Universal Retirement Protection:
The Relevance of MPF in the Debate

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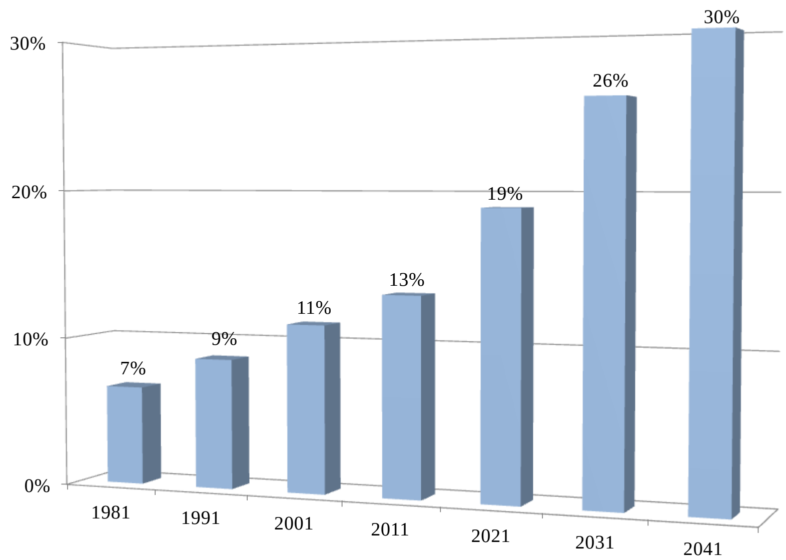
Challenges of an Ageing Population

Like many other societies in the world, Hong Kong has been facing the challenge of an ageing population. According to the Census and Statistics Department, the proportion of the population aged 65 and over is projected to rise markedly, from 7% in 1981 to 30% in 2041.[1] As Hong Kong people live longer, there will likely be a higher percentage of retired people in the population. That means, in turn, that the working population will have a larger number of retirees to support for a longer period of time.

Chart 1 Percentage of the Population Aged 65 and Above



Sources: Demographic Trends in Hong Kong 1981–2011, Census and Statistics Department
Hong Kong Population Projections 2012 – 2041, Census and Statistics Department

[1] See Census and Statistics Department (2012a and 2012b).

World Bank's Three-pillar Approach and the Launch of the Mandatory Provident Fund ("MPF") System

2. Ageing population, and the increasing resources needed to meet the retirement needs of this group, are issues affecting many nations in the world and much thought has been given internationally to how best to develop a viable, sustainable system that could support a growing elderly population, given limited public resources. Such a system would need to be a long-term one that is set within a comprehensive and effective institutional framework.

3. In Hong Kong, since the 1960s, debates and discussions had been taking place on the viability of setting up a mandatory retirement system. In the decades that followed, different forms of retirement protection schemes, such as pay-as-you-go pension schemes, centrally-operated provident funds and privately-run retirement schemes were put forward and debated both publicly and in the legislature.[2]

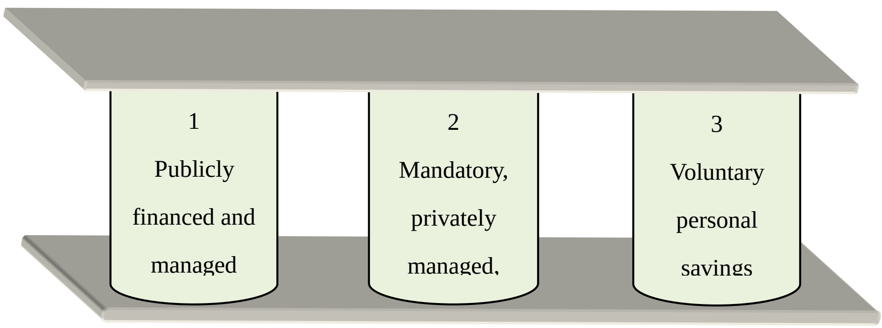
4. In 1994, the World Bank recommended a three-pillar approach to address the issue of old age protection ("1994 Framework").[3] The three pillars, as proposed at that time, comprised:

<u>Pillar One</u>: a publicly financed and managed social safety net;

<u>Pillar Two</u>: a mandatory, privately managed, fully funded contribution scheme; and

<u>Pillar Three</u>: voluntary personal savings.

Chart 2 World Bank's Three Pillars Framework



[2] Mandatory Provident Fund Schemes Authority (2011) and Legislative Council Secretariat (2005) provide details on the debates and discussions of retirement protection in Hong Kong before the establishment of the MPF System.

[3] World Bank (1994) gives a detailed account of the conceptual framework recommended by the World Bank.

5. According to the framework recommended by the World Bank, the three pillars have different primary objectives to achieve. While the first pillar would have the primary objective of alleviating old age poverty through redistribution of income, the second pillar serves the function of enhancing income-smoothing[4] or saving for retirement of the working population. The third pillar aims to provide additional protection for people who want more income and insurance in their old age.[5]

6. When the World Bank's three-pillar approach was published in 1994, Hong Kong policymakers studied its recommendations carefully and considered that, given the nature of the population in Hong Kong and the traditional financial and saving habits of its people, as well as its well-established and sound financial infrastructure, a mandatory system for saving for retirement was a good fit. In particular, Hong Kong had the Comprehensive Social Security Assistance Scheme as its first pillar of retirement protection and the population had a high saving rate for third pillar protection. A mandatory employment-related contributions system would thus complete the three-pillar approach, and incidentally make Hong Kong one of the pioneers in applying the World Bank's conceptual framework.[6] The Mandatory Provident Fund Schemes Ordinance ("MPFSO"), providing for the legislative framework of the MPF System, was enacted in 1995, and supplemented by detailed subsidiary legislation in 1998. The Mandatory Provident Fund Schemes Authority ("MPFA"), the statutory body charged with regulating and supervising MPF schemes, was set up in September 1998. The MPF System started to operate in December 2000.

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4 The objective of income smoothing is to enable individuals to smooth their income throughout their lifetime, so that they could maintain a reasonable standard of living once they retire.

5 See World Bank (1994).

6 See Mandatory Provident Fund Schemes Authority (2011) for a detailed account of the birth of the MPF System.

Achievements of the MPF System

7. As the second pillar of the World Bank's 1994 Framework, the MPF System has substantially strengthened the retirement savings of the working population of Hong Kong. The positive contributions made by the MPF System could be quantified in a number of ways as set out below.

Coverage of the Working Population

8. The MPF System is a mandatory system, which helps ensure that each working individual would be setting aside some retirement savings during his/her working life. All employees (except for exempt persons)[7] are covered by the MPF System. Employers in all industries have to enrol their regular employees (i.e. employees from 18 to 64 years of age and employed for 60 days or more) in an MPF scheme within the first 60 days of employment. Casual employees in the catering and construction industries, two industries identified as having high intra-industry mobility, are covered from the first day of employment. Self-employed persons from 18 to 64 years of age must enrol themselves in an MPF scheme within 60 days after they have become self-employed, unless they are exempt persons.

9. Before MPF was implemented, it is estimated that only about one-third of Hong Kong workers were covered by any sort of occupational retirement protection scheme. In 2000, this represented not much more than one million of the 3.3 million people employed at the time. Large sections of those employed had no cover of any kind. Post MPF, as at 30 September 2014, nearly 90% of Hong Kong's workers (about 3.2 million) are covered by the MPF System or some other form of retirement scheme. Most of the remaining workers are not legally required to join any local

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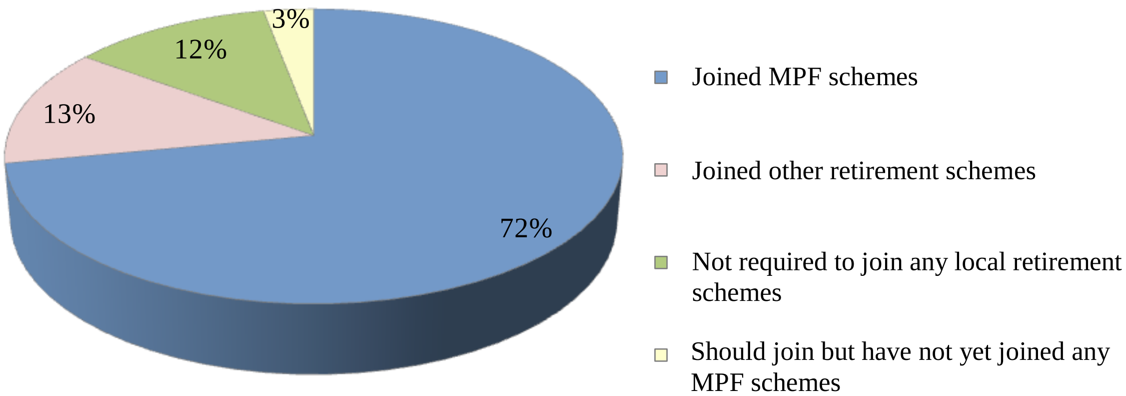
[7] The following categories of employees are exempt persons under the MPF System:
- (i) People covered by statutory pension or provident fund schemes, such as civil servants and subsidized or grant school teachers;
- (ii) Employees who choose to remain as members of occupational retirement schemes which are granted MPF exemption certificates;
- (iii) Domestic employees;
- (iv) People from overseas who enter Hong Kong for employment for not more than 13 months, or who are covered by overseas retirement schemes;
- (v) Employees who are employed for less than 60 days, excluding casual employees engaged in the construction and catering industries; and
- (vi) Employees of the European Union Office of the European Commission in Hong Kong.

retirement scheme; this group includes workers with overseas retirement schemes, employees aged below 18 or 65 and above, and domestic helpers. Coverage of the working population in Hong Kong is excellent by international standards.

Chart 3 Employed Population by Type of Retirement Schemes



Source: MPFA

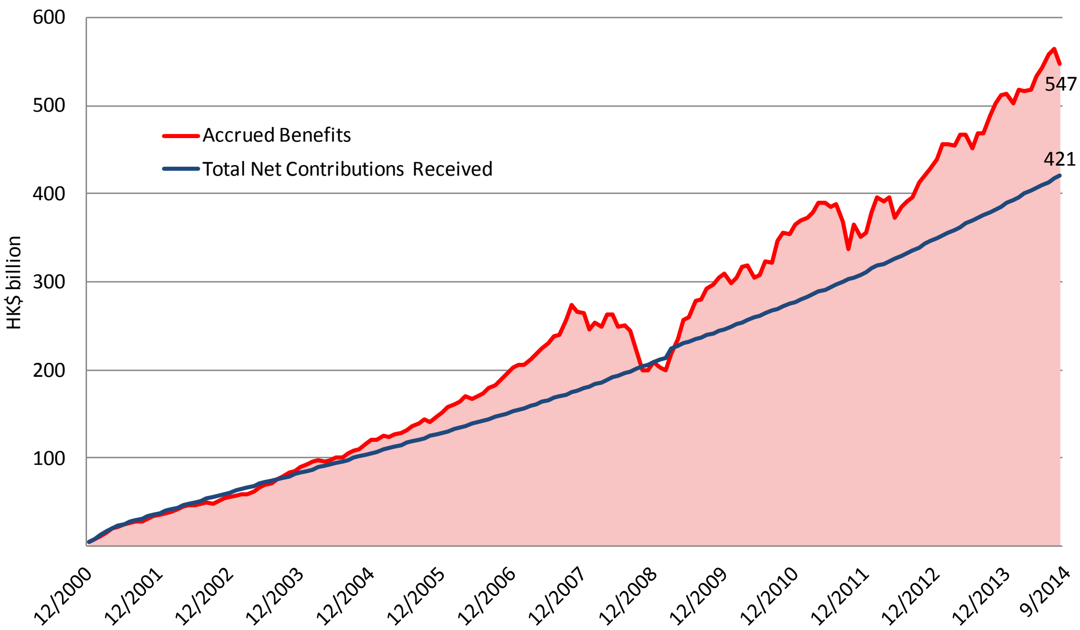
MPF Contributions and Accrued Benefits

10. On the back of high enrolment rate, the total MPF contributions made by employers, employees and self-employed persons have risen gradually since December 2000. Between December 2000 and September 2014, net contributions (i.e. contributions made, less the amount of benefits paid) stood at a net total of $420.65 billion. The effect of time and compounded returns are such that, as at September 2014, the accrued benefits (i.e. contributions plus investment return thereon) in the MPF System had grown to $546.60 billion. This means that in dollar terms, the MPF System generated an investment return of $125.95 billion after fees and charges had been deducted, which translates into an annualized internal rate of return[8] of 4.0% for the period. This is substantially higher than the inflation rate (1.7% per year) for the same period. Naturally, the precise details for individual MPF accounts will vary from this average figure, depending on individuals' choice of

8 The internal rate of return ("IRR") (also referred to as the dollar-weighted return) is a method to measure investment return. This method takes into account the amount and timing of contributions into and benefits withdrawn from the MPF System. The annualized IRR was calculated by raising the monthly IRR to the power of 12.

fund and on the timing of their contributions, but it can be seen that overall, the MPF System had added substantially to the retirement savings of workers.

Chart 4 Growth of MPF Contributions and Accrued Benefits



Source: MPFA

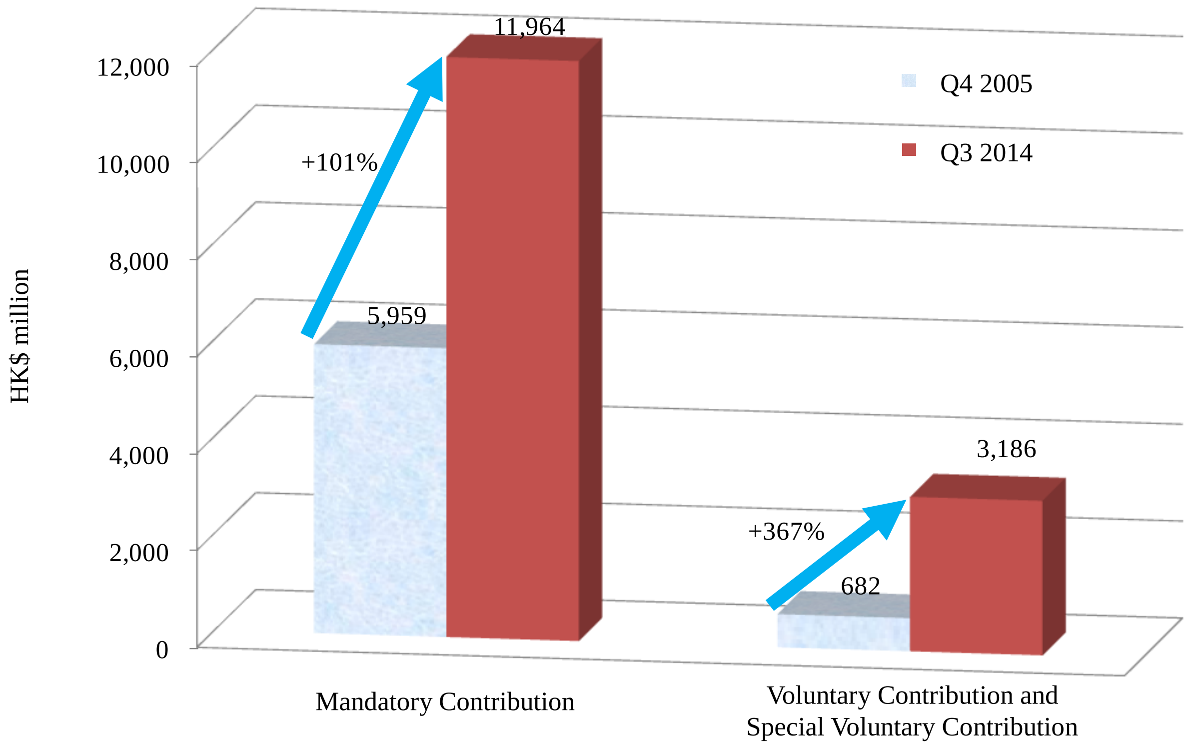
11. Generally speaking, the level of MPF mandatory contribution is on the low side compared to other jurisdictions. Employers, employees and self-employed persons contribute 5% of income subject to a maximum income level of $30,000 per month. Employees earning below a minimum income level of $7,100 per month are not required to contribute, but their employers are still required to make employer contributions for them. Many have suggested that contribution rates or the maximum income level should be raised, but keeping contributions at a moderate level reduces the month-to-month financial impact on members whilst at the same time allowing flexibility for scheme members to choose other forms of investments for additional savings.

12. For those scheme members who prefer to make use of the MPF System for additional retirement savings, the MPF System also accommodates voluntary

contributions from scheme members or employers. There are generally two types of employee voluntary contributions offered by MPF schemes: Voluntary Contribution ("VC") and Special Voluntary Contribution ("SVC"). The former is employment-related (i.e. contributions are deducted from the employee's income and made to an MPF scheme by the employer), whilst the latter is non-employment related (i.e. contributions are paid directly by a scheme member to a scheme).

13. The amount of VC and SVC recorded substantial growth over the past years. In the fourth quarter of 2005,[9] the amount of VC and SVC accounted for 10% of total contributions received in the quarter. In the third quarter of 2014, the share expanded to 21%. In dollar terms, the amount of VC and SVC rose by more than 360% from HK$ 682 million in the fourth quarter of 2005 to HK$ 3,186 million in the third quarter of 2014.

Chart 5 Amount of Mandatory and Voluntary Contributions Received



Source: MPFA

[9] The statistics on the amount of SVC are first available in respect of the fourth quarter of 2005.

Improving the MPF System

14. The MPF System affects the entire workforce of Hong Kong. The MPFA has been making use of a wide range of means to reach different sectors of the workforce to educate them on the MPF System in particular and the importance of financial planning for old age in general. In addition, the MPFA has constantly worked towards making improvements to the MPF System so that the System can better meet the expectations of stakeholders.

<u>Ensuring Contributions Are Made by Employers</u>

15. The MPFA's primary objective is to protect scheme members' rights and interests. It needs to ensure that relevant employees, relevant employers and self-employed persons enrol in the MPF System and make timely MPF contributions. Legislative amendment proposals were made to the Government over the years to enhance the deterrent effect against non-compliance with enrolment and contribution requirements. For example, housing allowance and benefits were excluded from income for the purpose of MPF mandatory contribution when the MPF System was first implemented, but some employers made use of the exclusion to arbitrarily reduce the amount of mandatory contributions that should be made. An amendment was thus made to remove the exclusion in 2008. In 2012, two enforcement related provisions came into operation, making employers' failure to pay mandatory contributions a continuous offence, and making employers' failure to pay any sum payable under tribunal or court awards a criminal offence.

16. To help employees detect employers' default in making contributions so that complaints may be lodged with the MPFA for follow-up, the MPFA set up a centralized enquiry line in September 2007 to give scheme members more convenient access to information about the recent history of their MPF contributions.

<u>Ensuring Compliance by Trustees</u>

17. Trustees (and their appointed service providers) are responsible for administration of MPF schemes, formulation of investment strategies and decisions,

and custody of scheme assets. The MPFA is responsible for supervising the trustees and adopts a proactive, risk-based supervisory approach in doing so. In addition to conducting on-site visits and monitoring the returns submitted by trustees off-site, the MPFA maintains a regular dialogue with trustees to discuss operational and topical issues. Codes and guidelines are issued on various issues to ensure that trustees act in compliance with statutory requirements. A set of Compliance Standards was issued in 2005 to promote good corporate governance, proper risk management and a positive compliance culture among trustees.

Widening the Scope of MPF Investment

18. The MPF legislation prescribes restrictions that MPF investment must meet. To keep up with market development, legislative amendments were made in 2002 and 2006 to relax some of the restrictions on fund investments while minimizing risks. Guidelines are frequently reviewed and updated, taking into account the development of new products and markets in the light of members' interest.

Ensuring Contributions Keep Up with Income Growth

19. The income in respect of which MPF mandatory contributions are required to be made is subject to a maximum level. If the maximum level does not keep up with the income growth of the workforce, members would in effect be making less and less retirement savings over time, thereby reducing the retirement protection provided by the MPF System. In this regard, the maximum level has been revised upwards from $20,000 a month at System implementation to $25,000 from June 2012, and then to $30,000 from June 2014. The minimum level, the income level below which employees and self-employed persons are not required to make MPF contributions, has also been revised upwards three times from $4,000 a month to $5,000 from February 2003, $6,500 from November 2011, and then $7,100 from November 2013, thus relieving those in the workforce with lower pay from having to make contributions that could pose immediate financial difficulties.

Enhancing Disclosure of MPF Information

20. To increase transparency of fees and to facilitate comparison of fees charged by different MPF funds, "The Code on Disclosure for MPF Investment Funds" was issued in 2004, requiring MPF providers to comply with standardized fee tables and fees disclosure. Since then, a range of tools have been introduced and made easily accessible so that scheme members can make informed MPF decisions. These include a Fee Comparative Platform, with five-year and ten-year annualized rates of return of MPF funds displayed alongside fee information, a Low Fee Fund List, and a Trustee Service Comparative Platform.

Expanding Investment Choices Available to Employees and Preventing Mis-selling

21. An employee is enrolled into the MPF scheme chosen by the employer. The arrangement has administrative appeal to employers, but limits the investment choices available to employees, which may, in turn, have an impact on market competition. To give employees greater control over their MPF investments, the Employee Choice Arrangement ("ECA") came into operation on 1 November 2012. The ECA gives employees a right to transfer the accumulated MPF benefits attributed to their own mandatory contributions to a scheme of their own choice. ECA therefore gives employees greater autonomy in managing part of their MPF investments and helps enhance members' engagement in their MPF investments.

22. To cope with the intensified selling activities following ECA implementation, better protection of scheme members against mis-selling was effected by putting in place a statutory regulatory regime for MPF intermediaries, giving legal backing to the administrative arrangement that was put in place with the inception of the MPF System.

Enhancing Efficiency of MPF Benefit Transfer

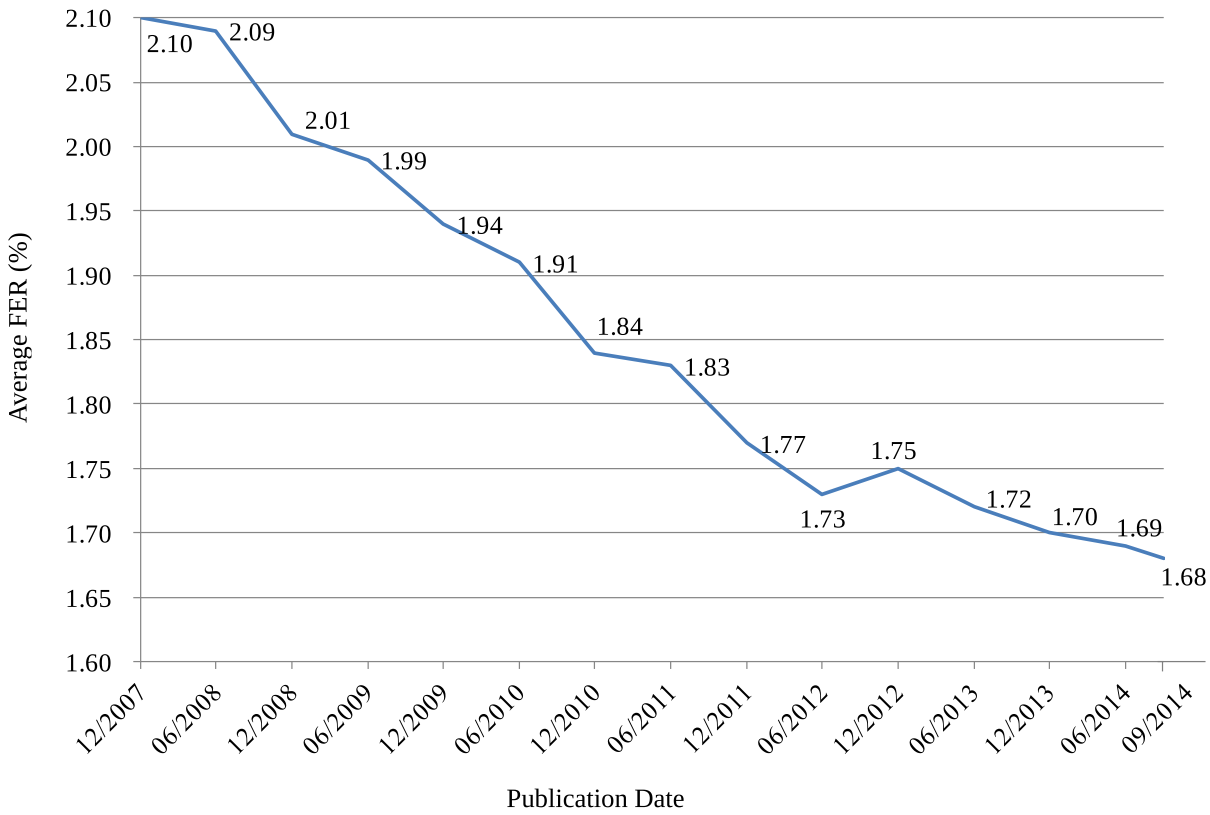
23. To enhance the efficiency of MPF transfer processes, an electronic system known as the “Electronic Portability Automation Services System” (“ePASS”) was launched when ECA came into operation. The ePASS provides a secure platform for automatic transmission of data on transfer of benefits between trustees. In June 2014, an E-Payment for MPF transfer, developed by the Hong Kong Monetary Authority, came into operation. This E-Payment system automates payments for the transfer of benefits between trustees. It further shortens the time needed for the transfers, and enhances the accuracy and efficiency of the transfer process.

Striving for Fee Reduction

24. As a privately managed system, fees are charged by operators to cover the cost and a reasonable profit element for their performance of the essential functions necessary in running MPF schemes. There has been much public debate about whether the fee level charged by MPF operators is reasonable. It is challenging to identify clear benchmarks to prove whether fees are or are not high, but it is clear that fees and expenses of a retirement savings system like MPF should not be compared to simple investment funds. Management of investment funds is only one component of what a retirement savings system provides. Administration of a retirement savings system is much more complex than that of a retail investment fund in relation to the need for regular collection of contributions and following-up on default contributions, ongoing management (including providing regular reports to members and processing transfer and fund switching applications), and payout of benefits in accordance with statutory requirements. Regardless of whether fees are objectively high or not, the MPFA has consistently maintained the position that lower fees are in members’ interests and this should be a natural target of the MPFA, the industry and all stakeholders. As MPF assets grow, there should be room for fee reduction as scale increases. Reduction of fees will translate into higher retirement benefits for scheme members. Over the past decade, the MPFA has made use of different means to bring fees down, including enhancing fee disclosure, implementing ECA to facilitate better working of market force, streamlining and simplifying administrative

processes, requesting trustees to offer low fee funds, and working with trustees to merge less efficient schemes and funds. The average MPF Fund Expense Ratio[10] dropped from 2.10% in December 2007 to 1.68% in September 2014, representing a reduction of 20%.

Chart 6 Trend of Average FER of MPF Constituent Funds



Source: MPFA

Current Major Initiatives

25. Building on the work that has started, the MPFA is currently pursuing initiatives that should bring about more substantial developments in the MPF System.

Phased Withdrawal of MPF Accrued Benefits on Retirement

26. The current legislation only allows scheme members who want to withdraw their accrued benefits to do so in a lump sum upon attaining age 65 or satisfying the

[10] The Fund Expense Ratio in relation to a fund is a synthetic indicator that shows, based on the most recent financial statements, the yearly level of fund fees and expenses that were deducted from the fund itself, as well as those deducted from any underlying funds in which the fund invests.

criteria for early retirement. To give members more flexibility in withdrawing their accrued benefits, the MPFA consulted the public and received broad support for providing an option to withdraw MPF accrued benefits in phases upon attaining age 65. Accordingly, the Mandatory Provident Fund Schemes (Amendment) Bill 2014, covering the legislative proposals to effect the above as well as other changes, was introduced into the Legislative Council in July 2014, and passed by the Legislative Council in January 2015. The MPFA is working with the trustees to prepare for the implementation of the changes.

Standardized Default Funds with Fee Controls

27. Under the MPF System, a scheme member is free to choose among the funds offered under the scheme. The number of funds offered varies from scheme to scheme, but each fund must have an investment objective different from the other funds in the same scheme. The right to make investment decisions by choosing among the funds in the scheme is a key right of scheme members. The investment return generated by those investment decisions is a key determinant of how much the member is likely to generate in retirement savings. The MPFA has been making use of a wide range of media to seek to reach out and educate scheme members on how to make informed MPF decisions. Some members, nevertheless, have not made any fund choices.[11]

28. At present, if a scheme member does not make any fund choice for their MPF investments, the trustee of the scheme will invest the contributions of the member in the default fund(s) of the scheme. There is no standardized default fund, and hence the performance and risks of default funds under different schemes vary widely. In addition, there are over 450 funds in the MPF market and some scheme members expressed difficulty in making their choice, particularly after the implementation of ECA.

[11] According to the Survey on Members' MPF Investment Knowledge 2013 conducted by the MPFA, some 24.1% of members indicated that they had never made a fund choice.

29. After reviewing the existing arrangements in MPF schemes for investing MPF contributions of scheme members who do not make investment choices and making reference to international research and approaches to default investment for defined contribution pension plans, it is considered that there is scope for introducing better investment solutions through offering a standardized default fund with fee control measures imposed for scheme members who do not, or do not want to, make an investment choice. The Government and the MPFA launched a joint public consultation in June 2014 in this regard. The consultation just closed on 30 September 2014 and the MPFA is studying the comments received to further develop the proposal.

<u>Standardization, Streamlining and Automation of Scheme Administration</u>

30. The MPF System involves many scheme administration processes, such as the processing of contributions received, the reporting of and following up with default contributions, and the processing of fund transfer and withdrawal requests. Many of these processes are paper-based. With a view to reducing the costs of the MPF System, thus creating more room for reduction of MPF fees, the MPFA will consider the feasibility of introducing more fundamental measures to standardize and streamline the administration of MPF schemes and to make it paperless as far as possible. The MPF account operations would become different and scheme members can enjoy more flexibility as a result.

Relevance of MPF in Debate on Universal Retirement Protection

<u>World Bank's Five-pillar Approach</u>

31. In 2005, in the light of operational experience, the World Bank expanded the 1994 Framework into a five-pillar framework ("2005 Framework").[12] The five pillars are:

<u>Pillar Zero</u>: a non-contributory, publicly financed and managed system that provides a minimal level of protection for retirement;

[12] Holzmann and Hinz (2005) gives a detailed account of the revised conceptual framework recommended by the World Bank.

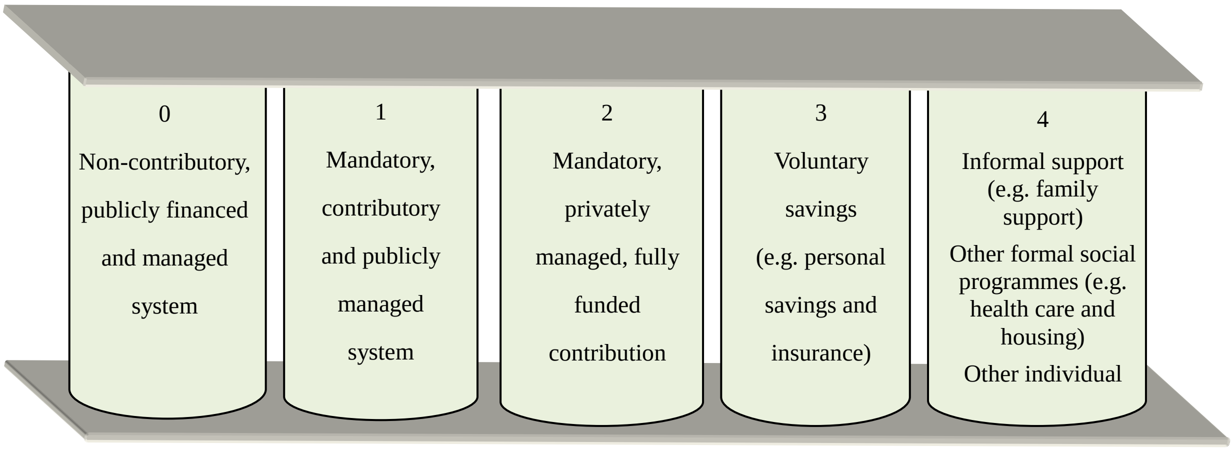
Pillar One: a mandatory, contributory and publicly managed system;

Pillar Two: a mandatory, privately managed, fully funded contribution system;

Pillar Three: voluntary savings (e.g. personal savings and insurance); and

Pillar Four: informal support (e.g. family support), other formal social programmes (e.g. health care and housing), and other individual assets (e.g. home ownership).

Chart 7 World Bank's Five Pillars Framework



32. Under either the 1994 Framework or the 2005 Framework of the World Bank, the MPF System is a second pillar system: a mandatory, privately managed, fully funded and defined contribution system.

33. The World Bank's multi-pillar approach is based on the premise that retirement savings adequacy is a complex issue and a diversified approach relying on multiple sources of retirement savings or income is required. Since each pillar has its own objective and target groups and is funded in a different manner, the multi-pillar approach could better address the needs of different target groups of the population and remain more resilient against the economic, demographic and political risks faced by pension systems. Each pillar complements the other pillars to provide old age security for the entire population in an efficient and effective way. Since certain pillars are better suited to achieve particular objective than others, it will

become more effective when multiple pillars work together.[13]

34. According to the World Bank, the core objectives of pension systems are protection against the risk of poverty in old age and smoothing consumption from one's work life into retirement (e.g. savings for retirement).[14] By default, the second pillar, in conjunction with other pillars, is designed to enhance retirement savings through smoothing consumption from work life to retirement. This role could not be replaced by other pillars like the zero pillar, which is designed primarily to address the issue of old age poverty.

35. In respect of target groups, the second pillar is primarily designed for the working population assisting them in accumulating wealth for retirement. In order to ensure high coverage rate, the second pillar normally requires mandatory participation. Other pillars may have different target groups. For instance, the zero pillar is basically designed to provide assistance to the elderly poor. Since participation in the third pillar is voluntary in nature, its coverage rate may not be as high as that of the second pillar.

36. Regarding the financing of the pension system, the second pillar is a fully-funded system which makes it more sustainable than some other pension systems, particularly those financed by government revenue (e.g. the zero and possibly to a certain extent first pillars). In a fully-funded system, pension schemes have adequate assets to cover all current and future payment obligations. In some overseas countries, owing to the fiscal difficulties of governments, members of pension schemes financed by government revenue may not eventually receive their entitled amount of pension benefits from governments. The MPF System is fully funded by contributions made by employees and employers. Upon retirement, members will be able to withdraw their accrued benefits from their accounts in

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[13] See World Bank (2008) for details on the framework adopted by the World Bank in evaluating pension systems.

[14] The World Bank has identified protection against the risk of poverty in old age and smoothing consumption from one's work life into retirement as the core objectives of pension systems. For further explanations, see World Bank (2008).

schemes irrespective of the fiscal position of the Government at that time. As such, the provision of a second pillar could reduce the risk of over-reliance on the pillars financed by Government revenue and consequently reduce financial pressure on those pillars.

Universal Retirement Protection for Hong Kong

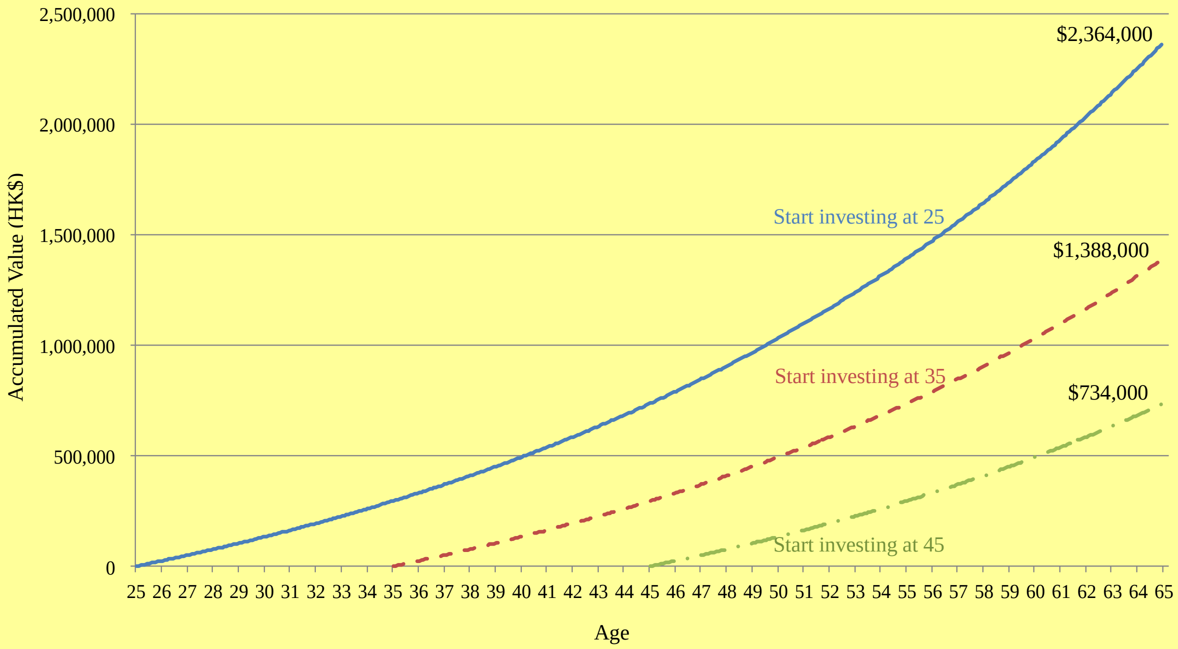
37. Hong Kong does not currently have a first pillar system under the 2005 Framework of the World Bank. Some have advocated for the establishment of a contributory universal retirement protection in Hong Kong to fill the void. Much of the current debate in Hong Kong is about the adequacy of the zero or first pillar as well as the second pillar. Some of the proposals put forward suggest that the MPF System be replaced by the universal retirement system entirely or that part of MPF contributions be diverted to become contributions for the universal retirement system instead.

38. Whilst there is much scope for discussion about the details and margins, it should be emphasized that the MPF System has contributed substantially to retirement protection of Hong Kong working population. In view of the role being performed by the MPF System as the second pillar, it should not be seen as something that can or should be replaced by other pillars, such as a universal retirement system. Nor should funding of the zero or first pillars be confused with private MPF contributions. The MPF System, as one of the pillars, is complementary to other sources of retirement savings, such as Government social security programmes and individual savings arrangements. These different pillars need to work together to provide for total retirement savings adequacy for the population. No single pillar can be an effective solution on its own.

39. The MPF System will only mature after 40 years, when participants have made contributions for a full career. Since it has been operating for a mere 14 years, the amount of benefits that scheme members have accumulated under the System can only reflect such a short contributory history.

Power of compounding

MPF is a long term investment. How long one makes contributions to the MPF System has a great bearing on the ultimate amount of accrued benefits to be accumulated upon retirement. This example assumes that a person contributes $2,000 to a fund every month and the annual rate of investment return is 4% per year (net of fees and charges). If that person joined the MPF System and started investing at age 25, he would have $2.36 million at age 65. If the same person joined the System and started investing from 35 years old, the amount of money received by the time the person reached age 65 would be $1.39 million. If the same person joined the System and started investing only from age 45, the amount received would be only $0.73 million at age 65.



40. Under the MPF System, scheme members can choose among the MPF funds in the scheme in which they are enrolled. Fund choices made by scheme members have an important impact on their saving outcomes as well as being the primary driver of the overall investment return of the MPF System. In other words, the overall investment return of the MPF System is a result of the aggregate performance of the funds chosen by members. The annualized internal rate of return of the MPF System, after fees and charges are deducted, is 4.0% for the period December 2000 to September 2014, beating the inflation rate of 1.7% per year for the

same period. Generally, MPF funds have achieved investment returns comparable with the markets they have invested into which is largely determined by fund choices made by members. The MPFA has been and will continue to work towards getting MPF fees to as low a level as reasonably practicable.

Concluding Remarks

41. Having undergone almost 14 years of operation, the MPF System has proven itself to be fundamentally sound and solid. As it will take 40 years to mature, the MPF System is still at a developmental stage. Over time, the MPF System should be able to make greater contribution towards the retirement protection of the people of Hong Kong. The MPFA will work towards the vision that scheme members will find it easy to manage MPF in accumulating funds for retirement, and the MPF System will be simple to administer and provide good value for money.

42. It must be recognized that MPF alone will not be sufficient to cover all retirement needs of the population of Hong Kong. After all, it is only one of the pillars of retirement protection. Discussions on zero and first pillar retirement protection will be useful for strengthening the overall framework that will ensure the elderly in Hong Kong are provided with the necessary financial resources for their retirement years.

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