For discussion
6 July 2009

LEGISLATIVE COUNCIL
PANEL ON FINANCIAL AFFAIRS

Review of Mandatory Provident Fund Schemes Compensation Fund

PURPOSE

This paper seeks Members' views on the review conducted by the Mandatory Provident Fund Schemes Authority ("MPFA") on the optimal level of the Mandatory Provident Fund Schemes Compensation Fund ("MPF Compensation Fund").

REVIEW RESULTS

Background

2. The MPF Compensation Fund is established under section 17(1) of the Mandatory Provident Fund Schemes Ordinance (Cap. 485) for the purpose of compensating scheme members (and other persons who have beneficial interests in the schemes) for losses of accrued benefits that are attributable to misfeasance or illegal conduct committed by the approved trustees or other persons concerned with the administration of those schemes. It covers relevant losses in accrued benefits arising from both mandatory and voluntary contributions without any limit.

3. As prescribed in section 188 of the Mandatory Provident Fund Schemes (General) Regulation, the MPF Compensation Fund's annual levy rate is set at 0.03% of the net asset value of the scheme assets. Apart from the annual levy contributed by MPF trustees from the scheme assets, the Government also provided a one-off grant of HK$600 million as seed money to the MPF Compensation Fund in 1999.

4. As of 30 April 2009, the net asset value of the MPF Compensation Fund stood at about HK$1,200 million. No claim has been made from the MPF Compensation Fund so far.

Review of local and overseas experience

5. In conducting the review on the optimal level of the MPF Compensation Fund, the MPFA has made reference to local experience of compensation funds established for other segments of the financial market, viz. the Investor Compensation Fund ("ICF") and the Deposit Protection Scheme ("DPS") Fund for the securities and banking sectors respectively, as well as overseas experience of compensation funds established for their respective pension system.

Local experience

6. In respect of the securities sector, the ICF was established under the Securities and Futures Ordinance (Cap. 571) in 2003 to pay compensation to those investors who suffer pecuniary losses as a result of default of a licensed intermediary or authorized financial institution in relation to products traded on the exchanges operated by the Hong Kong Exchanges and Clearing Limited in Hong Kong, with a compensation limit of HK$150,000 per investor in respect of both securities and futures trading. The ICF imposes a levy when the net asset value of the ICF falls below HK$1 billion, and suspends the levy when the ICF value exceeds HK$1.4 billion. For securities, the levy rate is set at 0.002% on each side of transactions. For futures contracts, it is HK$0.5 per side of a contract or HK$0.1 per side of a mini contract or stock futures contract. The optimal level of the ICF is based on an analysis of the funding needs arising from past claims prior to the establishment of the ICF.

7. For the banking sector, the DPS was launched in September 2006 to protect depositors and maintain the stability of the banking system. Like the ICF, there is a limit on compensation, set at HK$100,000 per depositor concerning the eligible deposits placed with each DPS member bank. Although a temporary measure was introduced by the Government in October 2008 to provide full protection to all deposits held with Authorized Institutions in Hong Kong until the end of 2010 as a precautionary measure against the global financial instability, the portion of protection borne by DPS remains unchanged. The target size of the DPS Fund is 0.3% of the total amount of relevant deposits in Hong Kong (translating into a fund size of approximately HK$1.5 billion based on the latest figures provided by the DPS members). Unlike the ICF where a standard rate of levy is charged, differential contributions are made by different DPS members to the DPS Fund based on that supervisory rating. The determination of the target size of the DPS Fund and thus levies payable by the DPS members are based on

the expected cost of the DPS which is generated from a statistical model by simulating the possible cost outcomes from the inputs of amount of relevant deposits and credit ratings of the DPS members. The Hong Kong Deposit Protection Board has recently consulted the public on recommendations to enhance the DPS framework in a number of areas including protection limit, compensation calculation basis, etc.

Overseas experience

8. There are not many pension systems overseas which have set up compensation funds to protect the public against frauds. For example, the United States, Canada and Singapore do not have such compensation funds for defined contribution pension schemes. As regards Australia and the United Kingdom which are operating compensation funds for frauds under their pension systems, their models adopt an ex-post approach whereby no initial reserve is built up and a levy is only imposed post-event to cover the payments made. Therefore, the question of an optimal level of reserve does not arise for both the Australian and the British models.

Application to the MPF Compensation Fund

9. Both the ICF and the DPS Fund adopt a hybrid funding approach which provides for ex-ante and ex-post collection of funds to meet the need for compensation payments. Under the hybrid approach, a reasonable fund reserve is built up with reference to a pre-set benchmark so that there is a ready sum for immediate payment when the need arises (i.e. the ex-ante portion). In the event of a large-scale payment from the fund, a post-compensation levy can be charged after the payment is made to restore the fund to a benchmark balance (i.e. the ex-post portion). This is unlike the experience of pension systems in Australia and the United Kingdom which adopt an ex-post funding approach. Under the ex-post approach, no pre-existing fund is established and a levy would only be imposed to recoup payments made by the fund. This type of arrangement may be most appropriate where there is no reasonable basis to estimate how much compensation may be needed over time and where alternative funding is readily available as necessary.

10. The experience of the ICF and the DPS Fund in adopting a hybrid funding approach provides reference for the current exercise to review the optimal level of reserve for the MPF Compensation Fund. We however note that both the ICF and the DPS Fund are set up to cater for losses arising from defaults. This is different from the stated purpose of the MPF Compensation Fund, which is to compensate for losses arising from

misfeasance or illegal conduct of MPF service providers. Besides, both funds determine the optimal reserve levels and levy rates using assessment models based on claims experience or probability of defaults. In contrast, the MPF System has only a short history and there have been no claims from the MPF Compensation Fund. Due to the unique nature of the MPF System and the MPF Compensation Fund, we have not been able to identify any relevant claim experience from overseas jurisdictions which may be used for our modeling purpose.

Possible parameters and latest market development

11. Due to the absence of relevant data from local or overseas past claims experience for conducting modeling similar to that of the ICF and the DPS Fund, the MPFA has examined the feasibility of determining the optimal reserve level of the MPF Compensation Fund upon which collection of levy may cease, and the trigger level upon which collection of levy should be re-activated to restore the fund balance where payments have been made, by making reference to some objective parameters. Possible parameters indicating the extent of coverage of the MPF Compensation Fund when a relevant event occurs include -

(a) percentage of total scheme assets;
(b) percentage of assets held by MPF trustees;
(c) percentage of assets held by MPF schemes; and
(d) percentage of assets held by MPF constituent funds.

12. There are altogether 17 MPF trustees operating 38 MPF schemes and 340 constituent funds under the MPF System as at 30 April 2009. Based on the above parameters, the existing level of the MPF Compensation Fund of about HK$1,200 million may provide coverage as shown below -

(a) 0.5% of total MPF scheme assets;
(b) 2%-9% of the assets held by each of the six largest MPF trustees, or all of the assets held by each of the five smallest MPF trustees;
(c) 4%-9% of the assets held by each of the seven largest MPF schemes, or all of the assets held by each of the 11 smallest MPF schemes; or
(d) 15%-29% of the assets held by each of the 10 largest MPF constituent funds, or 100% of the assets held by each of the other 283 MPF constituent funds.

13. The MPFA has considered the above parameters in the light of recent financial sector developments, notably the global financial crisis. In the period since late 2007, financial markets have faced a period of substantial losses and extreme volatility. A number of established financial institutions overseas were exposed to default risks and there have been widespread concerns about the sustainability of the financial systems to tackle the challenges. In this relatively uncertain economic and financial environment, scheme members may have more concern about the financial soundness of their MPF service providers and, in turn, the protection of their MPF assets.

Proposal

14. While operation of the MPF System has remained sound amidst the crisis and the MPFA has stepped up its surveillance work and supervision of MPF trustees to enhance prudential regulation, in the light of the considerations set out in paragraph 13 above, we consider that it would be prudent to retain the current levy rate of 0.03% of the net asset value of the scheme assets and review the issue again in 18 to 24 months' time.

15. In particular, given the uncertainty arising from the current financial turmoil, it might not be seen as a prudent step to stop building up the MPF Compensation Fund in this critical period. It may be seen as more prudent to consider suspending the levy after the economic and market conditions have stabilized and any major resultant implications have become apparent. Besides, the levy is a relatively small amount on a per member basis. The levy is only HK$19 a year when calculated on the basis of an average amount of HK$64,000 held in assets by each scheme member for the past six months ending on 30 April 2009.

16. In the next 18 – 24 months, the MPFA will continue to closely monitor market developments and take into account those developments in working out a mechanism to determine the optimal level of the MPF Compensation Fund with reference to relevant benchmarks, having regard to those parameters set out in paragraph 11. The MPFA will also solicit stakeholders' views in the process.

RELATED MATTERS

Scope of Fund

17. The MPFA has taken the opportunity of the review to examine if the scope of the MPF Compensation Fund should be extended to cover default mandatory contributions owed by insolvent employer companies, in the light of a suggestion made by a LegCo member during the scrutiny of the MPF Schemes (Amendment) (No.2) Bill 2007 in 2008.

18. After review, we agree with the MPFA's recommendation not to extend the scope of the MPF Compensation Fund because the proposed extension would fundamentally change the objective of the MPF Compensation Fund. A higher levy rate is likely to be required in order to meet the demand for more payouts arising from the extended scope. Other important considerations for the proposed extension are set out below -

(a) The proposed extension involves the controversial issue of whether contributions made by law-abiding employers and employees for retirement protection purpose should be used to settle default contributions owed by non-compliant and insolvent employers. This raises equity concerns which have to be carefully considered by the stakeholders involved.

(b) There is a risk that default contribution cases may increase since unscrupulous employers may abuse the MPF Compensation Fund and evade their MPF contribution responsibility.

(c) Employees may have less incentive to report default contributions by their employers, thus hampering the effectiveness of MPFA's enforcement actions.

19. The existing MPF legislation has already provided the MPFA with relevant powers to combat default contributions through a combination of civil actions and criminal prosecution. The MPFA will continue to undertake stringent enforcement actions to recover outstanding contributions and contribution surcharges from the defaulting employers on behalf of employees through the civil route. At the same time, prosecution actions will be initiated where appropriate.

Mandatory Provident Fund Schemes Authority
Financial Services and the Treasury Bureau
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