhead "Bridging loan to Protection of Wages On Insolvency Fund Board"

Members are invited to approve the creation of a new commitment of \$695 million under a new Head "Protection of Wages on Insolvency Fund" and Subhead "Bridging loan to Protection of Wages on Insolvency Fund Board" of the Loan Fund, to provide a bridging loan to the Protection of Wages on Insolvency Fund Board.

PROBLEM

The Protection of Wages on Insolvency Fund Board (the Board) needs funds to tide over its cash flow problem as a result of a substantial increase in the number of successful claims for payment under the Protection of Wages on Insolvency Ordinance, Cap. 380 (the Ordinance).

PROPOSAL

2. The Commissioner for Labour, with the support of the Secretary for Economic Development and Labour, proposes to provide a bridging loan of \$695 million to the Board to enable it to tide over its cash flow problem in meeting its financial commitments under the Ordinance.

/JUSTIFICATION

JUSTIFICATION

Importance of meeting claims payment under the Ordinance

3. Since its establishment in 1985, the Protection of Wages on Insolvency Fund (the Fund) has made significant contribution to maintaining Hong Kong's harmonious employer-employee relationship and social stability by providing timely relief to employees whose employers have become insolvent.

The case for a bridging loan

4. The Fund has been suffering from annual deficits since the Asian financial crisis in late 1997. The sharp increase in claims payment has not been matched by a similar increase in the Fund's income. As a result, the Fund's reserve dropped to \$195 million at end-March 2002. In an attempt to restore the financial health of the Fund, the Business Registration Certificate (BRC) levy has been increased from \$250 to \$600 per annum with effect from May 2002.

5. While this curative process of putting the Fund back on an even financial keel began in May this year, the prevailing difficult economic climate has continued to exert great pressure on the Fund. Between June and August this year, the number of new applications rose to 7 660, an increase of 65% over the figure of 4 631 for the same period last year. The continuing increase in the number of applications received has pushed the number of outstanding applications as at end-July and end-August 2002 to an all-time high figure of 14 000.

6. The collapse of the Treasure Restaurant Group involving 2 100 employees in June this year dealt a severe blow to the Fund. With forthcoming payments anticipated for the outstanding applications for this and other cases, and with the reserve of the Fund falling to \$113 million at the end of September 2002, the Board will be facing a serious cash flow problem in the near future as the Fund will be fully depleted before the effect of the increase in BRC levy (paragraph 4 above) is fully realised to help restore the financial viability of the Fund. To help the Board tide over this cash flow problem, we see a need for the Government to provide a bridging loan.

Proposed terms of the bridging loan

7. Having carefully assessed the projected requirements, we propose to provide a bridging loan of \$695 million to the Board. An illustrative cash flow projection of the Board taking into account the granting of the proposed loan is at Enclosure 1. It is proposed that the loan of \$695 million to the Board will be subject to the following terms -

Encl. 1

/(a)

(a) **Drawdown period:**

the loan would be drawn down by instalments as and when necessary by 31 March 2006;

(b) **Repayment terms:**

the loan will be repaid by half-yearly equal instalments (covering loan principal and interest) in nine years beginning on 1 April 2007. Interest accrued up to and including 30 September 2006 may be capitalised. 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) **Interest rate:**

interest will be charged against the loan from the date of drawdown at Government's "no-gain-no-loss" interest rate¹.

8. We propose that the interest rate for the bridging loan should be set at the Government's "no-gain-no-loss" interest rate, in line with the principle that it is the responsibility of employers to pay wages and termination benefits to employees.

9. According to the cash flow projection at Enclosure 1, the Board is expected to be able to repay the loan in full by 2015-16. Specifically, as the Mandatory Provident Fund (MPF) contribution builds up, a large part of the ex-gratia payment for severance payment, payable under the Fund, will be met by MPF savings. Besides, as the Hong Kong economy picks up over time, the number of insolvencies is expected to taper off, thus improving the Fund's financial position. The Administration, in conjunction with the Board, will closely monitor the financial situation of the Fund to ensure its long-term financial viability and to review the need for adjusting the BRC levy in future years.

/10.

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

Encl. 2

10. To ensure that the Fund is not subject to abuse, we have put in place stringent vetting mechanisms. The Fund screens out unqualified cases and on average 12% of the applications are so screened out. Even for applications screened in, the amount of payments approved represent only 64% of the claimed amount. There are also provisions in the Companies Ordinance to guard against employers taking refuge under limited liability and dishonestly shifting their wage liability to the Fund. At the same time, the Labour Department is stepping up prosecution against wage offences and enhancing public education on the early reporting of non-payment of wages. A note on the existing safeguards against possible abuse of the Fund is at Enclosure 2. The Administration, together with the Board, will continue to consider further measures to reduce possible abuse.

FINANCIAL IMPLICATIONS

11. The proposal to grant a one-off bridging loan at Government's "no-gain-no-loss" interest rate will not have additional financial implications for the Government.

BACKGROUND INFORMATION

12. The Board was set up in 1985 under the Ordinance to provide timely relief in the form of ex-gratia payment for wages, wages in lieu of notice and severance payment owed to employees by their insolvent employers.

13. The Fund is administered by the Board and is mainly financed by a flat annual BRC levy (currently at \$600). Other sources of income include money recovered from the remaining assets of insolvent employers through subrogation and returns from deposits of the Fund's balance. For 2001-02, the total income was \$201 million and the percentage accounted for by levy income, subrogation income and interest/investment income was 85%, 10% and 5% respectively.

14. We consulted the Legislative Council Panel on Manpower on 31 October 2002 and Members supported the proposed bridging loan.

**Protection of Wages on Insolvency Fund Board
Cash Flow Projection for 2002-03 to 2015-16**

Cash flow (\$M)

	<u>2002-03</u>	<u>2003-04</u>	<u>2004-05</u>	<u>2005-06</u>	<u>2006-07</u>	<u>2007-08</u>	<u>2008-09</u>	<u>2009-10</u>	<u>2010-11</u>	<u>2011-12</u>	<u>2012-13</u>	<u>2013-14</u>	<u>2014-15</u>	<u>2015-16</u>
Income														
Levy income on BRC	383.9	414.0	414.0	414.0	414.0	414.0	414.0	414.0	414.0	414.0	414.0	414.0	414.0	414.0
Subrogation income	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Other income	2.7	5.8	5.9	5.9	6.2	4.2	3.7	3.7	3.7	3.7	3.8	3.8	3.8	3.9
Total	406.6	439.8	439.9	439.9	440.2	438.2	437.7	437.7	437.7	437.7	437.8	437.8	437.8	437.9
Expenditure														
Claims payment	660.0	660.0	607.2	554.4	475.2	396.0	356.4	356.4	356.4	356.4	356.4	356.4	356.4	356.4
Less: Estimated MPF savings	-	(30.5)	(56.1)	(76.8)	(76.8)	(64.0)	(57.6)	(57.6)	(57.6)	(57.6)	(57.6)	(57.6)	(57.6)	(57.6)
	660.0	629.5	551.1	477.6	398.4	332.0	298.8	298.8	298.8	298.8	298.8	298.8	298.8	298.8
Administrative expenses	24.3	24.3	24.3	24.3	24.3	24.3	24.3	24.3	22.2	22.2	22.2	22.2	22.2	22.2
Total	684.3	653.8	575.4	501.9	422.7	356.3	323.1	323.1	321.0	321.0	321.0	321.0	321.0	321.0
Net operating cash flow	(277.7)	(214.0)	(135.5)	(62.0)	17.5	81.9	114.6	114.6	116.7	116.7	116.8	116.8	116.8	116.9
Loan from Government	280.0	215.0	135.0	65.0	-	-	-	-	-	-	-	-	-	-
Repayment of loan and interest [Note]	-	-	-	-	-	(115.7)	(115.7)	(115.7)	(115.7)	(115.7)	(115.7)	(115.7)	(115.7)	(115.7)
Net cash flow	2.3	1.0	(0.5)	3.0	17.5	(33.8)	(1.1)	(1.1)	1.0	1.0	1.1	1.1	1.1	1.2
Accumulated funds brought forward	194.9	197.2	198.2	197.7	200.7	218.2	184.4	183.3	182.2	183.2	184.2	185.3	186.4	187.5
Accumulated funds carried forward	197.2	198.2	197.7	200.7	218.2	184.4	183.3	182.2	183.2	184.2	185.3	186.4	187.5	188.7

Note: Assuming that the Government's "no-gain-no-loss" interest rate is 5.5% p.a.

**Safeguards Against Possible Abuse of
Protection of Wages on Insolvency Fund (PWIF)**

Employers taking refuge under limited liabilities and dishonestly shifting wage liabilities to PWIF

Safeguards under the Companies Ordinance (Cap 32)

- Under Section 275 of the Companies Ordinance, the court may, in the course of a company's winding up, declare a person personally responsible, without any limitation of liability, for all debts and liabilities of the company if he has an intent to defraud creditors (including employees who are owed wages) when carrying on any business of the company. The criminal liability under this section is a maximum penalty of unlimited fine and five years' imprisonment if prosecuted on indictment and a fine of \$150,000 and twelve months' imprisonment if prosecuted summarily.
- Section 273 of the Companies Ordinance provides that any person who conceals or removes any of the company's property before the winding-up with intent to defraud creditors shall be guilty of an offence. The maximum penalty is a fine of \$150,000 and two years' imprisonment if prosecuted on indictment and a fine at level 5 (\$25,001 - \$50,000) and six months' imprisonment if prosecuted summarily.
- The court is empowered under Section 168H of the Companies Ordinance to make disqualification orders against any person to act as company director if it is satisfied that the person is or has been a director of a company which has at any time become insolvent and that his conduct as a director of that company, either taken alone or taken together with his conduct as a director of any other company, makes him unfit to be concerned in the management of a company. The maximum period of disqualification is fifteen years. (Since 1994, the Official Receiver has obtained more than 260 disqualification orders and the average length of disqualification is 3.2 years. The Labour Department is in close touch with the Official Receiver's Office on directors involved in serial insolvencies.)

/Applicants

Applicants colluding with employers in making claims and applicants falsifying claims

Safeguards under the Protection of Wages on Insolvency Ordinance (PWIO) (Cap 380)

- Applicants applying for ex-gratia payment from PWIF must provide truthful information. It is an offence under Section 26 of PWIO to make false statements or provide false information. The maximum penalty is a fine of \$50,000 and three months' imprisonment.

Stringent vetting mechanism for applications for PWIF

- There must be a presentation of winding-up or bankruptcy petition against the employer. PWIF screens out unqualified cases and on average 12% of the applications are so screened out. Even for applications screened in, approved payments represent only 64% of the claimed amount.

Vigorous prosecution against wage offences

- Under Sections 23 and 25 of the Employment Ordinance, an employer must effect wage payments not later than seven days when wages become due. Penalty for the offence is a fine of \$200,000 and imprisonment for one year.
- Vigorous prosecution against wage offence can nip potential problems in the bud by reducing recourse to and liability on the PWIF. The number of summons taken out by the Labour Department has increased from 58 in 1999 to 97 in 2001 and 138 in the first nine months of this year.
- The Labour Department has mounted a promotion campaign to encourage early reporting of non-payment of wages. This includes TV and radio messages and special site visits.