FSDC Paper No.38

HK FINANCIAL SERVICES DEVELOPMENT COUNCIL 香港金融發展局

Mandatory Provident Fund System - The Way Forward

Feb 2019

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Executive Summary

1. The Mandatory Provident Fund (MPF) system was established on 1 December 2000 to help protect the financial well-being of Hong Kong's workforce when they reach the end of their working lives. The net asset value (NAV) of MPF schemes was HK$858 billion as of 30 September 2018.[1] This figure is made up of HK$613 billion of net contributions (from its inception through to 30 September 2018) and HK$245 billion of net investment returns during the same period.[2] The MPF system covers 73% of Hong Kong's working population.[3]

2. An effective pension framework is intended to ensure that individuals within the working population build a pension pot sufficient to maintain their lifestyle throughout their retirement years. As a mature economy, it is important that Hong Kong's pension framework develops and matures in an appropriate direction, with the financial services industry playing an integral role in its development.

3. Initially designed as a Pillar Two pension solution[4], MPF has much strength, including wide coverage and a high level of transparency. But critics would argue that there are still limitations that prevent it maximising its potential as a robust multi-pillar pension solution. These include: inadequate mandatory contributions to fund a reasonable retirement; inefficient administrative processes; varying degrees of financial literacy among members; a narrow choice of post-retirement products; and questions over the sufficiency of independent governance and oversight of MPF schemes. Strengthening members' engagement will encourage greater savings, enabling them to build a fuller pension pot.

4. There have been many positive initiatives introduced by the Mandatory Provident Fund Schemes Authority (MPFA), together with the Financial Services and Treasury Bureau

[1] MPFA, *Mandatory Provident Fund Schemes Statistical Digest* (September 2018), 2. Available at: http://www.mpfa.org.hk/eng/information_centre/statistics/mpf_schemes_statistical_digest/September_2018_Issue.pdf
[2] *Ibid*, 10.
[3] *Ibid*, 1.
[4] Please refer to Appendix I for the World Bank's multi-pillar pension framework.

(FSTB), in recent years. These include the Employee Choice Arrangement (ECA); the Default Investment Strategy (DIS); greater flexibility around withdrawal of accrued benefits; and the Governance Charter. The MPFA continues to advance reforms.

5. This paper aims to identify some of the perceived major issues and challenges to the MPF system and to outline recommendations to address them. These are designed to improve members' engagement and to grow the level of assets within the system. Together, these should enhance the system's potential to meet the long-term retirement needs of Hong Kong's working population and to ensure that they are provided with suitable investment options at a reasonable price and with easy access.

6. To further develop the MPF system as an effective baseline (Pillar Two) pension solution and to raise voluntary contributions (creating an integrated Pillar Two and Pillar Three pension solution), the Financial Services Development Council (FSDC) has made five recommendations:

    i. **Successful establishment, implementation and operation of eMPF –** the introduction of this centralised administration platform (eMPF) will be the biggest single reform of the MPF system to date. It can increase member engagement by lowering scheme administration costs and delivering a better user experience. To do this, eMPF needs to be able to handle straight-through processing (STP) and operate on a 'digital by default' basis. To avoid diluting its potential benefits, implementation of eMPF should follow a 'big bang', rather than staged implementation, approach. The platform should also integrate into the Government's 'Smart City' initiatives through the use of the new Hong Kong smart ID, so as to access MPF accounts as well as other Government utilities and services efficiently. There should be appropriate delineation of roles and responsibilities between the operator of eMPF, other services providers and the regulator.

    ii. **Enable and encourage MPF trustees / sponsors to provide more comprehensive advice and financial education –** more emphasis should be placed on improving members' financial literacy. Trustees are currently charged with protecting members' interests during the accumulation phase (i.e. growth of the pension pot) but cannot advise them on products and solutions for the de-accumulation phase (spending down the pension pot during retirement). Trustees should be able to provide members with appropriate information and advice on their post-retirement financial needs, what they should be aiming to save today, and what suitable products are available. This could be facilitated by the proposed eMPF platform providing education and product offerings to members through their MPF account.

iii. **Increase independent governance and oversight of MPF schemes –** there is scope to improve the independent governance and oversight of the MPF system. In the short term, the minimum requirements for independent non-executive directors (INEDs) on boards of trustees should be increased. But to comprehensively mitigate potential conflicts of interest within trustee boards over the longer term, a separate, independent governance and oversight board should be created at the MPF scheme level. This would be similar to governance structures commonly seen in the investment fund industry.

iv. **Update the Mandatory Provident Fund Schemes Ordinance (MPFSO) –** the MPFSO should also be revamped as part of these reforms. The Ordinance should give the MPFA more discretion and flexibility to react to changing environments. Changes to investment restrictions have been made in the past and it is recommended that updates to include suitable new asset classes and markets should continue to be allowed from time to time.

v. **Increase the level of contributions into the MPF system –** current contribution levels are clearly not enough to fund a reasonable retirement for a large portion of Hong Kong's working population. A bigger pool of assets within the system would allow for greater economies of scale, so it is desirable that incentives are established to encourage increasing contributions. These could include:

(a) tax incentives for employee voluntary contributions up to a maximum of 15% of relevant income when combined with mandatory contributions;

(b) greater flexibility for MPF members to select where to make their investments; and

(c) the introduction of additional asset classes and markets.

7. Each of the above measures can improve the MPF system. But these five recommendations were formulated as a package, with each complementing the others. To maximise the system's potential for Hong Kong's working population and its financial services industry, we advocate implementation of all five recommendations together.

Major issues facing the MPF system

8. It is first important to recognise the MPF's strengths. These include:

- A clearly defined objective and purpose;
- Wide coverage of Hong Kong's working population;
- Relatively high level of transparency;
- Flexible scheme structure;
- Immediate vesting of MPF mandatory contributions;
- Segregated custody of MPF assets by qualified custodians; and
- Comprehensive regulation and oversight provided by the MPFA.[5]

9. That said, a number of limitations have been identified, which are also recognised by the Government and MPFA. In its latest Annual Report (July 2018) the MPFA says the system "is notably under a continuous process of development and refinement".[6]

10. In this paper we focus on the following major issues:

- MPF mandatory contributions alone are inadequate to fund a reasonable retirement;
- MPF members have limited choice of providers when investing their mandatory contributions;
- Narrow and tightly defined investment restrictions;
- MPF administration infrastructure is inefficient, inconsistent and creates challenges for members when switching accounts;
- Members have varying degrees of financial literacy. There are prohibitions on trustees / sponsors providing retirement planning advice and recommendations;

[5] In addition to the MPFA, other financial services regulators in Hong Kong have an indirect interest in the MPF system. Investment managers and sponsors / promoters are regulated by the Securities and Futures Commission. The insurer / guarantor of guaranteed funds are regulated by the Insurance Authority. Finally, a number of MPF service providers are either themselves, or are subsidiaries of, licensed banks in Hong Kong, which are regulated by the Hong Kong Monetary Authority.

[6] MPFA, *Annual Report 2017-18*, 16.

- Insufficient range of products to cater for post-retirement needs;
- Insufficient independent governance and oversight; and
- The MPFSO and associated regulations are outdated.

MPF mandatory contributions in isolation are inadequate to fund a reasonable retirement

<u>Mandatory contributions:</u>

11. The current 10% rate of aggregated employee and employer mandatory contributions is relatively low and is limited by the maximum relevant income (RI) level. The resulting maximum mandatory contribution of HK$36,000 per annum is clearly insufficient for many workers in Hong Kong to fund a viable retirement. As noted by the MPFA in their most recent annual report, "MPF savings have always been considered inadequate for retirement".[7] The current maximum RI of HK$30,000 a month shows that the system is heavily focused towards those on the bottom rungs of the salary ladder. Many workers in Hong Kong will see their aggregated employee and employer contribution rate fall below 5%. For example, an employee earning HK$80,000 per month would make employee and employer mandatory contributions of 3.75% of their salary – clearly not enough to fund a proper retirement.

12. Many experts believe that employees need to save at least 20% of their compensation to maintain the same standard of living pre- and post-retirement. Singapore's Central Provident Fund presently mandates a 37% aggregate contribution rate from employee (20%)

[7] *Ibid*, 11.

and employer (17%) for those under the age of 55.[8] This is approximately 3.2 times higher than the level in Hong Kong: SG$2,220 (~HK$12,740) versus HK$3,000.[9]

Voluntary contributions:

13. As noted above, the MPF system currently serves as a Pillar Two solution.[10] Successful pension frameworks commonly allow tax-efficient voluntary contributions so as to create a supplemental Pillar Three component. While additional voluntary contributions to MPF schemes are allowed, this is not widely adopted: from 1 July to 30 September 2018, only 17% of MPF contributions were voluntary.

14. This low take-up is partly due to public perceptions that the MPF system has high costs (i.e. fees borne by members) and low returns (compared to international peers). Also, unlike many other jurisdictions, the MPF system currently offers no tax incentives to scheme members to make voluntary contributions. The 401(k) system in the US allows employees to make tax-efficient contributions up to an annual limit of US$18,500 (approximately HK$145,200). This limit, which excludes an additional US$6,000 (approximately HK$47,100) [11] of catch-up contributions potentially available to those over 50, is approximately four times that of Hong Kong.

15. While employers' and employees' mandatory contributions vest to scheme members immediately, the MPF system gives employers the option of including a customised vesting

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[8] Central Provident Fund Board of Singapore, "CPF Contribution Rate (From 1 January 2016) Table for Singapore Citizens or Singapore Permanent Residents (3rd Year Onwards)". Available at https://www.cpf.gov.sg/Assets/employers/Documents/Table%201_Pte%20and%20Npen%20CPF%20contribution%20rates%20for%20Singapore%20Citizens%20and%203rd%20year%20SPR%20Jan%202016.pdf

[9] For private sector and public sector non-pensionable employees mandatory contributions are required for employees earning an Ordinary Wages over SG$750 (approximately HK$4,300) per calendar month, up to an OW ceiling of SG$6,000 (approximately HK$34,430).

[10] Please refer to Appendix I for the World Bank's multi-pillar pension framework.

[11] Internal Revenue Service (US). "Overview of 401(k) Plan", (8 November 2018). Available at https://www.irs.gov/retirement-plans/plan-sponsor/401k-plan-overview

scale for any voluntary contributions that they wish to make for their employees[12]. This mechanism can be used to reward and retain key talent by incentivising them to remain with the organisation until they have moved along the vesting scale. However, despite this incentive, employer voluntary contributions are not widely adopted in Hong Kong.

MPF scheme members have limited choice of providers when investing their mandatory contributions

16. MPF scheme members presently have to invest their mandatory contributions with the provider(s) selected by their employer. As employers play an important role in the introduction of MPF options to employees and in the processing of their contributions, it is logical that they should have an initial say in the selection of providers.

17. The ECA, which was introduced in 2012, allows employees once a year to transfer the accrued benefits of their employee mandatory contributions to an MPF scheme of their own choice (the corresponding employer mandatory contributions remain with the scheme selected by their employer). Even if employees make use of this option, any future employer mandatory contributions will still go to the original MPF scheme selected by their employer. So employees' freedom to select constituent funds (CFs) from other providers is still limited.

Narrow and tightly defined investment restrictions

18. As the MPF system is a Pillar Two solution, schemes within it need to comply with largely conservative investment strategies, as well as tight investment restrictions that were set at the launch of the MPF system in December 2000. However, financial markets have changed since then. A number of markets that were still emerging at the turn of the century are now more developed. Whilst investment restrictions have been amended from time to time,

[12] For example an employer could select that employees are entitled to 20% of employer voluntary contributions after one year of completed service; 40% after two years; 60% after three years; 80% after four years and 100% after five years of completed service.

establishing a more structured periodic framework to review investment restrictions could open up MPF assets to other viable investment options on a timelier basis.

MPF administration infrastructure is inefficient, inconsistent and creates challenges for members when switching accounts

19. There are multiple MPF administration systems run by different service providers, with their own formats, rules and procedures. This lack of consistency results in costs that cannot be shared across industry players. This also means that MPF members who maintain accounts with different providers are unable to view and manage their aggregate benefits on a single platform. This is one of the main issues that eMPF is intended to address.

20. There are around 30 million transactions processed annually within the MPF system. Approximately two-thirds are paper based, including those executed via cheque[13]. This creates manual, labour-intensive administrative processes which, in turn, result in higher costs and fees ultimately borne by MPF members.

Members have varying degrees of financial literacy. There are prohibitions on trustees / sponsors providing retirement planning advice and recommendations

21. The MPF system operates as a 'one-size-fits-all' solution, meeting the needs of everyone from a young person starting out in life to a senior manager with a well-paid job. Many members have limited understanding of what logical long-term investment portfolios look like, how much risk to take on or where to get information on these topics. Members need access to a wide variety of digestible information, along with professional advice, to be able to make appropriate decisions on allocating their MPF investments.

[13] Dr David Wong, "Luncheon Keynote Speech at the Hong Kong Trustees' Association Conference - Reforming the MPF System to Improve Administration and Trustee Governance", (31 October 2017), para 17 at page 5. Transcript available at: http://www.mpfa.org.hk/eng/main/speeches/files/2017-10-31-speech-e-Chairman.pdf

22. The introduction of the eMPF would pave way for initiatives to increase scheme members' autonomy in choosing MPF schemes and CFs. But simply offering a wider variety of schemes and CFs, along with information on their past performance, is not enough. Indeed, more choice may just result in members being even more confused about what to do. Greater thought needs to be given to ensuring that members are able to identify and access investment options that are right for them.

23. The majority of CFs invest in plain vanilla equities, bonds and money market instruments. These serve a valuable purpose in protecting assets by diversifying risk, particularly for those relying on the system to fund a basic retirement. However, the low adoption of voluntary contributions highlights the fact that many members either look outside the MPF system for suitable investment options or – more worryingly – are not saving enough for retirement. MPF members may be prepared to take some calculated level of risk in their investment portfolios in exchange for potentially higher returns, but the system does not currently cater for this.

Insufficient range of products for post-retirement needs

24. The MPF system does not offer those who have already retired a sufficient range of products to help them logically draw down their pension pots over the period of their retirement, although members are allowed to withdraw their accrued benefits by instalments upon retirement or early retirement. Many have little or no idea how to invest this money. As a result, members may take on too much risk or use this money imprudently. Alternatively, they might put the money on overnight deposit without taking inflation into account – thereby potentially taking too little risk. Hong Kong's working population needs to plan for a longer retirement than most: the average life expectancy in 2016 is 81.3 years for males and 87.3 for females[14]. This means that someone looking to retire in Hong Kong at 60[15] would need to have an accumulated pension pot sufficient to maintain their lifestyle

[14] Census and Statistics Department, *Hong Kong Life Tables 2011-2066*, (September 2017), 7.
[15] An early retirement option is available to those aged at least 60 and who have ceased all employment and self-employment with no intention of becoming employed or self-employed again.

for more than 20 years. Life expectancy is forecast to increase to 87.1 years for males and 93.1 years for females by 2066.[16] If the retirement age remains unchanged, individuals' pension pots will have to sustain them for ever longer periods of time.

Insufficient independent governance and oversight

25. MPF trustees are responsible for overall oversight, as well as many of the day-to-day operations, of their MPF schemes – either through their own legal entities or sister companies. This often creates a significant potential conflict of interest: trustees have a commercial obligation towards their shareholder(s) and fellow group entities, but also need to act in the best interests of their members. Furthermore, many MPF trustee boards do not achieve sufficient independence from the schemes under their trusteeship. Therefore, we must ask whether MPF trustee boards really provide effective independent oversight and governance.

26. An independent board for MPF trustees is one way to mitigate these conflicts of interest. Right now, industry regulations stipulate that each MPF trustee must have at least one INED on its board.[17] However:

    a. In the UK, for defined contribution schemes "the majority of trustees on a master trust board, including the chair, must be independent of any company that provides services to the scheme".[18]
    b. The Australian Government, in September 2017, tabled the *Superannuation Laws Amendment (Strengthening Trustee Arrangements) Bill 2017.*[19] The bill requires registrable superannuation licensees to have at least one-third independent directors and for the Chair of the Board of Directors to be one of these independent directors.[20]

[16] Note 14.
[17] MPFSO, s.20.
[18] The Pensions Regulator of the UK, *Guide to the Trustee Board* (July 2016), 13.
[19] *See* the Parliament of Australia, Text of bill and explanatory memoranda. Available on:- https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=s1088.
[20] The Australian Government has delayed voting on this bill. It is, however, indicative of the trend towards having true independence of trustee boards in the pension industry.

27. Additionally, MPF sponsors are not currently under the MPFA's regulatory remit and therefore may not have the same focus on the value of the overall governance structure of an MPF scheme.

The MPFSO and associated regulations are outdated

28. The MPFSO is now almost two decades old. Much has happened in that time, including rapid changes in, and wider adoption of, technology. The MPFSO and accompanying regulations will also need to be revamped in preparation for the introduction of eMPF.

Recommendations

29. The MPF system is a vital Pillar Two solution within Hong Kong's pension framework. While it has substantially achieved its initial objective, there are a number of enhancements that could make it more effective while also helping it evolve into an attractive and viable Pillar Three solution. These enhancements would also increase the benefits that Hong Kong's financial services industry derives from its involvement in the management, operation and service delivery of the MPF system.

30. The FSDC's five recommendations are designed to increase members' engagement and to grow the level of assets within the system:

    i. Establish, implement and operate a centralised administration platform;
    ii. Enable and promote MPF trustees / sponsors to provide more comprehensive pension planning advice and education;
    iii. Increase the level of independent governance and oversight of MPF schemes;
    iv. Continue to update the MPFSO as required; and
    v. Increase the level of mandatory and voluntary contributions into the MPF system.

Establish, implement and operate a centralised administration platform

31. eMPF – a centralised administration platform within the MPF system – can introduce numerous benefits and enhancements to increase members' engagement. The platform should enable members to see their entire MPF holdings across multiple providers, to access information on CFs from other providers and to switch from one provider to another. Most importantly, eMPF should help to reduce costs, provided it is designed and operated efficiently and effectively.

Optimum design of eMPF:

32. The MPFA has stated that: “Once launched, [eMPF] will contribute to a simpler, cheaper, more reliable and more user-friendly system, deliver much better user experience, significantly improve the cost efficiency of MPF administration, and enable future reforms in the years to come”.[21] eMPF should provide economies of scale, thus reducing overall administration costs, with this reduction passed on to MPF members. It is therefore important that there is little or no duplication of effort between eMPF and MPF scheme service providers.

33. eMPF should be able to handle straight-through processing (STP). This means that it would take over all the transaction processing that is currently the responsibility of trustees, rather than just be an information dashboard. Anything other than STP would ultimately lead to an additional layer of administration and, as a result, additional costs in an already inefficient system.

34. The aim of eMPF is to improve the efficiency, reliability and accuracy of scheme administration as well as delivering an enhanced user experience for members. This should be at the forefront of decisions around its design, implementation and operation.

35. At the same time, the Mandatory Provident Fund Schemes (General) Regulation should be updated to relieve MPF trustees (and later the operator of eMPF) of onerous data retention requirements. At the moment, if an individual enrols in an MPF scheme at the age of 18 and withdraws all their benefits at the age of 65, the trustee is required to retain the records of the member’s contributions for 54 years.[22] This is significantly longer than other record keeping requirements in Hong Kong, including the seven-year retention period under the Inland Revenue Ordinance, the Companies Ordinance and the Securities and Futures

[21] Note 6.

[22] Section 93 of the Mandatory Provident Fund Schemes (General) Regulation (Cap.485A) requires that the approved trustee of a registered scheme must ensure that an accounting or other record required to be kept in respect of the scheme is kept for at least 7 years after the end of the financial period in which the record is made or, if the record relates to a person’s membership of the scheme, for at least 7 years after the person ceases to be a scheme member.

(Keeping of Records) Rules.[23] Industry players have observed that most member enquiries are related to their current MPF account balance and contributions for the previous year, rather than historic contributions.

36. This paper recommends that the Government demonstrates how eMPF will achieve targeted cost savings – as well as other user benefits – and quantify them if possible.

Digital by default:

37. Hong Kong has a high level of mobile adoption. Government statistics show that in 2017, 88.6% of people over the age of 10 had a smartphone, up from 85.8% in 2016. Penetration is highest among the 25-44 and 45-64 age brackets, with 99.6% and 95.1% respectively. A higher percentage of people over the age of 10 had a smartphone (88.6%) than had recently used a computer (79.8%).[24] Therefore, it is imperative that eMPF's design incorporates mobile-friendly interfaces. The Government is encouraged to employ financial technology (FinTech) to support mobile access of MPF services. The MPFA should also ensure an environment with sufficient cybersecurity checks and balances.

38. To achieve cost savings, the Government will need to mandate electronic submission of all enrolments, payments and withdrawals, which are currently substantially manual. eMPF should require employees and employers to go digital, while providing an opt-out for those who are not on-line. At the same time, the Government should consider providing secure access for members who wish to access their MPF accounts on-line.

39. Without a 'digital by default' mandate, many transactions will still be processed manually. Combined with the new eMPF platform, this could lead to an even more complex system than we have now and at a greater cost.

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[23] The Securities and Futures (Keeping of Records) Rules (Cap.571O) and the Inland Revenue Ordinance (Cap.112) both have a normal seven year (or shorter for certain specific transactions) record retention requirement.

[24] Census and Statistics Department, *Thematic Household Survey Report No. 64: Pattern of Smoking and Personal Computer and Internet Penetration* (March 2018), 7. Available at:- https://www.statistics.gov.hk/pub/B11302642018XXXXB0100.pdf

Delineation of roles and responsibilities between the operator of eMPF, other service providers and the regulator:

40. There needs to be clear delineation of the respective roles and responsibilities of the operator of eMPF, other service providers operating within the MPF system (including trustees) and the regulator. This should include the establishment of a robust governance, oversight and regulatory framework that the operator of eMPF will need to comply with and operate within.

41. As an example, in 2010 the UK Government established the National Employment Savings Trust (NEST) pension scheme, with 6.4 million members as of 31 March 2018.[25] While the trustee of the scheme is a public not-for-profit corporation, it appointed Tata Consultancy Services, a private sector operator, as the administrator of the scheme on an initial ten-year contract (with an option to extend for five years). Both the scheme and the trustee need to operate under the regulatory regime established by the Pension Regulator in the UK.

Establishing a single account identification number:

42. This paper also recommends that all members should have a unique account identification number (ID) to be used consistently within the MPF system, regardless of which trustee(s) / sponsor(s) looks after their MPF account(s). The Innovation and Technology Bureau's Hong Kong Smart City Blueprint (December 2017) includes a plan to provide all Hong Kong residents with a free electronic identity (eID) by 2020.[26] This would be the only authentication requirement when conducting government and commercial transactions. As the eID is targeted to roll out before eMPF, it could be a viable solution for eMPF member IDs.

[25] National Employment Savings Trust Pension Scheme of the UK, *Annual Report and Accounts 2017/18* (12 July 2018), 12.
[26] The Innovation and Technology Bureau, *Hong Kong Smart City Blueprint* (December 2017). Available at:- https://www.smartcity.gov.hk/doc/HongKongSmartCityBlueprint(EN).pdf

Enable and encourage MPF trustees / sponsors to provide more comprehensive pension planning advice and education

43. Most MPF members need better access to investor education materials and retirement planning advice if they are going to end up with a suitable plan for their circumstances. Equally, many trustees / sponsors want to provide investor education to their clients. For them to do so, they must be able to access and analyse relevant data on their clients and use it to provide a better service.

44. Accordingly, this paper recommends that trustees / sponsors continue to maintain their own databases of relevant client data. But to avoid duplication of effort and to achieve cost savings, collection and maintenance of this data should be within eMPF. This will require agreement within the industry on what data fields to include. These should be reviewed periodically – as the industry continues to evolve, what is deemed relevant data will also evolve. As trustees will retain fiduciary responsibility for their scheme members, they will need to be comfortable with the completeness and accuracy of members' data maintained within eMPF. This could be achieved through a combination of due diligence reviews and testing performed by trustees on the services provided by the eMPF operator, as well as periodic reporting by the eMPF operator on its internal processes and controls.

45. Section 41 of the MPFSO prohibits trustees from disclosing – or enabling other parties to access – any information they have collected unless this is to perform functions under the MPFSO.[27] This effectively bars them from cross-selling post-retirement products to their members. For MPF trustees to truly act in the best interests of members, they should be able to advise them not just on how to accumulate a pension pot, but what to do with it. This reduces the risk that 40 years of positive accumulation could be undone through one ill-advised post-retirement investment decision.

[27] MPFSO, s.41.

46. A trustee / sponsor might wish to use client-specific data to target clients with seminars, information booklets and other marketing and education materials. However, these marketing efforts should be solely directed towards investor education and assisting clients to consider their MPF options, rather than promoting non-retirement products.

47. This paper also recommends allowing members to ‘opt in’ to cross-marketing solicitations for non-MPF investment products. Many members, especially those with higher incomes, would welcome learning about additional savings / investments options outside of the MPF system to fund their future retirements. This would also help to promote Hong Kong as an international asset and wealth management centre. At the same time, data protection must be maintained.

Increase the level of independent governance and oversight of MPF schemes

48. The overall level of MPF governance can be improved. There have been a series of measures carried out by the MPFA in the last two years. While these will improve the standard of governance provided by MPF trustees, it remains critical that there be a clear segregation between the role of the trustee (governance and oversight) and that of service providers performing day-to-day activities (transaction processing). Currently, trustees are responsible for both.

49. Increasing independent governance and oversight can be partially achieved by raising the number of INEDs on MPF trustee boards. While the MPFA's Governance Principles encourage the appointment of more than one INED, this paper recommends that the minimum number appointed to a trustee board be increased to three, or a majority of the board, whichever is greater. To be effective, INEDs need to have a clear understanding of their roles and responsibilities, which should be centred on instilling good governance standards and practices within the MPF trustee. These roles, responsibilities and objectives need to be clearly documented and communicated.

50. Board members encounter an inherent and unavoidable conflict of interest in their responsibilities and duties to the MPF trustee's shareholder(s) and MPF scheme members, even if INEDs are appointed. The governance structures within the MPF system should assign priority to members' interests. One option would be the establishment of a separate board at the MPF scheme level, which could be responsible for the oversight and supervision of the scheme. This is a similar set-up to the investment fund industry where, typically, there is an independent board at the fund level. The investment manager commonly has responsibility for day-to-day management of the fund, while the board provides independent governance and oversight over the services provided by the fund manager and other service providers. The board at the investment fund level is distinct from the board of directors at the investment manager or other service provider level.

51. For an MPF scheme, this board would be distinct from those of the MPF trustee and / or sponsor. This would enable it to focus on MPF members' interests. It would also allow representatives from the product owners (sponsor and investment manager, etc.) to sit on the scheme board and provide them with a voice in managerial decisions regarding the scheme.

52. The introduction of eMPF should grant MPF members full portability between schemes offered by different service providers. The ability of MPF trustees to act independently will be of central importance to industry debate, as their role could change significantly. As part of the implementation of eMPF, this paper recommends that the Government and / or the MPFA conduct a holistic review of the future roles and responsibilities of MPF trustees and sponsors.

Update the MPFSO

53. This paper recommends a review and revamp of the MPFSO and subsidiary legislations. The MPFSO will need updating to support and complement the other recommendations raised in this paper, including revisiting investment restrictions, pursuing a 'digital by default' approach for MPF accounts, facilitating more cross-marketing opportunities and loosening requirements on retention of members' records. At the same time, the MPFSO should provide the MPFA with appropriate levels of authority and flexibility to react to future market developments.

54. Other updates and enhancements to the MPFSO and supporting regulations and guidelines that should be considered are as follows:

    a. Evaluating whether there are more effective methods to locate members or claimants than those set out in the MPFA's Guidelines on Unclaimed Benefits (Guidelines IV.21).
    b. Allowing MPF trustees to close inactive zero-balanced MPF accounts after a specific and reasonable period of time; and

c. Expanding the role of the MPFA so that the MPF system can better cater to the needs of those drawing down their pensions in retirement.

55. The evolving potential of FinTech to help MPF members better manage their accounts and make more informed investment decisions – and to help prepare for the launch of eMPF – should be taken into account when revisiting these regulations.

Increase the levels of mandatory and voluntary contributions into the MPF system

56. The FSDC understands that the MPFA's latest review of MPF contribution levels suggests, among other things, an increase in the upper limit of monthly mandatory contributions. This paper strongly supports this as a way of increasing the system's effectiveness as a Pillar Two pension solution.

Increasing the level of voluntary contributions:

57. Members are encouraged, and should be incentivised, to save enough for their long-term retirement needs. This paper advocates the establishment of tax-efficient voluntary contributions to do this. Presently, under the Inland Revenue Ordinance, employers are entitled to make tax-efficient contributions to MPF schemes on behalf of their employees (employer contributions) up to 15% of an individual employee's total emoluments.[28]

58. Employees should be provided with similar incentives. While still required to pay their mandatory contributions, employees should have the option of topping up tax-efficient voluntary contributions to an aggregate total of 15% of their relevant income.

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[28] Section 17(1)(h) of the Inland Revenue Ordinance specifies that no deductions shall be allowed for any sums that the person has, as an employer, paid in respect of an employee as; (i) an ordinary annual contribution to a fund established under a recognized occupational retirement scheme; or (ii) an ordinary annual premium for a contract of insurance under such a scheme; or (iii) regulator contributions paid to a mandatory provident fund scheme, to the extent that the total of the payments exceeds 15 percent of the total emoluments of the employee for the period to which the payments relate.

59. Following the proposal in the Government's 2018-19 Budget for tax concessions for MPF voluntary contributions,[29] the Inland Revenue and MPF Schemes Legislation (Tax Deductions for Annuity Premiums and MPF Voluntary Contributions) (Amendment) Bill was gazetted on 7 December 2018. The proposed maximum deduction per person per year of assessment is HK$ 60,000. When the Bill is enacted into the law, it will apply from the year of assessment 2019/20[30]. This paper recommends a maximum permitted annual tax-advantaged amount of up to 15% of an employee's relevant income. While this may be insufficient to meet the retirement needs of many members, it should still be significantly higher than the proposed HK$60,000 limit.

60. Under current proposals, tax-efficient voluntary contributions would be subject to the same withdrawal restrictions as mandatory contributions. This means that members would not be able to access those funds until retirement. This may not incentivise workers, particularly those just starting their careers, to maximise their voluntary contributions. As well as having to save for their retirements, workers have other financial needs. To incentivise voluntary contributions, this paper recommends the exploration of early withdrawal mechanisms.

61. As well as encouraging employees to top up, employers also need to see MPF as a viable option for retaining and rewarding employees. More promotion is needed to remind employers that MPF enables them to set a vesting scale for voluntary contributions based on their business and staff characteristics. eMPF must be designed to make vesting on voluntary contributions easy to calculate and simple for employers to create and manage on an ongoing basis.

Greater ability for members to select the MPF schemes and CFs into which their contributions are invested:

[29] Hong Kong Special Administrative Region Government, The 2018-19 Budget Speech (28 February 2018), para 93. Available at: https://www.budget.gov.hk/2018/eng/budget14.html

[30] Legislative Council Brief, File Ref.: INS/2/18C - Inland Revenue and MPF Schemes Legislation (Tax Deductions For Annuity Premiums and MPF Voluntary Contributions) (Amendment) Bill 2018 (27 November 2018). Available at: https://www.legco.gov.hk/yr18-19/english/bills/brief/b201812071_brf.pdf

62. Employers play a pivotal role in introducing employees to both the MPF system and service providers. Those starting their careers might not have pension planning at the forefront of their minds and may therefore be content for their employer to select a provider on their behalf. While it is important that employers continue to play this role, individuals' understanding of MPF increases through their working life and they may be attracted to products offered by alternative service providers. MPF members should be afforded more freedom to select schemes and CFs from these providers if they feel these would be more suited to their retirement needs. This includes the choice to select where accrued benefits associated with employer contributions are invested. Currently, a scheme member is only allowed to transfer his personal account accrued benefits to another MPF scheme in accordance with s149 of the Mandatory Provident Fund Schemes (General) Regulation.

63. This also ties into the objective of maximising the take-up of voluntary contributions: the eMPF should be designed so as to provide members with a wide range of MPF schemes and CFs to choose from for their employee contributions, and to make switching a more pain-free process. At present, employees are permitted to choose which MPF scheme their personal accounts and Special Voluntary Contribution accounts accrued benefits are invested in, but the process for transferring accrued benefits from scheme to scheme is time consuming and administratively cumbersome.

Investment restrictions should be subject to a holistic review:

64. The MPF has been successful in its aim of creating a Pillar Two pension solution. For it to evolve into an effective Pillar Three solution, it needs to be able to attract voluntary contributions from its members, including sophisticated investors. Investment restrictions therefore need to be reviewed and re-aligned in light of current market conditions. This may include allowing additional asset classes and markets. The MPFSO rules on permissible asset classes were set a long time ago and at present there is no periodic assessment of their continuing suitability. For example, this paper endorses consideration of the following:

- Addition of Chinese stock exchanges as recognised exchanges;

- Hong Kong-domiciled SFC authorised funds; and
- Higher permissible asset allocations to Real Estate Investment Trusts.

65. To incentivise members to increase their contributions and to address the ‘one size fits all’ challenge of the current system, a combination of these four recommendations would be useful:

a. provide tax incentives for employees’ voluntary contributions;
b. encourage employers to increase their levels of voluntary contributions;
c. give MPF members greater ability to select where they invest; and
d. introduce additional asset classes and markets.

Other recommendations

66. As well as the core recommendations identified above, this paper recognises that some areas of the MPF system require further consideration over the longer term.

Introduction of alternative asset classes

67. Investors may wish to invest in more alternative asset classes, given that some of these have delivered higher returns over an extended period. However, no suitable alternative products are readily available in Hong Kong for introduction into the MPF system. If stable and long-term alternative products can be provided, these might provide an attractive investment option for certain members. For example, the Canadian Pension Plan (CPP) had a net asset value of US$356 billion and experienced 5-year and 10-year annualised rates of return of 12.1% and 8.0% respectively as of 31 March 2018.[31] The alternative investments allocated to CPP’s investment portfolio included 20.3% of private equity, 12.9% of real estate and 8.0% of infrastructure investments, which all yielded positive returns in the fiscal year of

[31] Canadian Pension Plan Investment Board, *2018 Annual Report* (May 2018), 47. Available at:- http://www.cppib.com/documents/1800/CPPIB_F2018_Annual_Report_English.pdf

2018.[32] By comparison, CFs within the MPF system generated annualised returns of between 0.1% (MPF Conservative Funds) and 7.4% (Equity Funds) during the five year period ended 31 March 2018 - significantly lower than the CPP.[33]

68. Investment restrictions should be subject to regular review, with new markets or asset classes introduced if these fit in with the overall objectives of the MPF system. This paper therefore encourages moving the investment restrictions under the MPFSO to an MPFA code or guideline. This will grant the MPFA greater flexibility, as it can amend investment restrictions by updating the relevant code or guideline, rather than needing to update legislation. This is similar to retail funds authorised in Hong Kong – investment restrictions are not included in the Securities and Futures Ordinance. The SFC instead uses the Code on Unit Trusts and Mutual Funds to handle updates to investment restrictions and guidelines.

Introduction of a wider range and selection of post-retirement products

69. As the MPF industry matures, more people will have contributed to it for 20+ years and, in line with the recommendations above, assets within the system will have grown further. This will create increasing demand for the industry to come up with 'de-accumulation products' to help members better manage their money during their retirement years. The HKMC Annuity Plan, launched on 5 July 2018, is one example of a post-retirement product.[34]

70. Providers should be encouraged to produce more post-retirement products, allowing members to receive a steady income while spending down their assets prudently. Insurers

[32] *ibid*, 46.

[33] According to information published within its 2017 Annual Report, the Ontario Teachers' Pension Plan, which had a net asset value of US$190 billion as of 31 December 2017, had generated 5 and 10 year annualised returns of 9.6% and 7.6%, respectively for the periods ended 31 December 2017. As of 31 December 2017, 17% of the plan's investment portfolio consisted of non-publically traded equities, with a further 25% consisting of real asset investments including real estate and infrastructure projects.

[34] Under the scheme, residents aged 65 or above could register, between 19 July and 8 August 2018, to invest between HK$50,000 and HK$1,000,000 in exchange for guaranteed lifetime monthly payments. For those applicants aged 65 at the time of application, the guaranteed monthly payments range from HK$290 to HK$5,800 for men and HK$265 to HK$5,300 for women.

and annuity providers should also address these needs. To be successful, the MPF service providers should offer appropriate information and professional advice about post-retirement issues and suitable products to members approaching retirement age.

Conclusion

71. The underfunding of pensions is a major global problem. It is important that Hong Kong take steps so that its working population can save enough for a comfortable retirement. Hong Kong's financial services industry has a pivotal role to play in the continued growth and development of the MPF system.

72. eMPF will represent the largest reform to Hong Kong's pension framework since the introduction of the MPF. There will be significant public pressure for it to deliver tangible results, to increase members' engagement with the system through lower fees and to rationalise the inefficient administration model currently in play. This paper emphasises that eMPF needs to handle straight-through processing and mandate a 'digital by default' approach. It should also be implemented through a 'big bang' approach and be outsourced to a private operator. It should use the Smart City initiative's eID or a similar single ID. eMPF also needs to allow trustees and sponsors to access relevant data on members in order to provide member education and advice. The interests of members should be paramount in the design and operation of eMPF.

73. The trustee governance structure should be further strengthened to minimise conflicts of interest. The independence of MPF trustees will continue to attract public scrutiny after the introduction of eMPF.

74. Successful implementation of the recommendations in this paper may also require an overhaul of the MPFSO. As technological developments disrupt our lives and the business environment, the MPFSO needs to stay up to date.

75. Existing MPF assets in isolation are generally not enough for Hong Kong people's retirements. One major goal of any reform must be to encourage the increased funding of members' MPF plans. For Hong Kong to have a more efficient and effective overall pension framework, the MPF system should expand into an integrated Pillar Two and Three

solution. As MPF assets continue to grow there will be more demand for suitable investment products to maintain members' standard of living in their post-retirement years.

76. Hong Kong is fortunate to have a system in place that covers the majority of employees. With some adjustments and enhancements it can become a truly great system which operates efficiently and flexibly to meet the retirement needs of the working population of Hong Kong.

Appendix I: The World Bank pension framework

In 2005 the World Bank published a conceptual pension framework made up of five core pillars[35]	
Pillar Zero	non-contributory government-funded basic pension plan with the objective of providing elderly people with a minimum level of protection
Pillar One	mandatory earnings-related public pension plan
Pillar Two	mandatory earnings-related occupational or private pension plans
Pillar Three	voluntary contributions to occupational or private pension plans as well as voluntary savings (e.g. personal savings and insurance plans)
Pillar Four	non-financial support, including access to informal support (such as that provided by one's family), other formal social security programmes (e.g. heath care and / or housing), and other individual financial and non-financial assets (e.g. property ownership)

[35] *See* Holzmann, Robert; Hinz, Richard, *Old Age Income Support in the 21st century: An International Perspective on Pension Systems and Reform* (2005, Washington, DC: World Bank). Available at: https://openknowledge.worldbank.org/handle/10986/7336 and World Bank, *The World Bank pension conceptual framework* (2008, Washington, DC: World Bank) Available at: http://documents.worldbank.org/curated/en/389011468314712045/The-World-Bank-pension-conceptual-framework

Appendix II: Glossary of acronyms

CF – Constituent fund

DIS- Default investment strategy

ECA – Employee choice arrangement

FSDC – Financial Services Development Council

FSTB – Financial Services and the Treasury Bureau

INED – Independent non-executive director

MPFA – Mandatory Provident Fund Schemes Authority

MPFSO – Mandatory Provident Fund Schemes Ordinance

RI – Relevant income

SFC – Securities and Futures Commission

STP – Straight-through processing

About the Financial Services Development Council

The Hong Kong SAR Government announced in January 2013 the establishment of the Financial Services Development Council (FSDC) as a high-level and cross-sector platform to engage the industry and formulate proposals to promote the further development of Hong Kong's financial services industry and map out the strategic direction for development. The FSDC advises the Government on areas related to diversifying the financial services industry, enhancing Hong Kong's position and functions as an international financial centre of our country and in the region, and further consolidating our competitiveness through leveraging the Mainland to become more global.

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