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Protecting the Interests of Pension Users

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SUMMARY PAPER

Key points from the Hong Kong Perspective

General background

The population of Hong Kong is aging faster than almost anywhere else in the world. The percentage of those over 65 has increased from 4.5% in 1971 to 12.6% in 2007 and is projected to rise to 24.6% by 2030. Fertility rates have fallen from 3.5 children per female in 1971 to 1.002 in 2007.

Like many jurisdictions, the policy response to this demographic shift has been to rely on the World Bank's multi pillar approach to retirement income security. The mandatory provident funds system has been in operation since December 2000. It is a 2nd pillar, defined contribution, mandatory savings system. Employers and employees are each required to contribute 5% of salary (subject to maximum and minimum thresholds). Investment structures are generally through master trust arrangements similar to Australian retail superannuation funds. Assets under management are currently around HKD265 billion (A\$37 billion), with monthly inflows of around HKD2.2 billion (A\$310 million). The MPF system is not administered through, or related to, the taxation system. None of contributions, fund earnings or payouts are subject to taxation.

Topic

Pension users have a number of clearly identified interests, including: the protection of wealth as pensions accumulate; the security of earnings on investments made by pension managers and funds managers; the risk and return on their investments in pensions; and the certainty of access to pensions through the lengthy retirement period. Governments also have moral obligations in supporting and maintaining private pension systems. Some the issues include:

1. *the quality and relevance of the supervisory framework to protect pensioner interests,*
 - The supervisory framework of the Mandatory Provident Fund (MPF) system in Hong Kong is principally focused on ensuring that the key regulated party, the trustee, acts in members' interests and in compliance with the law. In the past this

has led to some criticisms that scheme operators were too focused on ‘tick the box’ compliance with the law rather than a genuine focus on members’ interests.

- One response to this was a stronger move to risk based supervision. While risks in this context are considered quite broadly they are driven by the ultimate quality of outputs to members.
- Another response has been to strengthen and refocus the internal compliance efforts of service providers. New Compliance Standards issued in 2006 have been used as a way to get service providers to focus their own efforts on issues and risks that have a material impact on members rather than focusing on section-by-section compliance with the law.
- Supervisory efforts have also been directed at areas that have a high impact to end users. The major initiative in this respect has been a focus on reducing fees and charges over the medium term (discussed in more detail below).

2. *the integrity of funds managers and asset managers in these roles in maintaining pension value;*

- There are generally no issues concerning the integrity of investment managers in the MPF system (who are required to be separate from the trustee). All investment managers are required to meet the requirements of the Hong Kong Securities and Futures Commission (SFC) and are subject to SFC supervision. SFC requirements, like requirements in Australia, include minimum levels of skills, experience and resources, including financial resources. Importantly MPF scheme operators (the trustees) are given an additional statutory responsibility under the MPF legislation to appoint and supervise the investment manager.
- The only notable issue that this has raised is the sufficiency of governance in circumstances where the investment manager is the scheme sponsor and has some powers over the trustee (eg. appointment or remuneration). Whilst this represents a clearly imperfect governance model, it is difficult to find evidence that it has produced any less satisfactory outcomes for members than other models.

3. *the quality of information available on a timely basis to pensioners;*

- In common with other systems, the MPF system has disclosure requirements at a variety of levels relating to different needs and stakeholders.
- The primary point-of-sale document is the scheme offering document which is somewhat similar to an Australian PDS. The obligations and liabilities relating to this document are somewhat less clear than in Australia however.
- Ongoing information to members is primarily directed through twice yearly fund fact sheets (fund level information) and annual benefit statements (member account level information).
- Significant effort has been to improve various aspects of this information set over the past few years.

- The major focus has been on improving information about fees and charges. At point-of-sale this has included standardizing and simplifying the presentation of fee information in offering documents. Ongoing, fund level information, has been improved by requiring fund fact sheets to include standardized expense ratio information. Member level information has been improved by, inter alia, providing account level fee information in annual benefit statements. The MPFA is also introducing a web based fee comparative platform for easy comparison of fees and charges across all providers and funds.
- Quality, timely information about fees and charges is now available. The next challenge is to get scheme members to focus on this information as part of their decision-making processes. It is expected that in the medium term this will help market forces work more efficiently and reduce fees from current levels (around 2% of fund value per year).
- More general challenges relate to making offering documents easier to understand and generally improving the quality of decision making by scheme members.

4. *how consumers are properly informed and whether they understand the range of risks they face; and*

- Despite Hong Kong being a sophisticated center for financial services, the general populace, covered by the MPF system, has very low levels of financial literacy. Improving this remains a major long-term challenge.
- The MPF system is quite tightly regulated, so most of the non-investment risks are minimized. For example, the entry restrictions for service providers are reasonably tight and, as such, there is very little risk associated with the central fiduciaries, the trustees. Also, unlike Australia, minimum investment restrictions are contained in the law which should minimize risks such as liquidity, counterparty and diversifiable risks.
- Investment risk is somewhat constrained compared to Australia due to the investment structures and restrictions. There is however plenty of scope for risk appetite (for example through country or sector specific equity funds)
- Clearly most members do not have a good understanding of the trade-offs between risks and return. A standardized risk measure (standard deviation over 3 years) has been introduced for use in fund fact sheets to assist in educating members about risk and return.
- Consumer understanding will need to be further advanced, if portability across providers is expanded, as is currently under consideration.

5. *the legal certainty that funding will be available to meet income flows in retirement.*

- As a pure defined contribution, 2nd pillar system, the MPF system does not purport to ensure adequacy of retirement incomes. Adequacy can only be assessed in conjunction with other savings pillars like government assistance (income, housing and health care), private savings and family financial support.

- The MPF system does however provide a high level of assurance that accrued benefits will be available and accessible by retirees upon meeting withdrawal conditions. A compensation fund exists for the purpose of compensating members in the unlikely event of misfeasance by fund operators.
- Members must of course accept their own risk when it comes to investment returns. Longer-term improvements to disclosure and investor education are directed at helping members understand and make better decisions about investment and risk.