

Review Report on the Lump Sum Grant Subvention System

Lump Sum Grant Independent Review Committee

December 2008

LSG reserves

4.21 Before the introduction of the LSGSS, NGOs were not allowed to keep any reserves. Unspent subventions were returned to the Government at the end of each financial year. As a result, NGOs did not have the incentive to save money and could not budget for future development. When the LSGSS was introduced, these shortcomings of the old subvention mode were addressed by allowing NGOs to manage their own resources and keep reserves. The objective was to encourage wise spending and planning in the use of public funds. NGOs may also meet contingency requirements, such as price fluctuations and unforeseen service needs, more effectively. As NGOs need to accumulate sufficient savings to meet their commitments to Snapshot Staff in future, this has become another important function of the reserves under the LSGSS.

4.22 According to the LSG Manual, unspent LSG must be kept in the NGO's Reserve Fund and reported to the SWD in the NGO's Annual Financial Report (AFR). The level of cumulative reserve (including interest but excluding PF reserve) at the end of the financial year should not exceed 25% of the NGO's operating expenditure (excluding PF expenditure) for that year. This percentage was agreed between the SWD and the NGOs after thorough deliberation, so as to strike a balance between public interest and NGOs' concerns about financial viability in the long run. Any amount above the 25% cap has to be returned to the Government in the following financial year, unless the NGO has applied to, and obtained the permission of, the DSW to lift the cap. Exemption en bloc was granted for three years from 2004-05 to 2006-07, to enable NGOs to save, without limit, surplus TOG and SOG in a separate account, basically for meeting contractual commitments in future. As a matter of principle, LSG Reserve must be used on FSA activities and the related support services.

4.23 Since 2001, NGOs operating under the LSGSS have gradually built up reserves, as shown below –

Table 5 : Cumulative Reserves of NGOs from 2000-01 to 2006-07

Financial year	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
LSG reserves (\$m)	219.539	608.145	1,051.429	1,395.950	1,603.267	1,860.304	2,047.491

4.24 As at 31 March 2007, 140 out of the 164 NGOs operating under LSGSS had accumulated reserves totaling about \$2.05 billion, or 33% of their annual operating expenditures in 2006-07. 43 NGOs were keeping reserves at or above 40% of their annual operating expenditures. Details of NGOs' reserve position as at 31 March 2007 are tabulated at **Annex 4**.

4.25 Frontline staff, staff unions and social work students are of the view that such sizeable reserves could have only come from cutting staff costs, as that accounts for about 80% of NGOs' subventions. They do not have any means to guard against this, nor do they see any incentive for NGOs to spend their reserves on staff. The resentment is particularly strong where staff are not aware of their management having any plans to put the reserves to good use. They have suggested to the IRC that the SWD should closely monitor the level of reserves kept by NGOs, and require them to spend the reserves on service enhancement and staff development.

4.26 On the other hand, NGOs have pointed out that their reserves are mainly for honouring their commitments to Snapshot Staff. They are necessary for the NGOs' operation and sustainability in the long term.

4.27 The IRC understands that many subvented organisations in the public sector are allowed to accumulate reserves. For example, the Hong Kong Tourism Board is allowed to accumulate reserves up to four months of its operating expenditure; the eight higher education institutions funded by the University Grants Committee may normally accumulate reserves of not more than 20% of their respective recurrent grants. As a resource management tool to help an organisation meet contingency needs and budget for future development, a reserve certainly has its merits. In the context of the LSGSS, it is not only an integral part of the design, but also essential for the NGOs to meet contractual commitments. No stakeholder seems to dispute the need to retain this facility, but NGOs and staff do differ in proposing how it should function. NGOs, for instance, have suggested that the SWD should raise the maximum reserve level or should give them even greater flexibility in the investment of their reserves, so that the return on capital can be higher. Staff, however, have proposed that the SWD should impose more restrictions on the level and the use of the reserves, and require NGOs to spend them on staff welfare.

4.28 The IRC considers that reserves should be put to good use for service enhancement and strategic developments, including the development of a strong team

of staff. NGOs are encouraged to be prudent, but not overly conservative, in estimating their reserve requirements. In Chapter 3, we have proposed that NGOs should have access to an actuarial service to be made available by the Government, so that they may ascertain their ability to honour their commitments to Snapshot Staff, and gainfully deploy the surplus. NGOs should be encouraged to make use of this service and to invest their reserves in staff, through, for instance, improving their conditions of employment and supporting their professional development.

Recommendation 9

In managing their reserves, NGOs should take into account their Snapshot Staff commitments, as well as the need for service enhancement and staff development. As per **Recommendation 2**, they may make use of the Government-funded actuarial service to assess their ability to meet Snapshot Staff commitments.

4.29 Noting that 21 NGOs have not accumulated any reserves at present, the IRC has examined the profiles of these NGOs to see if there is a correlation between the funding level and the NGO's ability to save money. The correlation is not apparent, as the 21 NGOs ranked between 67th to 171st in terms of the amount of subventions they received in 2006-07, while the 43 NGOs that had accumulated reserves at or above 40% of their operating expenditure ranked 5th to 173rd. The level of reserves varies greatly among NGOs, and depends on a lot of factors including the management philosophy, size, service type and development plans of the individual NGOs. Although views are diverse as to whether the maximum reserve level should remain at 25%, or should be raised (as requested by some NGOs) or lowered (as requested by some staff), there is no evidence that the current level is inappropriate. As the main purpose of the reserves is to help NGOs meet contractual and contingency requirements, instead of arguing for an adjustment to the maximum reserve level, the IRC considers it more important for NGOs to make good use of this facility and be able to seek further assistance when necessary. We therefore recommend that the SWD establish a mechanism whereby NGOs which anticipate financial difficulties can alert the SWD in advance, so that remedial measures can be taken as appropriate before the NGOs concerned exhaust their reserves.

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4.30 At the NGO level, it requires careful deliberations to determine the optimal level of reserves, and staff's contribution to such deliberations would be helpful. We have recommended in the previous chapter that a Best Practice Manual should be developed for NGOs by the welfare sector. We further recommend that the manual should address the question of how to set a reasonable level of reserves and how reserves should be put to good use.

As per **Recommendation 1**, the Best Practice Manual recommended for welfare NGOs should also address issues in relation to the level of reserves and their gainful deployment.

PF reserves

4.31 Under the LSGSS, PF provision is calculated on an actual basis for Snapshot Staff (i.e. at 5%, 10% or 15%, depending on the length of service) and at a standard rate of 6.8% of the mid-point salaries of the recognised notional establishment of the subvented service unit for non-Snapshot Staff. Staff representatives have pointed out to the IRC that some NGOs have, for various management reasons, decided not to fully deploy the PF provision for its intended purpose, such that non-Snapshot Staff receive PF of less than 6.8%.

4.32 In the case of non-Snapshot Staff, the standard 6.8% PF provision may be higher than actually required in the initial years of service expansion because the staff are still at relatively junior levels, but the requirement may be greater in due course if the NGO has put in place a policy to increase the percentage of PF contribution according to the length of service of the staff concerned. NGOs are therefore allowed to put the surplus of PF provision for non-Snapshot Staff into a separate PF reserve account for future use.

4.33 As at 31 March 2006, NGOs' total PF reserves for non-Snapshot Staff funded on the standard (6.8%) rate amounted to \$138.3 million. For the NGOs who have accumulated PF reserves in excess of their current and future requirements, there is room for deploying the surplus on staff welfare. As a matter of principle, PF reserves can only be spent on PF. It serves no useful purpose for NGOs to accumulate excessive reserves. The IRC therefore strongly encourages NGOs to use all their PF reserves for non-Snapshot Staff for the designated purpose, whether as ordinary contributions to the PF or as special contributions to award good performance.

Recommendation 11

NGOs should fully deploy the PF provisions and reserves for non-Snapshot Staff on PF contributions, including possibly special contributions to award non-Snapshot Staff for their good performance.

Reduction in the baseline provision under EPP/ES

4.34 It is a common concern among NGOs that they are in need of additional resources, primarily because of the reductions imposed upon them under the EPP/ES.

4.35 EPP was implemented from 2000-01 to 2002-03, when the Government and subvented sectors alike were expected to permanently reduce their recurrent expenditures by 5%, mainly through efficiency savings. Accordingly, in 2000-01, the SWD first applied a 1% reduction to the subventions of all welfare NGOs. In the following two years, NGOs were required to deliver further savings, but only up to a cumulative 4% (as against the original target of 5%). 77 small NGOs receiving subventions of less than \$3 million per annum were not required to deliver more than the 1% savings already achieved in 2000-01 because, constrained by their size, they had limited scope for service re-engineering. The total EPP contributions from subvented welfare NGOs amounted to about \$110 million.

4.36 In 2003-04, the SWD again applied, across-the-board, a 1.8% ES reduction to NGOs' subventions, followed by another 2.5% in 2004-05. A further 1% reduction was applied to NGOs in 2005-06, but this time 74 NGOs with recurrent subventions below \$3 million were exempted. The total ES contributions from subvented NGOs were \$342 million, representing not more than 5.3% (1.8% + 2.5% + 1%) of their recurrent subventions.

4.37 In other words, under EPP and ES, a total of not more than 9.3% (4% EPP and 5.3% ES) subventions reduction was imposed on welfare NGOs, with nearly half of them contributing less than this percentage (the least being 5.3% (i.e. 1% EPP + 1.8% ES + 2.5% ES)). The actual contributions of \$452 million (\$110 million from EPP and \$342 million from ES), however, represented only a 6.5% reduction, not 9.3%. This is because, apart from exempting small NGOs from some of the savings requirements, the SWD also allowed NGOs to deliver savings through service re-engineering, such as closure of under-utilised service units, instead of contributing in monetary terms. Moreover, for all NGOs, certain items of recurrent subvention