立法會
*Legislative Council*

LC Paper No. CB(1)350/11-12

Ref: CB1/PL/FA

**Panel on Financial Affairs**

**Special meeting on 21 November 2011**

# Background brief on Mandatory Provident Fund Schemes Compensation Fund

## Purpose

This paper provides background information on the establishment and review of the Mandatory Provident Fund Schemes Compensation Fund (the Compensation Fund). It also summarizes the views and concerns of members when the subject was discussed at the Panel on Financial Affairs (the Panel).

## Background

2. The Compensation Fund was established under section 17(1) of the Mandatory Provident Fund Schemes Ordinance (MPFSO) (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 by other persons concerned with the administration of the schemes. It covers relevant losses in accrued benefits arising from both mandatory and voluntary contributions without any limit.

3. Regarding the operation of the Compensation Fund, MPFSO stipulates[1] that the Mandatory Provident Fund Schemes Authority (MPFA) must apply to the Court of First Instance if it has reasonable grounds to believe that a loss in accrued benefits has occurred as a result of misfeasance or illegal conduct and that the matter has not been resolved to the satisfaction of the person who

[1] Sections 17B and 17C of MPFSO

suffers from the loss. If the Court determines that there is misfeasance or illegal conduct, MPFA shall compensate the scheme members or their beneficiaries who have suffered accrued benefit losses in accordance with the order made by the Court.

4. MPFSO provides[2] that MPFA may appoint administrators for the Compensation Fund, but if there are no such administrators, MPFA must administer the Fund. According to MPFA's 2010-11 annual report, MPFA has been appointed as the administrator of the Compensation Fund until 31 March 2013.

5. The Government provided a one-off grant of $600 million as seed money to the Compensation Fund in 1999. As prescribed under section 188 of the Mandatory Provident Fund Schemes (General) Regulation (Cap. 485A), the annual levy payable by the approved trustee of a registered scheme for the purpose of the Compensation Fund is 0.03% of the net asset value of scheme assets. This levy rate has been in force since the commencement of the MPF System in 2000. At the time of establishing the Compensation Fund, it was envisaged that the Compensation Fund could cease to collect levies once the level of the accumulated reserve reached $900 million.

6. As at 31 March 2011, the net asset value of the Compensation Fund, including the $600 million seed money from the Government, the levies collected and investment returns, was around $1,516 million.

## Review of the Compensation Fund in 2006

### Review findings

7. On 3 July 2006, MPFA briefed the Panel on its review of the optimum level and the levy rate of the Compensation Fund. As advised by MPFA, the initial target level of $900 million was set arbitrarily, given that there were no such claims in overseas countries and there were no statistics overseas that could be used to estimate the size of the Compensation Fund required. While it was estimated in 1997 that it would take eight to 10 years for the Compensation Fund to build up a reserve of $900 million, the Fund reached this level on 30 June 2006. This was mainly because the growth of MPF schemes assets had substantially exceeded the initial estimates.

[2] Section 17(2) of MPFSO

8. The findings of MPFA's review were as follows:

(a) As MPF schemes assets had been growing at a significantly faster rate than initially projected, it would be prudent to keep a larger pool of reserves in the Compensation Fund for protection coverage.

(b) The MPF System was still in a phase of rapid development after implementation for only five years. It would take at least another three to five years to observe the development of the market as well as to refine and improve the System to a more mature stage.

(c) No claim had been made to the Compensation Fund so far. Without any claims experience, there was not sufficient information to build a suitable model to determine the optimum level of the Compensation Fund.

(d) The levy was still an insignificant amount on a per member basis, with an annual average impact of the levy on each enrolled scheme member at about $22 in 2006.

9. In the light of the findings, MPFA considered it prudent to retain the current levy rate of 0.03%, and proposed that the issue be reviewed again in 36 months' time.

<u>Deliberations of the Panel</u>

10. During the Panel discussion on 3 July 2006, members in general were concerned that despite the insignificant amount of levy to be paid by individual scheme members, it would be unfair to them if they were required to pay the levy continuously due to the absence of a target level of the Compensation Fund. Members urged MPFA to work out as soon as possible the optimum size of the Compensation Fund or a model/mechanism for determining the optimum level of the Fund. In this regard, a member suggested that the target level of the Compensation Fund be pitched at a certain percentage of the total asset value of MPF schemes.

11. Pursuant to the request of Panel members, MPFA provided a progress report (LC Paper No. CB(1)497/07-08(01) in December 2007 on its review of the optimum level of the Compensation Fund. MPFA stated in the progress report that the amount of voluntary contributions as a percentage of mandatory contributions had been increasing, from about 9% in 2002 to 12.8% in 2006. The continued increase in the rate of growth for both mandatory and voluntary

MPF contributions as well as the total asset size of MPF funds indicated that it would be prudent to maintain collection of levy to ensure that the Compensation Fund offered reasonable protection cover for scheme members.

12. On a member's concern about the investment strategy for the Compensation Fund, MPFA advised that the investment strategy followed a prudent principle with the objective of catching up with the rate of inflation. About 70% of the reserves were placed in fixed deposits, 10% in bonds and 5% in equities.

## Review of the Compensation Fund in 2009

### Review findings

13. MPFA conducted another review of the Compensation Fund in 2009 and briefed the Panel on the matter on 6 July 2009. MPFA advised that as at 30 April 2009, the net asset value of the Compensation Fund stood at about $1,200 million, and no claim had been made to the Compensation Fund so far. In reviewing the optimum level of the Compensation Fund, MPFA had made reference to local experience of compensation funds established for other segments of the financial market, viz. the Investor Compensation Fund (ICF) for the securities sector and the Deposit Protection Scheme (DPS) Fund for the banking sector, as well as overseas experience of compensation funds established for their respective pension systems.

14. MPFA noted that both the ICF and DPS were set up to cater for losses arising from defaults, which was different from the stated purpose of the Compensation Fund of providing compensation for losses arising from misfeasance or illegal conduct of MPF service providers. Besides, both funds determined the optimum reserve levels and levy rates using assessment models based on claims experience or probability of defaults. In contrast, the MPF System had a shorter history and there had not been any claim made to the Compensation Fund.

15. As regards overseas experience, MPFA noted that there were not many pension systems overseas which had set up compensation funds to protect the public against frauds. While Australia and the United Kingdom were operating compensation funds for frauds under their pensions systems, their models adopted an ex-post approach whereby no initial reserve was built up and a levy was only imposed post-event to cover the payments made. The question of an optimum level of reserves did not arise under this funding approach.

16. In the absence of relevant data from local or overseas past claim experience for conducting modeling similar to that of the ICF and DPS Fund, MPFA had examined the feasibility of determining the optimum reserve level of the Compensation Fund by making reference to certain objective parameters which indicated the extent of coverage of the Compensation Fund when a relevant event occurred[3]. After considering those parameters and the developments of the financial sector since late 2007, notably the global financial crisis, MPFA considered it prudent to continue collecting the levy at the rate of 0.03% of the net asset value of scheme assets, and revisit the issue again in 18 to 24 months' time.

17. MPFA also took the opportunity of the review to examine whether the scope of the Compensation Fund should be extended to cover default mandatory contributions owed by insolvent employer companies, in the light of a relevant suggestion made a Member in 2008 during the scrutiny of the MPF Schemes (Amendment) (No. 2) Bill 2007. The Administration supported MPFA's conclusion that the scope of the MPF Compensation Fund should not be extended on account of the following:

(a) The proposed extension would fundamentally change the objective of the Compensation Fund;

(b) A higher levy rate was likely to be required in order to meet the demand for more payouts arising from the extended scope;

(c) The extension would involve equity concerns as to whether the contributions made by law-abiding employers and employees for retirement protection purpose should be used to settle default contributions owed by insolvent employers;

(d) There was a risk of an increase in default cases as unscrupulous employers might abuse the Compensation Fund and evade their MPF contribution responsibility; and

(e) Employees might have less incentive to report default contributions by their employers.

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[3] The parameters cited in the Administration's paper include: (a) percentage of total MPF 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.

Deliberations of the Panel

18. During the Panel discussion on 6 July 2009, some members urged MPFA to consider suspending the collection of levy for the Compensation Fund as soon as possible. In this regard, a member asked whether MPFA would consider adopting the ex-post funding approach, and whether it would be more cost-effective to provide insurance coverage to protect MPF scheme members. Another member considered it fair to collect levy for the Fund from approved trustees, rather than from scheme members, and the levy rate for individual trustees could be determined on the basis of credit ratings assigned by MPFA. There was a view that MPFA could minimize the risk of compensation by stepping up its supervisory efforts to ensure compliance and proper conduct of approved trustees.

19. MPFA advised that given the relatively uncertain economic and financial environment, it might not be opportune to stop building up the Compensation Fund. As the Fund had started with the collection of levy to build up a reserve, instead of adopting the ex-post approach, consideration might be given to moving to a hybrid funding approach under which a reserve was built up based on a pre-set benchmark and a post-compensation levy could be charged after any large-scale payment from the Fund. Given the absence of past claim experience for conducting modeling, the premium for taking out insurance for MPF scheme members would likely be on the high side. To ensure that trustees had put in place a proper framework to monitor and ensure compliance with their legal obligations and fiduciary duties, MPFA had promulgated a set of Compliance Standards for trustees to adopt. In the wake of the financial turmoil, MPFA had also stepped up its supervisory efforts and required the trustees to provide information about their investment portfolio and management accounts.

20. A member expressed deep regret about the Administration's decision of not acceding to the proposal to extend the scope of the Compensation Fund to cover default mandatory contributions owed by insolvent employers. He considered that the Administration's arguments were not justified, and the protection of employees' right to the mandatory contributions owed by employers should be enhanced through extending the scope of the Compensation Fund.

**Recent development**

21. The Administration will brief the Panel on the result of MPFA's review on the Compensation Fund and the Authority's recommendations on the levying mechanism at the meeting on 21 November 2011.

**Relevant papers**

22. The relevant papers are available at the following links:

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| Panel meeting on 3 July 2006 | Agenda<br>Minutes (paragraphs 50 to 67)<br>Follow-up paper<br>CB(1)497/07-08(01) |
| Panel meeting on 6 July 2009 | Agenda<br>Minutes (paragraphs 46 to 57)<br>Follow-up paper<br>CB(1)2423/08-09(01) |

Council Business Division 1
Legislative Council Secretariat
16 November 2011