

**Luncheon Talk**  
**Hong Kong Securities and Investment Institute (“HKSI”)**  
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Good afternoon, Chairman Craig Lindsay, Mr Bonn Liu and fellow members of HKSI and guests.

**INTRODUCTION**

I am very honoured today to be invited by HKSI to share with you the MPFA’s latest development on the regulation of MPF schemes and their service providers. It’s like home-coming to me as I was very privileged to have served on the Board of the HKSI for over 5 years. I must first caveat that all the views and opinions expressed in my presentation are entirely those of mine and should not be taken as representative of the official position of the MPFA.

2. Some of you might have heard a lot about our recent reform initiatives including proposals on core funds and the preparatory studies on full portability. So for a change, I would like to focus today’s discussion on the low profile side of MPFA’s work which is our supervision of schemes and trustees and our enforcement actions.

3. I am sure most of you have seldom heard about the supervisory and enforcement work of MPFA. Partly I think it’s because in the first decade of the establishment of MPF system, most of the public attention is on how MPFA was doing in terms of getting employers registered for their staff in MPF schemes and pursuing outstanding default contributions. To that end, the MPFA has achieved a great deal – as compared with the relatively low rate of enrolment 10 years ago, today, over 99% of Hong Kong employers have enrolled for MPF schemes. Our recovery rate for

defaulted contributions by employers stood constantly at over 93% of the claims filed. Overall, our enforcement against defaulting employers has been satisfactory and effective.

4. That said, this only represents part of our work in the MPFA. On the other side of the equation, when the monies are contributed, someone need to take care of those contributions, make sure the amount is accurate and also rightly invested in accordance with the investment options that employees have pre-selected. Or in the case of a default arrangement, get invested into one of the default funds prescribed by the trustees within the MPF scheme.

5. Our MPF system has passed through the first phase of establishment and for a defined contribution pension system to mature, 40 years is considered as the necessary timeframe.

6. As a relatively young pension system, MPFA still has a lot of work to do to improve it and that includes stepping up our supervision to better protect members from potential risks of losing their retirement savings.

7. In today's talk, I am going to start by looking at what is the general regulatory approach towards risks of financial institutions after the global financial crisis and how this is relevant to our supervision and enforcement work.

8. Next, I will dedicate my time to examine key risk areas that MPF trustees and service providers should pay attention to and how good governance could bring about better value for money to MPF members.

9. Finally, I will briefly touch on our supervisory and enforcement approach towards trustees and MPF intermediaries.

## **REGULATORY FOCUS ON RISK DETECTION AND MANAGEMENT**

10. The goal of enhancing the capability of financial institutions to detect and properly manage risks has become all the more clear following the global

financial crisis where we saw how abrupt market incidents could cause damages to various participants in the global financial markets including pension members. Post-GFC, I noted that there arose a general consensus amongst regulators around the globe that financial industry including pension providers, custodians, investment managers should raise their risk management capability and treat clients more fairly. Regulatory emphasis is placed on the fact that these service providers are in many ways a fiduciary towards their customers and are expected to exhibit a very high standard of care and professionalism.

11. In the case of long term investments and holdings, pension providers may argue that it would be difficult for them to foresee risks in such a long time horizon. Some might even say that pension providers, custodians and investment managers had not been implicated in any way by the last global financial crisis. Hence there is no reason why regulators should see the need to step up surveillance and enforcement in that respect. In a highly inter-connected global market, it would be inconceivable that undesirable conduct or behavior is confined to certain types of institutions but not others. In fact, it was only within the last two years that we saw some of the largest collapses of UK and Australian pension plans due to fraudulent practices of senior management of trustees. These mishaps might be partly attributable to the long bull market before the GFC and the sudden market contraction afterwards.

12. The first wave of GFC in 2008 hit the global market by surprise due to a sudden implosion of “too big to fail” institutions, sending huge repercussions across the financial market up to the sovereign level. The second wave came in the form of a quiet and unnoticeable undercurrent when the global economy was slowly recovering.

13. Given the post-GFC market condition, firms that used to be profitable through engaging in exotic or risky investments or transactions were no longer able to sustain a highly profitable business. There are countless examples to demonstrate that because of the less than promising returns ordinary financial transactions could bring to a firm, some financial institutions or market players started to take on

excessive risks, cutting corners on compliance or deploying shenanigans to cover up these risks from being detected by their own internal compliance. Some might have designed their compliance logic and standards to the bare minimum of just meeting the law. So when the storm comes, there was insufficient buffer for compliance and the firm immediately fell below not just internal compliance standards, but the black letter law as well.

14. In a minute, I will go through with you three recent examples seen in overseas markets to illustrate that even in what was generally perceived as a plain vanilla type of financial business such as pensions or insurance, things could go really wrong in the absence of a strong risk culture at the top management of a firm.

#### **MPFA SUPERVISION AND ENFORCEMENT WORK**

15. Let me now turn to the structure of the MPFA on supervision and enforcement.

**[Slide 4 – Structure]**

**[Slide 5 – Enforcement Division]**

16. Since January 2014, the MPFA has integrated its enforcement functions into one single division. In this Division, we have a dedicated team to handle complaints on trustees conduct and scheme administration. Second, we have an investigation team that investigates into cases referred to us from various sources including complaints received.

17. Third – we have a specialist disciplinary team. This team has a broader spectrum of work than just trustee regulation. It also takes care of cases which have been investigated by three other regulators on the conduct of MPF intermediaries and MPFA will decide, based on evidence collected, whether to impose disciplinary actions or not.

18. Finally the prosecution team – which handles all assessment work of criminal investigations and make referrals to the Department of Justice for prosecution

purpose. MPFA itself does not possess any prosecution powers, even for summary offences. Offences that may be prosecuted under the MPFSO include those committed by employers for default contributions, employees in deceiving the trustees to withdraw on the ground of permanent departure, unregistered dealings by MPF intermediaries and dereliction of duties by trustees.

**[Slide 6]**

19. Our MPF system falls within the description of the second pillar of the World Bank's model for retirement protection, and contributions made to the MPF schemes will be privately managed. Contributions are therefore overseen and safeguarded by the trustees rather than MPFA. Although the system has been in place for over 13 years, I still sometimes hear people saying that MPFA is the fund manager or the trustee of the MPF schemes – clearly this is not the correct understanding.

**IMPORTANT ROLES OF MPF TRUSTEES IN PROTECTING MEMBER INTEREST**

**[Slide 7]**

20. Unlike some other countries where contributions to work place DC pension are voluntary, say the UK, the Hong Kong situation is significantly different.

21. Employees are mandated into the MPF schemes registered by their employers and as such, at the outset, employees don't have a choice of the type of financial service providers. The architecture of the MPF system is found on the cornerstone that trustees are going to manage the monies and making sure everything is in good order for scheme members so that when it comes to their retirement, members can have a certain level of retirement protection based on their contributions and accrued benefits over the years.

22. Trustees in a mandatory system are therefore expected to have a higher duty of care as compared with say in the space of retail products where investors are free to choose their own service providers. Members therefore place their entire trust and reliance on the integrity and professional judgment of trustees in managing the

schemes in a manner that is prudent (as stated in the MPFSO) and professional.

23. It follows that if trustees or service providers to MPF schemes like investment managers or custodians took the view that they only need to do what is minimally required of them under the express provisions in the law, then they are lending themselves to potentially huge risks of failure to properly manage the schemes or investments. First, the law sets out the broad principles and obligations imposed on trustees and their service providers. Second, the law is not supposed to be read or taken as an operational or risk management manual. Unfortunately, I note that at least some part of the industry still holds this misperception.

24. The MPFSO is sufficiently clear in spelling out the duties for trustees – as set out in Regulation section 43 – it mentions the obligation to be prudent, to possess necessary knowledge and skills, able to minimize risks and, more importantly, a key concept that trustees have the duty to act in members’ interest and not in their own.

25. The above are cardinal rules on which trustees should develop the necessary measures to make sure not just those operational tasks like collecting contributions and reporting default contributions to the Authority are carried out, but on a broader perspective, proactive measures should be taken to ensure that members’ investments in the schemes are properly protected from risks of loss or other detriments.

**[Slide 8,9]**

### **RISKS AND CHALLENGES TO TRUST ADMINISTRATION**

26. As identified by IOPS – International Organisation of Pension Supervisors, defined contribution (“DC”) plans have to tackle a number of risks.

27. In the case of the MPF scheme context, the level of operational risks should be a key focus for trustees and their administrators.

**[Slide 9]**

28. If we refer to this **slide 9** – the asset under management of the MPF system now exceeds HK\$500 billion and the monthly average contributions amounted to over HK\$4 billion. As I just mentioned the MPF system has a over 99% enrolment of all HK's employers covering over 260,000 employers and 2.4 million employees.

29. If you think about the volume of transactions that all the trustees and administrators have to process each year, simple arithmetics will tell you that the total number of payment transactions that need to be processed will exceed 30 million transactions (we are not even counting transfers). These transactions involve the verification of data and reconciliation of the same against payment and the timeliness in payment.

30. In the years to come, we would expect the volume of transactions to further grow in number as well as the monetary value of each transaction as the system matures. The industry need to start planning and thinking now about how to address the impact and stress on their administration and business models due to their growth, especially when we anticipate in the coming decade, some of our members will be retiring. The system will no longer just have to cope with massive contributions but also withdrawals in the years to come. Trustees also need to consider the impact of the reform proposal to allow phased withdrawals, which would mean an increase in volume for trustees who in the past years need only cater for a one-off withdrawal.

31. The launch of the Employee Choice Arrangement (“ECA”) makes it possible for employees to make transfers between schemes of their accrued employees' benefits.

32. In order to ensure that service providers to MPF business are able to cope with the expected increase in transactions, I would urge trustees and sponsors of MPF schemes to plan ahead on how to enhance their capability in terms of infrastructure, resources, governance and expertise to cope with the obligations

towards members while maintaining a viable business.

33. To help industry achieve a higher level of automation in processing data and payment, the MPFA has embarked on a number of initiatives. Come June this year, we hope to see the launch of the Electronic payment and settlement system between trustees that would help increase accuracy and enhance speed when members are making ECA transfers amongst trustees.

34. We are grateful for the cooperation of the trustees in working together with the MPFA in making this initiative possible. However, this probably is one of the many areas that trustees should start considering whether there are any opportunities to embark on automation on a wider scale for their operational processes so as to streamline their operations and to minimize risks (see the primary obligations in section 43).

**[Slide 10]**

35. Talking about operational risks, a DC pension system is capable of having “latent risks” hidden at the dark corners of the system without being noticed for a relatively long period of time due to a number of factors:

- Infrequent transactions by members
- Layers of data that might have different owners or stored in different systems
- The relatively long period of investment timeframe – over 30 years

36. It would be a nightmare to members if the operational risks mentioned in **Slide 10** cannot be properly managed by those in charge of the operations of MPF schemes. So you may ask if that be the case: how could such deficiencies be uncovered and fixed by trustees or other service providers in scheme administration?

37. Before we discuss possible means to detect and contain the risks, let me go to the case studies which I previously promised you.



**[Slide 11 - 13]**

38. This is a fraud committed on the superannuation funds of Australia where the funds were not invested as described by the trustees and professionals like auditors or custodians of the funds were not able to pick up the “red flags” – i.e. risk indicators that there might be something fishy of these funds. By the time the funds were investigated, the interest of Superannuation members in the schemes were already damaged as the assets were already misappropriated by the management team of the trustee.

39. None of the service providers or the auditors had the level of skepticism to challenge the information before them or to pick up the negative signals arising from their review of the funds’ data and operations.

**[Slide 14, 15]**

40. The next case happened in the UK. Same as the last one - this is about fraud. Mr. Pitcher, one of the directors in two trustees of DB pension plans was able to siphon monies out of the plans without other members of the Board noticing. No independent and well qualified investment advisers were consulted before investments were made – the Board simply relied on this Mr. Pitcher who of course was the fraudster and redirected all these monies into investing in some offshore vehicles controlled by him. He was sentenced to imprisonment for 8 years.

**[Slide 16]**

41. Although the UK and Australian pension regulations are fundamentally different from Hong Kong in that we have much stricter requirements on investment fund types etc, the lesson learnt from these examples is that:

- (a) Good governance and professional skepticism need to be in place at various levels of the operations of trustees and service providers to pension plans. Whistle blowing mechanism will be useful to help unveil risks that are hidden from top management.
- (b) Board of Trustees should ensure they have got the right expertise and where necessary get independent experts to help advise them on investments or risk management.

- (c) Risks generated from internal management or staff's misconduct are the trickiest and most difficult to detect so high level of awareness and monitoring mechanism should be in place.
- (d) Board of directors and those charged with frontline management functions should be held accountable for risk management as well and not just the risk and compliance teams. They should be able to identify or pick up patterns of emerging risks and stem those from spreading.

42. I could see amongst our audience, there are a large number of senior executives from MPF scheme sponsors and trustees. I would like to take this opportunity to urge all of you that it is really high time that a rigorous debate be carried out internally to see if those risks parameters and risk management tools are effective or otherwise have become obsolete since the date they were first employed.

43. Sometimes upon reading the audited reports on internal controls of financial institutions (and I am not suggesting this is from trustees or other MPF service providers), I found it amazing that year on year, some firms tend to set the same control objectives and risk profile for their auditors to review notwithstanding the fact that the same firm had already been severely reprimanded, penalized or sanctioned over the past years.

44. Had sufficient attention been paid by the senior management or at the board level of such firms, one would have imagined the risk calibration and focus of control objectives will have to be adjusted to reflect the past events in particular when regulatory breaches are found and sanctioned.

## **GOOD GOVERNANCE STANDARDS**

### **[Slide 16]**

45. That brings me to the discussion of governance. As recently pointed out by Financial Stability Board ("FSB") in its consultative document last November, regulators agreed that global financial institutions need to beef up governance in order to better equip these institutions against all sorts of risks they may encounter while doing business in the rapidly changing financial market.

46. Of particular interest to me in the FSB paper is the stress on the need to ensure proper ownership of risks within a financial institution. I recall a few weeks ago in the SFC regulatory forum held in Hong Kong, one of the speakers made a similar observation. He pointed out that while global firms tend to set up their own risks monitoring and compliance functions, this kind of structure may sometimes encourage frontline staff for instance equities or derivatives traders to take on excessive risks. Part of this is due to their belief that as frontline staff, they need not share in the responsibility of risk management and control. If something goes haywire, tough luck to the chief risk officer and his/her team who fail to pick up the red flags. But by then, damage is already done to the firm as a whole.

47. This could well be a good starting point if your operation, whether as trustees, custodians, administrators or fund managers, has become so big that operating functions and risk and compliance are sitting in different teams or even different legal entities without at the same time clearly defining the ownership of risks, or ensuring there is an integrated oversight on the risks pertinent to your business.

48. The other governance concern is whether these risks brewing at the bottom of the food-chain in a firm are ever escalated to the ears and eyes of the Board of the firm. Or would they be otherwise buried amongst the information contained in what people called “high level management report” so that as a Board member, one could not see the whole picture of the risks lurking in the operation.

49. A case in point is a recent UK FCA enforcement action against HomeServe an insurance company that sells home insurance. In short, the UK financial conduct authority imposed on HomeServe a hefty fine of the equivalent of HK\$360 million as it was found to have serious systemic and long running failures affecting key aspects of its business. Failure to have in place adequate IT software and carry out effective tests on its IT systems resulting in customers being overcharged was one of those findings of failures.

**[Slide 18- 19]**

50. Governance in the context of trust administration entails a meaning much broader than just good corporate governance. Trustees and their service providers should carry out a thorough review of the extent to which their current ongoing relationship with product providers or sponsors might put them in a potentially difficult position to make impartial judgment for the overall benefit of MPF scheme members.

51. The other area that is worth the attention of the board of MPF trustees is how strong the trustee's discipline is in driving investment managers to perform better for members. I understood that most trustees would have review mechanism of the performance of investment managers – I would therefore urge the trustees' board to examine whether it has set sufficiently clear benchmarks for investment managers, and when those benchmarks are not met, would there be any real possibility of the termination of the investment mandate?

**[Slide 20 and 21]**

52. Finally I would touch on two very important governance matters that are close to a regulator's heart – compliance risks and business continuity risks.

53. Non-compliance with the regulatory requirements or a firm's own internal control procedures could be attributed to a combination of reasons. Non-compliance could arise when a frontline staff, without escalating the issue, decides to undo a control measure and thereby causing an omission. Non-compliance could also happen if the workflow logic is not properly set to gate-keep certain standards and thereby resulting in breach of the legal obligations imposed on the scheme administration.

54. As an MPF regulator, we believe that a good compliance system involves not just the hardware of IT infrastructure and proper setting of risk indicators, a great deal depends on the capability of well trained staff who possess the right mindset and professional skepticism to spot the "red flags" in the operating environment, the support from the senior management to take decisive actions to

uncover the root causes and take remedial action to minimize the negative impact that such mistakes may bring, and a proper feedback mechanism to prevent a repeat of similar mistakes in future.

55. The final topic on governance is about business continuity plans of trustees and MPF service providers. As you may be aware, under the G20 resolution regime, public consultation in Hong Kong has already started on how to establish its own resolution regime.

56. Out of the 15 trustees and all the custodian banks serving the MPF system, the group companies of 4 trustees and 5 custodian banks fall within the definition of “SIFI” – systemically important financial institutions. Naturally their group companies will have to develop a resolution plan such that as and when crisis hits and the group companies have to undergo resolution, business continuity can be assured for their subsidiaries or affiliated companies.

57. We have already formed a dedicated team to focus on reviewing the current business continuity plans (“BCPs”) and it will not be long before this team approaches the MPF trustees and their boards to discuss the robustness of the BCPs and how they could further their plans to cater for the future resolution regime.

**[Slide 23]**

58. Good governance of a firm breeds good behavior and that would in the long term bring about positive results in protecting members. With that, I should leave this topic by showing you the key suggestions from Financial Stability Board which you may find useful as reference.

59. Before closing, perhaps I should say a few words on the long awaited elaboration of our approach and regulatory philosophy underpinning our supervision and enforcement work.

60. On supervision - **[Slide 24 and Slide 25]**

61. On enforcement – it would be useful to take a quick look at the model provided by IOPS for enforcement in the context of pension plans. Although IOPS model might be using terminologies different from MPF regulation, you would no doubt see that the majority of the work of a regulator of pension plans should be in the space of enforcement of standards and the legal obligations imposed on various service providers, and taking timely measures (in IOPS terminology “intervention”) to ensure members’ interest is safeguarded.

62. It has always been our belief that most trustees are prepared to enter into constructive dialogue to ensure that they are on the right side of fence for compliance. That’s why our supervision team colleagues have been regularly holding meetings with trustees and various service providers. However, adopting this approach does not preclude the Authority from further enforcement actions, or should not be taken as a sign of indulgence on the part of the Authority when blatant failures occur.

63. In circumstances where members’ interests are already at risk, and prompt actions are warranted, the Authority would not hesitate to use one or more of the powers to direct compliance e.g. failure to keep proper books and records. At the same time, if circumstances suggest that members’ interest may be prejudiced, the Authority may even have to consider commencing formal investigations under section 32 of the Ordinance. This is particularly important if information requested of a regulatee is not forthcoming or the regulatee fails to provide the Authority with a full and frank disclosure of the details of the incident. It is worth pointing out that under the MPFSO, there is a wide spectrum of obligations imposed on trustees or service providers under 96 provisions of the MPFSO for which sanctions in the form of financial penalties may incur. And breach of another 52 provisions may result in criminal liability.

64. To do justice to today’s title, I ought to briefly talk about our regulatory work on MPF intermediaries. The transition period for registering MPF intermediaries into the MPFSO regime will expire on 31 October this year. For those who have not made up your mind to seek registration, please do so as soon as possible.

65. For those who are registered MPF intermediaries, I am sure you are familiar with the regulatory model. MPFA acts as the registrar of intermediaries and takes disciplinary actions against breaches of conduct requirements of MPF intermediaries. Frontline regulators like the HKMA, SFC and OCI act as the supervisor of intermediaries conduct and investigator of suspected breaches.

66. I hope my presentation today gives you a better idea of the regulatory approach of the Authority and the supervision and enforcement currently undertaken by us.

67. It is my belief that effective supervision and enforcement actions are crucial to maintaining public confidence in our MPF system. I hope I have provided you with sufficient food for thought in how to better equip yourselves in the future development of your MPF business.

68. Thank you.