For discussion on
15 May 2018

Legislative Council Panel on Manpower

Preliminary idea on
abolishing the "offsetting" arrangement
under the Mandatory Provident Fund System

Purpose

This paper explains to Members the Government's preliminary idea on abolishing the "offsetting" arrangement under the Mandatory Provident Fund (MPF) System.

Background

2. In 2017, the previous-term Government put forth a proposal to progressively abolish the "offsetting" arrangement (key features at Annex A) but both employees and employers were not receptive to the proposal.

3 Abolishing the "offsetting" arrangement is one of the priority tasks of the current-term Government. Since its assumption of office in July 2017, the Government has been in active discussion with the labour and business sectors to explore viable options. The Government has made clear its determination to resolve the matter and willingness to increase its financial commitment to mitigate the impact of the abolition on enterprises, in particular micro-, small- and medium-sized enterprises (MSMEs).

The preliminary idea

4. Having considered the views of the labour and business sectors, the Government has come up with a preliminary idea to abolish the "offsetting" arrangement with the following key elements –

(a) the rate for calculating severance payment (SP) and long service payment (LSP) reverts to two-thirds of the monthly wage of the employee for each year of service, and the maximum SP/LSP keeps at $390,000;

(b) employers each sets up a designated saving account (DSA) under his/her own name and contributes 1% of his/her employees' monthly income[1] to the DSA until reaching 15% of the employees' annual income for payment of SP/LSP as elaborated in paragraphs 7 – 9 below;

(c) the Government provides a two-tier subsidy with duration extended to 12 years and the quantum increases from $7.9 billion to $17.2 billion to help share employers' expenses on SP/LSP within the 12-year transitional period with details set out in paragraphs 10 – 12 below;

(d) there would be no retrospective effect, i.e. the SP/LSP entitlement for an employee's employment period before the Effective Date[2] could continue to be offset by the employer's MPF contribution made both before and after the Effective Date;

(e) other technical features as embodied in the previous-term Government's proposal should remain, as set out in paragraphs 14 – 16 below.

5. Further elaboration on the key elements of the preliminary idea is set out in the ensuing paragraphs.

(A) Calculation of the SP/LSP entitlement

6. Taking into account the strong objection of the labour unions to adjusting downwards the SP/LSP rate to half of the employee's monthly wages as suggested in the previous-term Government's proposal, and to afford better protection for lower-paid workers, it is essential to maintain the calculation of the SP/LSP entitlement at two-thirds of an employee's monthly wages. By the same token, the current SP/LSP cap should be kept at $390,000.

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[1] An employee's income refers to the "relevant income" specified under the Mandatory Provident Fund Schemes Ordinance (MPFSO). According to MPFSO, "relevant income" refers to all monetary payments paid or payable by an employer to an employee, including wages, salary, leave pay, fees, commissions, bonuses, gratuities, perquisites or allowances, but excluding SP/LSP. Currently, under the MPF System, when making MPF contributions for their employees, employers are required to provide the trustee with the information of "relevant income" of an employee in the contribution period to which the contribution relates.

[2] An Effective Date is a future date on which the abolition of the "offsetting" arrangement comes into operation.

(B) The DSA

7. The DSA serves as an effective tool to assist employers to save up in advance to meet their future SP/LSP obligations to address the business sector's concern over the inability of employers, especially the MSMEs, to pay SP/LSP when the need arises after the abolishing of the "offsetting" arrangement. Key features of the DSA system under contemplation may include –

(a) taking account of the fact that the need to pay SP often arises when employers are least able to pay, the DSA should be designed as a compulsory and dedicated saving scheme to fulfil the very purpose of statutory SP/LSP;

(b) employers only need to contribute 1% of their employees' monthly relevant income (subject to the same monthly relevant income cap for MPF contributions by both employers and employees[3]) to their own DSAs;

(c) while monies in DSAs are essentially employers' own assets, employers may withdraw monies from their DSAs only for payment of SP/LSP. Unless the business folds and all the employees' SP/LSP liabilities have been cleared, the monies in an employer's DSA cannot be deployed for other purposes;

(d) while ensuring that DSAs could provide a reasonable cushion against the potential SP/LSP liabilities, to avoid locking up unlimited or unnecessary operating capital of the enterprises, employers may stop making contributions to their own DSAs once the savings in their DSAs have reached 15% of the annual relevant income of all their employees;

(e) the DSA system should avoid heavy penalty or tedious enforcement measures, given that its purpose is to assist employers to meet their SP/LSP obligations and that monies in the DSAs are essentially employers' own assets;

(f) employers should be encouraged to continue to make voluntary MPF contributions for their employees; hence the possible arrangement for employers making voluntary MPF contributions

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[3] Also see footnote 1. The monthly income cap follows the maximum level of income for contribution under MPFSO, which is currently set at $30,000.

at 1% or above, in addition to the 5% mandatory contribution stipulated by the MPFSO, be exempted from setting up their DSAs. Likewise, employers making contributions in excess of 5% under the Occupational Retirement Schemes Ordinance (ORSO) and school provident funds may also be exempted;

(g) the monies collected from DSAs could be put into certain low risk instruments for preserving the principal and maintaining high liquidity for required SP/LSP payment which could arise anytime; and

(h) a preliminary view is to commission trustee(s) for the collection and disbursement of monies for the purpose of DSAs under a separate agreement to avoid mingling DSAs with the statutory MPF schemes. The implementation of e-MPF in future will help reduce the administration costs of both MPF schemes and DSAs.

8. Based on the set of offsetting claim data in 2015 provided by the Mandatory Provident Fund Schemes Authority (MPFA) and assuming an investment return of 1% in real terms per annum for the saving in DSAs, the estimated proportion of incident employers (i.e. employers who have initiated dismissals that necessitate SP/LSP payment) with adequate funds in their DSAs to meet the SP/LSP payable is tabulated below –

Firm size	**Proportion of incident employers(Note 1) with adequate funds in their DSAs to meet the SP/LSP payable**	
	Year 10 after the abolition	**Year 20 after the abolition**
Micro-sized firms (1 - 9 employees)	49%	56%
Medium-sized firms (10 - 49 employees)	88%	90%
Large firms (50 or more employees)	98%	99%
All firms	76%	79% **(Note 2)**

Note:

(1) Figures denote the estimated shares in the respective group of incident employers having adequate funds in their DSAs to meet the SP/LSP payable. Estimates have taken into account the 12-year Government subsidy period and excluded closure cases for small firms. The position in Year 20 after the abolition of MPF offsetting represents broadly a “steady state” when the

impact of Government subsidies has subsided and employers have accumulated saving in their DSAs up to the cap of 15% of the annual relevant income.

(2) Under the existing “offsetting” arrangement, about two-thirds of the employers need to top up the payment for paying SP/LSP after netting the accrued benefits of their MPF contribution. Under the preliminary idea, after netting the accrued savings in their DSAs, the overall proportion of employers needed to make top-up payment will drop to around 20%.

9. Not all employers will be able to save up adequately under their DSAs for discharging their full SP/LSP liabilities, and some would need to make top-up payment as many incident employers do at present. Small firms would be more likely than medium- or large-sized firms to need to make top-up payment especially in initial years. In gist, 99% of large firms (50 or more employees) would have adequate funds in their DSAs when the need to pay SP/LSP arises in Year 20 after the abolition, while 90% of medium-sized firms (10 – 49 employees) would be able to do so. For micro-sized establishments (1 – 9 employees), the corresponding proportion would be much lower at 56%. On average, micro-sized employers who do not have adequate funds in their DSAs would need to top up some $219,000 after exhausting their savings accrued in their DSAs. The top-up amount, however, may vary significantly across employers depending on different factors, such as the number of claims involved, the income and years of service of the dismissed employees, etc. An estimate of the total amount of top-up payment for incident employers at different points of time after the abolition of the “offsetting” arrangement is provided below –

Year after the abolition	**Estimated total top-up payment ($ million) (in 2016 prices)**	
	All firms	**Micro-sized firms (<10 employees)**
Year 1	21	12
Year 10	1,200	750
Year 20	2,342	1,505
Average top-up payment for each incident employer with insufficient funds in DSA in Year 20 ($)	*($306,000)*	*($219,000)*

(C) Extending the subsidy period and increasing the quantum of the Government subsidy

10. To further assist employers to better cope with the policy change of abolishing the "offsetting" arrangement, the Government's financial assistance to employers or the subsidy period may be extended from ten to 12 years, and the Government may provide a two-tier subsidy to incident employers to share their SP/LSP expenses on a reimbursement basis. Under the first-tier subsidy, the maximum rate of Government subsidy would be pitched at 50% of the SP/LSP payable in the first three years after abolition of the MPF offsetting arrangement. Thereafter, the subsidy rate would be reduced progressively by five percentage points each year until it is diminished to 5% in the 12th year. Should an employer's accrued balance in his/her DSA be insufficient to pay SP/LSP after discounting the first-tier subsidy, he/she could apply for the second-tier subsidy which shares the outstanding SP/LSP amount at the same rate as the first-tier in the relevant year. The special arrangement should help address the concerns especially of MSMEs which would benefit most under the second-tier subsidy. A table showing the maximum first-tier and second-tier subsidy an employer can get is set out below –

Year after the abolition	**The Government's maximum* subsidy to employers as % of SP/LSP payable**		
	First-tier Subsidy	**Second-tier Subsidy**	**Total (First-tier + Second-tier)**
1	50%	25% (50% x 50%)	75%
2	50%	25% (50% x 50%)	75%
3	50%	25% (50% x 50%)	75%
4	45%	24.75% (55% x 45%)	69.75%
5	40%	24% (60% x 40%)	64%
6	35%	22.75% (65% x 35%)	57.75%
7	30%	21% (70% x 30%)	51%
8	25%	18.75% (75% x 25%)	43.75%
9	20%	16% (80% x 20%)	36%
10	15%	12.75% (85% x 15%)	27.75%
11	10%	9% (90% x 10%)	19%
12	5%	4.75% (95% x 5%)	9.75%

* This shows the maximum Government subsidy ratio. As most employers would probably have savings accrued in their DSAs, it is likely that in most cases requiring the second-tier subsidy, the Government only needs to share part of the employer's remaining SP/LSP after netting the first-tier subsidy.

11. A few examples showing how the two-tier Government subsidy and the savings in DSAs could help alleviate the burden of employers are set out at Annex B.

12. The two-tier subsidy system would increase the Government's financial commitment significantly to $17.2 billion (comprising $14.7 billion under the first-tier subsidy and $2.5 billion under the second-tier subsidy) (in 2016 prices)[4], as opposed to $7.9 billion under the previous-term Government's proposal.

(D) Offsetting SP/LSP for employment period before Effective Date

13. Under the previous-term Government's proposal, employers are only allowed to offset the pre-Effective Date SP/LSP with their pre-Effective Date MPF contributions. We consider it appropriate to relax this requirement by allowing employers to offset the pre-Effective Date SP/LSP with their MPF contributions made both **before and after** the Effective Date. This arrangement would be administratively less complicated and hence less costly as there is no need for MPF trustees to determine the value of the accrued benefits from employers' MPF contributions before the Effective Date, and to segregate an employee's MPF account into pre- and post-Effective Date. It would also benefit employers, albeit slightly, as their out of pocket payment pertinent to the SP/LSP related to the period before the Effective Date could be reduced. Over a longer run, however, such difference would diminish as the accrued benefits derived from employers' MPF contributions before the Effective Date would grow due to investment returns and may outgrow the "offsettable" SP/LSP before the Effective Date.

(E) Other technical details

Applicability of the abolition arrangements

14. The abolition arrangements should also be applicable to the occupational retirement schemes under ORSO and the two school provident funds under the Grant/Subsidized Schools Provident Fund Rules under the Education Ordinance with the same Effective Date set for the MPF System. The concerned employers, as well as those who make voluntary contributions under the MPF System in excess of the

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4 The estimates are based on MPFA's administrative records for SP/LSP offsetting cases in 2015, with suitable adjustments to take into account (a) those cases which are not subject to MPF "offsetting"; (b) normal economic fluctuations; (c) the projected demographic profile of our labour force; (d) moral hazards; and (e) wage increase. On top of that, periodic cyclical slowdown is also assumed.

mandatory 5%, can make use of the accrued benefits derived from the voluntary contributions for offsetting SP/LSP. Likewise, gratuity based on length of service as voluntary payment of employers to employees should also continue to be used to offset SP/LSP.

15. For employees not covered by the MPF System (currently domestic helpers, whether foreign or local, and employees aged below 18 or aged 65 or above) or other statutory retirement schemes, their employers will not be reimbursed with any subsidy from the Government when any SP/LSP cost is incurred.

Adoption of the monthly wages at Effective Date for calculation of the SP/LSP entitlement for employment period before the Effective Date

16. As in paragraph 4(d), under the “no retrospective effect” principle, any SP/LSP payable for the employment period up to the Effective Date would be calculated on the basis of the monthly wages as at the Effective Date, as opposed to the last monthly wages at the time of dismissal (if the dismissal is after the Effective Date). Such “grandfathering” arrangement should also help contain the risk of indiscriminate dismissals by any employers so as to avoid the abolition of the “offsetting” arrangement.

Next step

17. We are exchanging views on the above preliminary idea with major stakeholders including the business and labour sectors, with a view to developing a more practical and acceptable proposal in taking the matter forward.

Advice sought

18. Members are invited to give their views on the content of this paper.

Labour and Welfare Bureau
Labour Department
May 2018

Annex A

Salient features of the abolition proposal recommended by the previous-term Government

(a) The “offsetting” arrangement will be abolished as from a future date (an Effective Date) with no retrospective effect. In other words, accrued benefits from employers’ mandatory MPF contributions before the Effective Date and the returns derived therefrom will be “grandfathered”. This “grandfathered” amount can be used to offset SP/LSP payable for the employment period before the Effective Date. If the accrued benefits from employers’ contributions fall short of the full SP/LSP payment after “offsetting”, employers still have to pay the shortfall before the Effective Date to fulfil their SP/LSP obligations.

(b) The amount of SP/LSP payable for the employment period from the Effective Date will be adjusted downwards from the existing entitlement of two-thirds to half of the last month’s wages as compensation for each year of service (i.e. 75% of the existing entitlement).

(c) The Government will share part of the SP/LSP expenditure of employers in the ten years from the Effective Date. The proposed Government subsidy during the ten-year transitional period is as follows:

Year after the abolition	Employers’ net SP/LSP payment as % of SP/LSP payable	Government’s subsidy to employers as % of SP/LSP payable
1	50%	50%
2	50%	50%
3	60%	40%
4	60%	40%
5	70%	30%
6	70%	30%
7	80%	20%
8	80%	20%
9	90%	10%
10	90%	10%
11	100%	--

(d) The abolition arrangements will be extended to the ORSO schemes and two school provident funds with the same Effective Date set for the MPF System in the following manners -

  (i) the accrued benefits from employers' contribution before the Effective Date can be used for "offsetting";

  (ii) from the Effective Date onwards, the 5% employer's contribution will be preserved for retirement and cannot be used for offsetting. The SP/LSP payable for the employment period from the Effective Date will be revised to one-half of the last month's wages per year of service; and

  (iii) if SP/LSP is triggered, employers of the scheme members of ORSO schemes and two school provident funds are also entitled to receive government subsidy in the transitional period.

(e) Employees not covered by the MPF System (currently domestic helpers, whether foreign or local, and employees aged below 18 or aged 65 or above) or other statutory retirement schemes, given that they are not to benefit from the abolition of "offsetting", their SP/LSP entitlements at the current quantum will remain unchanged. Their employers will also not be entitled to be reimbursed with any subsidy from the Government even if any SP/LSP cost is incurred.

(f) The abolition of "offsetting" will not be applicable to voluntary contributions under the MPF System (i.e. those in excess of the mandatory 5%). Likewise, employers' contribution in excess of 5% under ORSO schemes and school provident funds can continue to be used for "offsetting".

(g) The estimated one-off expenditure in providing subsidy to employers is $7.9 billion (in 2016 prices). The estimated maximum tax forgone arising from tax deductions for making LSP provisions is about $18 billion (in 2016 prices) over ten years.

Annex B

Examples of how the Government subsidy and the DSA saving operate to help alleviate an employer's burden in paying SP/LSP

Example 1: A micro-sized enterprise dismissing employees **during the Government subsidy period**

Assumptions

- A company has operated for five years after the abolition and has employed five employees each earning an average monthly wage of $15,000 throughout the period

- At Year 5 after the abolition, the company dismisses two employees each with five years' service. The last monthly wage of each of the dismissed employees is $15,000

	(a) SP/LSP payable	**(b) Accrued balance in DSA**	**Government subsidy (c) First-tier*** (a) x (subsidy rate in the relevant year)	**Government subsidy (d) Second-tier*** [(a) – (c) – (b)] x (subsidy rate in the relevant year)
Calculation	($15,000 x 2/3) x 5 years x 2 employees	($150 x 12) x 5 employees x 5 years	$100,000 x 40%	($100,000 - $40,000 - $45,000) x 40%
Amount	**=$100,000**	**=$45,000**	**=$40,000**	**=$6,000**
			Total amount of subsidy = $46,000	
	Amount of top-up payment by employer= $9,000 $100,000 (a) – [$45,000 (b)+ $40,000 (c) + $6,000 (d)]			

* The first-tier subsidy is calculated by applying the Government's subsidy rate in the relevant year to the SP/LSP payable. The second-tier subsidy is calculated by applying the Government's subsidy rate in the relevant year to the outstanding amount of SP/LSP payable after netting the first-tier Government subsidy and the accrued balance in the employer's DSA.

Example 2: A medium-sized enterprise dismissing employees **during the Government subsidy period**

<u>Assumptions</u>

- A company has operated for ten years after the abolition and has employed 30 employees each earning an average monthly wage of $15,000 throughout the period

- At Year 10 after the abolition, the company dismisses six employees each with ten years' service. The last monthly wage of each of the dismissed employees is $15,000

<table>
<tr><th rowspan="2"></th><th rowspan="2">(a)
SP/LSP payable</th><th rowspan="2">(b)
Accrued balance in DSA</th><th colspan="2">Government subsidy</th></tr>
<tr><th>(c)
First-tier*

(a) x (subsidy rate in the relevant year)</th><th>(d)
Second-tier*

[(a) – (c) – (b)] x (subsidy rate in the relevant year)</th></tr>
<tr><td>Calculation</td><td>($15,000 x 2/3) x 10 years x 6 employees</td><td>($150 x 12) x 30 employees x 10 years</td><td>$600,000 x 15%</td><td>Not applicable as the total amount of first-tier subsidy and the accrued balance in DSA is sufficient to cover the SP/LSP payable</td></tr>
<tr><td rowspan="3">Amount</td><td>=$600,000</td><td>=$540,000</td><td>=$90,000</td><td>=$0</td></tr>
<tr><td></td><td></td><td colspan="2">Total amount of subsidy = $90,000</td></tr>
<tr><td colspan="4">No need to make top-up payment by employer.
Remaining balance in DSA: $30,000
$540,000 (b) –[$600,000 (a) - $90,000 (c)]</td></tr>
</table>

* The first-tier subsidy is calculated by applying the Government's subsidy rate in the relevant year to the SP/LSP payable. The second-tier subsidy is calculated by applying the Government's subsidy rate in the relevant year to the outstanding amount of SP/LSP payable after netting the first-tier Government subsidy and the accrued balance in the employer's DSA.

Example 3: A micro-sized enterprise with **employees employed before the abolition** of the "offsetting" arrangement being **dismissed after the abolition**

Assumptions

- A company started operation five years before the abolition of the "offsetting" arrangement and has employed eight employees since then with each of them starting with an average monthly wage of $12,000, which was subsequently revised to $15,000 immediately after the abolition of the "offsetting" arrangement

- At Year 5 after the abolition, the company dismisses three employees each with ten years' service (i.e. five years before the abolition and five years after the abolition). The last monthly wage of each of the dismissed employees is $15,000

Summary of amounts involved

	Amount	**Items**
Each employee to receive / to retain	$131,000 ($393,000 for 3 employees)	$90,000 being SP/LSP for 10 years of service ($270,000 for 3 employees) $41,000 being MPF preserved ($123,000 for 3 employees)
Employer payout	$325,800	$243,000 MPF contribution for 3 employees dismissed $72,000 DSA contribution $10,800 top up payment
Government	$67,200	$60,000 first-tier subsidy $7,200 second-tier subsidy

(I) For pre-abolition SP/LSP (five years)

<table>
<tr><th rowspan="2"></th><th rowspan="2">(a)
SP/LSP payable</th><th colspan="2">(b)
Employer's 5% mandatory MPF contribution to all three employees</th></tr>
<tr><th>Made before the abolition</th><th>Made after the abolition</th></tr>
<tr><td>Calculation</td><td>($12,000 x 2/3) x 5 years x 3 employees</td><td>($600 x 12) x 5 years x 3 employees</td><td>($750 x 12) x 5 years x 3 employees</td></tr>
<tr><td rowspan="4">Amount</td><td rowspan="2">$120,000</td><td>$108,000</td><td>$135,000</td></tr>
<tr><td colspan="2">Employer's total mandatory MPF contribution to the three dismissed employees' MPF account# = $243,000</td></tr>
<tr><td colspan="3">No top-up payment by employer required as the employer's total mandatory MPF contribution made before and after the abolition is sufficient to cover the SP/LSP to be paid to the dismissed employees.

Amount of MPF contribution by employers to be preserved in employee's account:

− for all three employees: $123,000
[i.e. $108,000+$135,000-$120,000]

− for each employee: $41,000 ($123,000÷3)</td></tr>
</table>

Assuming that there is no investment returns to the MPF contribution.

(II) For post-abolition SP/LSP (five years)

	(c) SP/LSP payable	(d) Accrued balance in DSA	Government subsidy (e) First-tier* (c) x (subsidy rate in the relevant year)	Government subsidy (f) Second-tier* [(c) – (e) – (d)] x (subsidy rate in the relevant year)
Calculation	($15,000 x 2/3) x 5 years x 3 employees	($150 x 12) x 8 employees x 5 years	$150,000 x 40%	($150,000 - $60,000 - $72,000) x 40%
Amount	**=$150,000**	**=$72,000**	**=$60,000**	**=$7,200**
			Total amount of subsidy = $67,200	
	Amount of top-up payment by employer = $10,800 $150,000 (c) - $60,000 (e) – $72,000 (d) - $7,200 (f)			

* The first-tier subsidy is calculated by applying the Government's subsidy rate in the relevant year to the SP/LSP payable. The second-tier subsidy is calculated by applying the Government's subsidy rate in the relevant year to the outstanding amount of the SP/LSP payable after netting the first-tier Government subsidy and the accrued balance in the employer's DSA.