MPF System - Evolution into its third decade

The Honourable Bernard Chan, Chairman Dr David Wong, Dr Pablo Antolin, distinguished guests, ladies and gentlemen, good afternoon.

Now that the Mandatory Provident Fund System is nearly half way to maturity, we at the MPFA felt that 2018 was as good a time as any to review and recap what the MPF System has delivered thus far. We also wanted to come to a better understanding of the challenges we face and the opportunities we have to make the System better for our working population.

But first we needed to remind ourselves that the MPF is not a one-of-its-kind system. Around the world, there are many other pillar 2 systems with comparable features that we can learn from and tools we can adopt to enhance our privately managed retirement savings system. I am not saying these systems will provide us with a ready-made, fit-for-purpose solution for tackling the growing challenges that lie ahead. But they could give us a good starting point on our journey towards an improved MPF System.

Let's begin by looking at some of the big questions people might have about our MPF System. What is its social function? Who is it designed for? And how can it help society solve problems such as the rapid ageing of our population, poverty amongst the elderly, and the growing financial and economic burdens that will be placed on future generations?

Before I go deeper into how we plan to address these issues, I would like to acknowledge an old friend of the MPFA and a leading expert on privately managed pension systems — Dr Pablo Antolin of the Private Pension Unit of the OECD. We recently collaborated with him to develop the Default Investment Strategy model that

I will be discussing with you a bit later. All of us at the MPFA are most grateful for his wise counsel.

Now I would like to share with you some of my personal insights and a quick snapshot of where the MPF System stands today within the broader context of a privately managed second pillar pension system under the World Bank model. More specifically, I would like to review the strengths we can take pride in and fortify, along with the minuses we should seek to improve through better collaboration with stakeholders, the adoption of innovative technology, and the education of members trying to save for their retirement.

I joined the MPFA in 2012 as a former securities market regulator. Even though I had over 20 years of financial services and regulatory experience under my belt by that time, I held the naïve belief that reforming the MPF System would be a rather straightforward process. I thought it should be no more complex than stepping up our oversight of MPF fund products, disclosing more information, and regulating the trustees more rigorously. While it is true that all these steps are necessary, they are not enough to deliver a more effective MPF System.

Anyone with an in-depth understanding of our MPF and similar systems will know that they only function well if we can win the support of employers and employees for this type of fully funded system. It is also important that the benefits in each member's account are not subject to the risk of insolvency of either an employer or the government, which is not the case in a defined benefits or pay-as-you-go system. And finally, all those in the system should recognise that longer human lifespans pose a huge threat to individual retirement benefits, one which can only be resolved through a multi-pronged approach that includes the ability of members to increase their future MPF contributions.

Given that our MPF System is a privately managed pension system, it is equally important that all those in the financial services industry, including trustees, custodians, investment managers and every service provider down the value chain, understand they must deliver more efficient services, offer fees competitive in the market and develop innovative solutions that lead to better investment performance for members. Only then can the objectives of all parties become aligned and provide a better outcome.

As our Chairman has mentioned in his opening remarks, Hong Kong has fared relatively well in terms of coverage, sustainability and security under our MPF System, according to the World Bank's Outcome Based Assessment Framework for Private Pensions.

This is especially true when you look back about 20 years around the time the MPF System was conceived. Back then, only 10 jurisdictions or countries had a second pillar system in place. Even Chile, the country that first launched a second pillar system and is still considered a leading model, only started its pension system in 1981. So when we launched our MPF System in 2000, there were few reference points here or anywhere else in the world. Nor did those tasked with operating MPF schemes, such as trustees and fund managers, have any practical ideas or experience they could contribute to ensure the success of this massive pension programme.

I ask you to try this thought experiment. You are there at the inception phase of the MPF System back in the year 2000. You have been asked to build a pension system that must interact with and involve millions of workers, thousands of employers, and dozens of service providers. Your mandate is to ensure that all contributions are collected on time from employers, and that default contributions are paid back to employees. Add to this challenge the fact that no one has ever done this before and you must build the pension system as a separate function independent of any tax collection or payment channels. Finally, this ideal pension system must deliver a highly reliable fail-safe service that processes payments, makes investments, transfers money and remains resistant to fraud, market volatility, a devastating epidemic such as SARS and one of the most severe financial crises in modern times, with members' assets intact and securely protected.

How would you start? Where would you turn to come up with a pension system that provides a financially secure retirement for Hong Kong people? Would you be able to protect employees' interests, even when new enhancements and reforms are being regularly introduced, and have it run like clockwork?

I wanted you to take this imaginary tour with me back in time so you could see for yourself how difficult it is to build a new social programme — which is essentially what a second pillar pension scheme is — all from the ground up. Understanding this is of the utmost importance to our discussion on what should be done to reform the MPF System and to make it serve our members better in their retirement.

Challenges to Second Pillar Retirement Savings System – Global and Hong Kong

Around the world, fundamental societal changes are taking place in different forms and at differing rates of progress — social demographic shifts, urbanisation, advances in medical science and healthcare technology — the list goes on.
Interestingly, while all this has been happening right before our eyes, World Bank experts have remarked that only recently have high income countries finally woken up to the challenge of population ageing. Today, they realize that the problem cannot be passed on to future generations and that a combination of tools should be explored to address this complex issue. They are coming to the conclusion that changes at the

societal level such as prolonging the retirement age may be necessary, although these are obviously beyond the remit of the MPFA.

At the time of the global financial crisis, economies that did not have a second pillar pension scheme and relied heavily on the government-funded first pillar pension system found it impossible to instigate reforms through the implementation of a second pillar scheme due to austerity measures.

In economies that have a second pillar scheme such as we do in Hong Kong, we can see a number of common issues. Unlike pillar 1 schemes that depend on a government's ability to fund retirement payouts, in pillar 2 schemes the provision of adequacy is a vital factor. This is mainly a combination of the years of accumulation, the amount contributed and the investment returns throughout the accumulation period. The other key factor is the ability to reduce the volatility of investments in order to protect a member's assets as he approaches retirement age. What's more, throughout the entire accumulation period it is critical to keep pillar 2 administration and investment costs low. As a rough calculation, we can see that an increase in fees of 100 basis points would reduce accumulated assets by as much as 20% over a 40-year investment horizon.

So, in the context of our MPF System, we should be focusing on two key areas for enhancement and reform as Chairman pointed out — adequacy and efficiency. With regard to the former, leveraging existing functionalities within the MPF System is not only a must, it is imminent, and by introducing new policy measures we can help to deliver a higher level of adequacy. To achieve better operational efficiency, on the other hand, deeper reforms may be necessary. We feel that fundamental changes in our operating platform and the infrastructure underpinning the administration of our MPF schemes together with a new investment approach should ultimately result in greater market competitiveness, mobility of member's benefits across the system and overall cost savings.

Improving adequacy

Currently, the MPF System does not have a target replacement ratio. This in turn makes the debate of what is or is not adequate for an individual somewhat subjective and arbitrary.

The adequacy issue is particularly challenging when an individual's choice of funds and fluctuations in the securities markets affect accumulated benefits as that person comes closer to retirement age. The adequacy level is further complicated by the increase in human lifespans due to better medical care, safer work environments and a stronger awareness of the need to maintain a healthy lifestyle.

Our MPF System has been designed for the average worker with little investment knowledge. However, it also caters to those who have some expertise in the investment world. This explains why we offer hundreds of funds as well as a simple, relatively worry-free Default Investment Strategy that allows members to ride through market cycles while seeking to achieve long-term growth.

Under the existing MPF framework, the amount of mandatory contributions is subject to the minimum and maximum levels of relevant income, with the contribution rate fixed at 5% each for employers and employees as well as for self-employed persons. A rough calculation based on the median income of an individual would mean that a 10% contribution represents a replacement ratio of about 34% after 40 years in the workforce.

We recommend that for successful retirement planning, members should set realistic goals. To help them with their planning, they can access our MPF calculators or make use of retirement planning tools offered by our trustees on their platforms. Anyone who wants a more personalised service can seek assistance from MPF intermediaries. Members also have the choice of making additional voluntary contributions.

To encourage individuals to save more for their retirement, the Financial Secretary has announced a variety of tax concession measures. At the beginning of April 2019, individuals will enjoy concessions on their salary tax by making voluntary contributions to a tax-deductible voluntary contribution (TVC) account. At this moment, we are working with the Government on the relevant legislative changes. We have also formed a working group with MPF trustees to help them cater for these new TVC accounts.

Within the MPF legislation is a statutory mechanism that was set up to review the income levels for making mandatory contributions according to changes in the earnings distribution of Hong Kong's workforce. This review is held at least once every four years. In 2018, we completed our latest review and made recommendations to the Government for further deliberation. For your reference, the last review resulted in an increase of the minimum relevant income level to $7,100, while for the maximum relevant income level an adjustment to $30,000 was made in two phases over a period of 4 years. This review and adjustment process will have to be maintained so there is a better alignment of the actual income distribution of the workforce with the contribution levels to bridge the adequacy issue.

On Efficiency

To give you a better understanding of the cost efficiency of the MPF System, let's take a quick look at how it operates today.

Each month, the MPF System serves over 2.8 million employees and self-employed persons. This involves processing a vast number of micro contributions, of which a significant part appears in the form of paper cheque payments. It also requires the system to issue paper statements and handle hundreds of calls each day from employers, employees and the self-employed. This is done in parallel with fund allocation, which is usually completed within a week after the contributions are checked. It is a relatively efficient process, especially compared with the pillar 2 systems of some developed countries, where contributions are received on a quarterly basis and funds allocated a full 18 months after the contributions are received and checked. If we had proposed such a slow-paced scheme back in the beginning, you can be certain it would not have gained the support of Hong Kong workforce.

We will only be able to achieve accurate, high speed payment processing and serve members instantly with on-demand information, at a reasonable price, by employing technological solutions.

If you do a quick scan of the MPF landscape, you can see that our System is approaching 10 million accounts, with some small balance accounts left over due to job changes or work cessation. All of the 14 trustees maintain their own purpose-built administration systems but with no single set of standards governing how their MPF processes are communicated across the System.

Then there are more recent issues that make us question whether the MPF business model and operational platforms developed 20 years ago will remain feasible over the next decade. For example, we can see an increasing number of millennials entering the job market, many of whom — the so-called slashies — are now engaging in new forms of self-employment. We should also consider the impact of the 4th industrial revolution where individuals are demanding instant access to information and high-speed transactions on digital platforms and paper-less payments. Another trend in the region and other parts of the world with defined contributions systems is the emergence of Fintech, which is already playing a pivotal role in improving cost efficiency, the customer experience and transparency.

In the UK, reforms and digital-first concepts have taken firm root in that country's pension system via fully digital, paperless online registration for both employers and employees under the NEST pension scheme. In India, their micro-pensions scheme makes use of a virtual ID instead of the traditional "wet signature", which we still see in use today in Hong Kong. While down under, Superannuation in Australia some years ago made the decision to carry out a holistic digital transformation of their system that resulted in over 90% of employers making contributions via electronic means.

Closer to home, our financial services sector has caught up with technology by delivering on demand, 24/7 services into the hands of customers who, these days, literally seem unable to put down their smart phones. In the banking industry, we have entered a new era of Smart Banking, while insurance companies are competing to be the first to adopt InsurTech. Among financial advisers, we have seen the advent of all kinds of Wealth Management Tech, including robo-advisers and e-distribution platforms for funds.

These and other Fintech solutions are sure to catapult the entire MPF industry into a new age of open architecture and enhanced operational efficiency. As far as I am aware, the only missing piece in the drive towards a tech overhaul of the industry is the vision and determination to make the necessary changes.

I would therefore like to take this opportunity to invite the MPF industry to rethink their business models and ask the following three questions: As an industry, should you support an open infrastructure so that everyone is competing on a level playing field in the race to win customers through better products and services? As an industry, do you see a future in the business of retirement planning and asset management for an ageing population? And, as an industry, do you support the idea that the MPF System needs a digital transformation to deliver simpler, user-centric_and readily accessible services at relatively lower fees for the millions of members and employers?

If you answered yes to all three questions, I am pleased to let you know that both the Government and the MPFA fully support this digital transformation and will be doing so through the introduction of the eMPF initiative. What remains to be seen is whether the MPF industry will accompany us on this transformation journey as it will require behavioural changes on the part of both employers and members, such as embracing digital tools and letting go of paper forms and records. It also requires an open mind on the part of trustees and operators. They need to support the use of technology, including open APIs and the adoption of common norms and standards as necessary components leading to the automation of key processes in scheme administration. Looking ahead, I am optimistic that even with an open architecture, MPF service providers with top class retirement and pension expertise, strategic leadership in digital transformation and technology along with the right mind-set and governance culture will deliver value for money to our members. These providers will not only survive but continue to thrive and lead the market in the competition for new business.

I also remain hopeful that market forces will remain the key driver leading to fee reductions and better service for our MPF members as we progressively roll out the new e-MPF initiative.

Finally, it would be remiss of me not to mention the key regulatory efforts that have been committed by the MPFA for the continual enhancement of the system. These include…

- *Enhanced Governance of Trustees*. Further to the pledging ceremony on 24 May

2018 when MPF trustees pledged to uphold and abide by the Governance Charter, the MPFA has developed a set of governance principles to assist MPF trustees in implementing the core values set out in the Charter. The implementation of good governance will be introduced to MPF trustees in phases over the next 12 to 18 months:

(i) Phase 1 (Governance Principles) – The MPFA is in the process of liaising with MPF trustees and seeking their support of the governance principles and the elaborations underpinning each principle.

(ii) Phase 2 (Adoption) – MPF trustees will be given 6 months to assess whether their existing governance framework and arrangements are in adherence with the Governance Principles.

(iii) Phase 3 (Ongoing training) – The MPFA will from time to time provide additional guidance or training for MPF trustees on the expected standards underpinning each of the Governance Principles.

- *Increased transparency in fees and fund performance of MPF schemes*. Starting with the launch of the interactive platform for comparing the performance of all 467 funds in the System, we have taken action to standardize the commentaries on fund performance by the board of directors of MPF trustees. These commentaries are now in the MPFA's designated repository and are open to public viewing. Additionally, MPF trustees will be required to provide a breakdown of management fees charged by different service providers in the offering documents of MPF schemes by the end of this year.

- *Thematic inspection of the cyber resilience of MPF trustees*. Having noted the increasing risks of cyber attacks, a thematic inspection process has been commenced this month for MPF trustees. This is a useful opportunity for the MPFA to better understand the strengths and weaknesses of the operations of MPF trustees and their capabilities when moving towards eMPF.

- *Greater market efficiency and fee reductions*. Since 2014, 17 schemes have been merged into 7 in order to gain greater economies of scale and create opportunities for fee reductions. From the launch of the Employee Choice Arrangement in November 2012 to the end of September 2018, 269 funds had reduced their fees by up to 57.14%, and out of 467 constituent funds 240 are already within the low fee funds category. In addition, the MPFA and the Securities and Futures Commission have jointly agreed to streamline the approval process for new fund applications. This should shorten processing time by 40%.

As the supervisory authority of MPF schemes, trustees and MPF intermediaries, we are dedicated to strengthening governance of the MPF industry and helping them develop a resilient risk management framework such that the industry is able to deal with dynamic market conditions and emerging operational risks such as cyber threats.

In closing, I would like to say that to have the MPF System work better for the retirement plans of Hong Kong people, the new eMPF initiative will be critical for transforming our current quasi-open infrastructure into a completely open and competitive infrastructure. The success of this transformation will require employers and individual members to adopt a digital-first, paperless mode of thinking. Because it is only when money can flow freely and benefits are transferred on a common and seamless platform that we will be able bring the full benefit of better service and customer experience, as well as lower costs to our members in the MPF System.

Thank you.