XIII. SUPERVISION OF PRIVATELY MANAGED, DEFINED CONTRIBUTION PENSION SCHEMES IN HONG KONG

by
Hong Kong Mandatory Provident Fund Authority (MPFA)

Overview of the private pension system

System, scheme organization and history

Funded pension provision in Hong Kong is done through two main venues: a voluntary system of privately managed funds and a mandatory system comprised of privately managed, provident funds – the Mandatory Provident Fund System (MPF).

Hong Kong has a long history of private arrangements for retirement savings. Such schemes date back to 1919 when the first scheme was established. Gadbury et all note that these schemes have functioned virtually unregulated until 1993, when the Occupational Retirement Schemes Ordinance (ORSO) came into force. The only restriction present in the system was a ceiling of 15% on the contribution levels and taxation of benefits that exceeded a certain amount.

The Occupational Retirement Scheme Ordinance defined and regulated retirement funds, requiring such entities to be established either under trust or in an approved insurance policy. According to this law, every employer that provides a retirement scheme must register with the government and undergo professional certification, including annual audits. In 1999 there were 19,000 ORSO schemes covering more than 900,000 employees.

In 1995, the Mandatory Provident Fund Schemes Ordinance was approved and in 2000, the Mandatory Provident Fund (MPF) system was introduced. Mandatory provident fund schemes are defined contribution savings schemes that provide a lump sum at retirement. In this system, employers must enroll eligible employees in, and self-employed persons must join, a mandatory provident fund scheme. Employers may choose among three types of schemes and make arrangements for employees to become a member of the scheme chosen, whereas the self-employed may join a master trust scheme or, if eligible, an industry scheme.

Both employers and employees can contribute 5% of the employee's salary up to the limit of HKD 20,000 per month. In addition, employees, employers and self-employed persons may make additional voluntary contributions to the mandatory provident fund scheme.

As mentioned before, there are three types of schemes that employers can choose to provide a framework for retirement savings.

Employer-sponsored schemes: Occupational mandatory provident fund scheme sponsored by a single employer and its associated companies. Membership this type of fund is restricted to the employees of this employer and of its associate companies.

Industry Schemes: Industry-wide mandatory provident fund scheme established for employees in industries with high labor mobility. At present, industry schemes exist for the catering and construction industries. These schemes are only open to employers and self-employed persons active in the respective industries. Accrued pension rights are fully portable within the industry. Employers in the respective industries may choose to enroll their employees in the industry scheme, but are not obliged to do so.

Master trust schemes: membership to master trust schemes is open to employees of more than one employer, self-employed persons and persons with accrued benefits transferred from other schemes. By pooling the contributions of small employer units together for administration and investment, such master trust schemes may have a high degree of efficiency resulting from economies of scale and are thus especially suitable for small and medium sized companies.

A central organizational feature of the MPF'a in Hong Kong is the fact that all schemes operate with an approved trustee. A very similar structure can be observed in the Australian system of retirement income provision. The legislation and regulation as a whole hinges on the role and the involvement of trustees in the operation of the pension funds. Many of the responsibilities of compliance; prudential management and monitoring are the responsibility of the trustees.

General information about the financial system and culture

Hong Kong has a well developed financial system, with a large number of specialized participants and a comprehensive monetary and financial regulatory systems. As Jeremy Gadbury et all note, the these systems started to be implemented in the 1960's, providing support for the rapid economic growth that occurred in the past four decades.

The entire organization of the financial system relies very heavily on the institution of the trustee and many transactions are conducted in the absence of strict regulation, by virtue of the market forces. The role of the government in supervising financial markets is relatively small, limited to a basic legal framework that provides the basis for prudent conduct.

Gadbury et all note that legal authority for regulating and supervising the financial and monetary sector in Hong Kong comes form three main sources: laws and ordinances enacted by the legislature; rules and guidelines formulated by financial institutions themselves; and rules, codes of conduct and detailed regulations issued by the regulatory bodies.

In Hong Kong, social security is provided mainly through market-based instruments, supplemented by basic "safety net" arrangements that are financed through general tax revenue. Like in many other developed countries, Hong Kong has a population that is aging rapidly, putting all the instruments of social security provision under stress, but especially those that are non-contributory and financed from the general state budget.

Until 2000 though, coverage of the market-based retirement income provision instruments was fairly limited. The introduction of the Mandatory Provident Fund scheme has been an important step towards addressing the challenge of the population ageing phenomena and putting social security on financially sound and sustainable basis.

The functional organization of the funded component of the retirement system in Hong Kong follows very closely the Australian approach. More specifically, there is a great deal of emphasis put on governance mechanisms and reliance on the institution of the trustee for ensuring adequate prudential behavior.

Market Size and Concentration

At present, there is no accurate account of the market share of MPF providers. The general view though is that there are many market participants and that, as the schemes mature, this number will go down significantly following a process of consolidation that will lead to higher concentration levels in the market.

From the market share estimates made by Watson Wyatt Hong Kong Limited, we can infer that almost 60% of the MPF market share is shared among three sponsors that offer all together 10 pension schemes.

Figure 1: **Basic Statistics on the Mandatory Provident Retirement System in Hong Kong**

MPF COMPLIANCE RATE	
Employers	97%
Employees	96%
Self-employed Persons	80.3%
APPROVED TRUSTEES	19
MPF SCHEMES	48
Master Trust Schemes	44
Industry Schemes	2
Employee Sponsored Schemes	2
APPROVED CONSTITUTENT FUNDS	321
By Fund Type	
Balanced Fund	134
Equity Fund	73
Capital Preservation Fund	48
Guaranteed Fund	37
Bond Fund	19
Money Market Fund	10
By Sponsoring Scheme	
Master Trust Schemes	299
Industry Schemes	12
Employer Sponsored Schemes	10
APPROVED POOLED INVESTMENT FUNDS	253
REGISTERED MPF INTERMEDIARIES	24,663
Corporate	253
Individual	24,231

Source: MPFA at: http://www.mpfahk.org/main.asp?nodeID=66&langNo=1

Apart from the sponsors themselves, there is al large number of intermediaries, who are certified professionals registered with the MPFA. The role fulfilled by intermediaries is to sell MPF schemes and to advise the participants or the scheme managers.

The number of registered MPF intermediaries, as disclosed by the MPFA was 24,663, out of which 25,765 are individual intermediaries and 253 corporate intermediaries[1]. The number of intermediaries providing services for the MPF is quite large, considering the fact that the number of schemes is close to 49. Their activity is supervised jointly by the Securities and Futures Commission; the Insurance Authority and the Hong Kong Monetary Authority, as a result of an official understanding with the MPFA.

The MPF intermediaries are not only subject to registration requirements and compliance with rules set forth by the four institutions that are responsible for supervision, they are also required to go through specialized training in their area of expertise.

Coverage

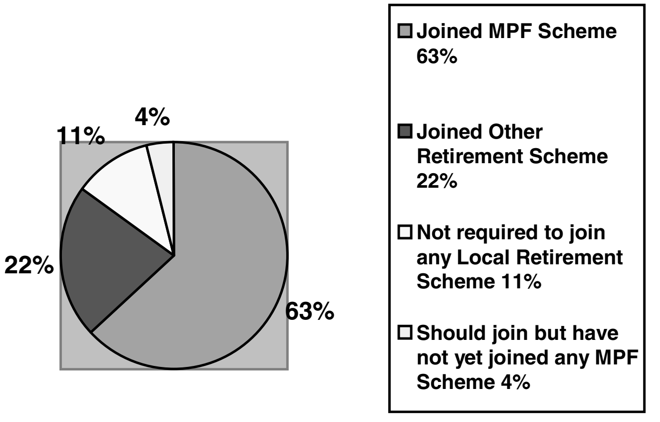
With the implementation of MPF on 1 December 2000, complemented by personal savings and the Comprehensive Social Security Assistance (CSSA) Scheme operated by the Government, Hong Kong now has in place all the three pillars for old-age protection.

Before the implementation of the MPF System, only about one-third of the workforce of 3.4 million people had some form of retirement protection. Now, 85 per cent of the working population are under retirement protection, regardless weather it is mandatory or voluntary. The chart below shows coverage distribution among the different types of retirement schemes, for eligible working population.

Tax Treatment

The different types of recognized occupational retirement schemes and MPF schemes are collectively treated in the tax legislation as “ recognized retirement schemes”.

Figure 2: **Coverage of Employed Population by Type of Retirement Scheme Estimated Population by Type of Retirement Scheme (as of 31 Dec.2003)**



Source: The Mandatory Provident Fund Authority – www.mpfahk.org

Contributions: made by the employer to a recognized retirement scheme are deductible expenses, as long as they do not exceed 15% of an employee's emoluments for the period for which they are made.

The contributions paid by the employees used to benefit from no tax relief, prior to the introduction of the MPF in 2000. All contributions were made out of after-tax income.

The mandatory contribution of an employee to the MPF are deductible against salary tax up to a yearly amount of HK$12,000. This cap is used for aggregated employee contributions to MPF and the voluntary retirement schemes. Gadbury et all note that, since contributions are deductible against salary taxes and there are relatively few people who pay these taxes, the value of the tax deduction for retirement savings is very small.

Benefits: Pension benefits are generally tax-free when they are received upon termination of employment, at retirement age or at termination in the following circumstances:

- termination occurs after 10 years of service or more;
- the employee has reached the specified retirement age in the scheme, which must be at least 45;
- termination occurs by reason of death or incapacity.

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If pension benefits are accessed while the contributor/beneficiary is still employed, they are subject to the general salary tax.

This rule does not apply after the employee turns 60. After this age pension benefits received by employees are no longer subject to tax, under the current regulations.

When the employee reaches the age of 60, he or she is deemed to have retired from employment for tax purposes, although he or she may still actually be in employment with the same employer. In such a situation, the benefits received will be tax free.

There are no public guarantees for either the MPF or the voluntary pension schemes.

The table below summarizes the tax regime of the different types of schemes, for each potential participant and/or beneficiary.

Figure 3 **Taxation of ORSO and MPF schemes summarized**

	Employee	**Self-Employed**	**Employer**
Mandatory Contributions	Allowable deduction up to HK$12000 a year	Allowable deduction up to HK$12,000 a year	Allowable deduction up to 15% of emoluments
Voluntary Contributions	Not allowable	Not Allowable	
Scheme Level	Free of Honk Kong taxes		
Benefits from mandatory MPF contributions	Free of Tax	Free of Tax	Not applicable
Benefits from ORSO and voluntary MPF contributions if received on termination of employment	Employer's balances: taxable on less than ten years of service, unless received on retirement, death or incapacity, in which case will be tax free. Own balances: free of tax	Free of tax	Repayments subject to profits tax

Source: Jeremy Gadbury, Alan Taylor, Jonathan Watkin, *Pensions and retirement funds in Hong Kong*, 2003

Member Protection

There are no explicit public guarantees for either the MPF or the voluntary pension schemes. Members are protected against losses in accrued benefits due to misconduct or fraud of fund administrators and trustees by the MPF compensation fund. This fund was basically established by the government with an initial subsidy of HK$600 million and is maintained with a levy of .03% of the value of assets of the schemes.

Summary of Supervisory Practices in Hong Kong

Hong Kong has a three pillar pension system: a publicly managed, tax-financed social safety net; a mandatory, privately managed, fully funded provident scheme (MPF) and a voluntary personal savings and insurance pillar. Within the mandatory provident scheme, plans can be set up as a master-trust[2], governing multiple companies, an industry scheme for an entire sector or as an employer-sponsored scheme.

The supervisory authority in Hong Kong is the Mandatory Provident Fund Authority (MPFA), established in 1998. All schemes are funded in individual accounts and must be set up under trust, with trustees approved by the Mandatory Provident Fund Authority.

The number of privately managed schemes in Hong Kong is much smaller than in other countries with pension regulation based on Trust Law and the number of mandatory reporting requirements and adequacy criteria is higher, but the market can still be described as an open one.

There are no formal licensing procedures apart form the approval of trustees and financial intermediaries, but the MPFA monitors and validates compliance with capital adequacy requirements that are in place.

MPFA monitoring function is moderately intense[3]. Although the volume of information reported to the supervisor is fairly high, the trustees and auditors serve as an intermediary layer for monitoring this information. Master trusts, industry schemes and employer-sponsored schemes have to submit annually: trustee returns containing mainly financial information; a statement with policy information and a report on internal controls that includes assessments from independent auditors regarding general performance as well as compliance with capital requirements regulations. Trustees must also publish annually a consolidated report that is submitted to the MPFA and is accessible to any member upon request. Communication to members is generally the responsibility of the trustees. The supervisor ensures transparency by making available daily information about trustees and correction activities on its web-site.

Apart form these traditional sources of information MPFA also relies on whistle-blowers that are usually auditors that must report to the supervisor whenever they come across an event of non-compliance. With regard to measurement and analysis, it is only very little that is done by the supervisor. This activity falls under the responsibility of the trustees and auditors.

Investigations and other types on intervention occur whenever the supervisor believes there has been non-compliance. MPFA suspends or withdraws approval for trustees when the assessed non-compliance exceeds a certain limit. The supervisor can also initiate and supervise the procedure of scheme wind-up whenever a pension scheme has been unable to fulfil its responsibilities towards members.

These facts describing intervention and supervision, combined with their frequency suggests a **re-active** approach that appears to be typical for systems where pension funds are established under trust.

The activities of the Mandatory Provident Fund Authority in Hong Kong resemble very much those carried out by Australian Prudential and Regulatory Authority in Australia, with the exception of the monitoring activity. The MPFA monitors more information in a more pro-active way than its Australian counterpart.

Organization and scope of authority of the Supervisory Agency:

The Institution in charge of private pension supervision in Hong Kong is the Mandatory Provident Fund Schemes Authority (MPFA). The MPFA is a specialized institution that was established in 1998.

The mission of the Mandatory Provident Fund Schemes Authority (MPFA) is to ensure the provision of retirement protection for Hong Kong's workforce through an effective and efficient system of prudential regulation and supervision of privately managed provident fund schemes under the MPF system.

Some of the most important responsibilities of the MPFA as a supervisor and regulator are: to ensure compliance with relevant legislation; register the MPF schemes; approve qualified persons as trustees, regulate the affairs and activities of approved trustees and ensure that they administer the registered schemes in a prudent manner.

The MPFA fulfills its mandate by operating in close collaboration and interaction with other financial market supervisors and regulators that are in charge of maintaining compliance in adjacent sectors of the financial market.

The Mandatory Provident Fund Schemes Authority is an independent agency. The MPFA is the lead regulator in this field, although it shares regulatory responsibilities with the other regulatory institutions in the financial market. In the exercise of supervision and regulation of provident schemes and their adjacent intermediaries, the MPFA collaborates closely with The Office of the Commissioner of Insurance; The Hong Kong Monetary Authority; and the Hong Kong Securities and Futures Commission.

Office of the Commissioner of Insurance – Ensures that the insurance companies involved in the MPF business comply with the capital requirements and that they are properly operated. Approves and regulates the activities of financial intermediaries who conduct their primary business in the insurance field.

The Hong Kong Monetary Authority (HKMA)– established in 1993- performs the functions of a central bank and banking sector supervisor. It regulates all the banks that are involved in the MPF process as custodians, trustees or intermediaries.

Hong Kong Securities and Futures Commission(CFC) – oversees the futures and securities market as an independent organization, separated form the governmental apparatus. The role of the SFC in the context of the mandatory provident funds is to: authorize certain MPF schemes; license certain service providers, like investment managers and custodians who engage in securities lending. The role of this institution is significant, given that the size Hong Kong securities and futures market is the second in Asia, after Japan.

In terms of organizational structure, the MPFA is overseen by a board of directors and receives advice from a committee of scheme representatives and other various groups for the regulatory work it undertakes.

Entry requirements and administration:

In the MPF system there are several types of trustees, but the most common ones are the local corporate trustees and the individual trustees. Individual trustees operate in this capacity only for the employer-sponsored MPF schemes.

The MPFA has the responsibility to approve both the individual and the corporate trustees. Since the trustees have such a crucial role in the governance of the retirement income provision system, the criteria they have to meet in order to obtain approval from MPFA are stringent, with specific limits and rules for capital adequacy, financial soundness, and internal control mechanisms.

Capital adequacy requirements for individual trustees are paid-up share capital and net assets of at least HK$150[1] mil or HK$30 million contingent on continuous financial support from a well-established financial institution. The equivalent capital adequacy requirement for the individual trustees is to have an insurance policy or a bank guarantee against potential losses caused by improper conduct, that covers approximately 10% of the value of the assets in the scheme. This requirement, together with the multiple sanctions that could affect trustees if they fail to meet their responsibilities are very powerful deterrents to conduct that could jeopardize the interests of the scheme members.

In addition to prudent behavior, trustees have to submit regular returns, financial statements and internal control reports to the MPFA and they are required to act as "whistleblowers" and report instances of non-compliance of auditors, funds managers, etc.

The main responsibilities of the trustees are:

– comply with the governing rules;
– exercise the care, skill, diligence and prudence to be reasonably expected of a person who is administering provident fund schemes;
– act in the interests of schemes members and not in the trustees' interests;
– ensure that the funds of the scheme members are invested in different investments so as to minimize the risk of losses of those funds.
– manage the contribution and benefit administration themselves;
– appoint a custodian to hold the scheme assets (an approved trustee may be custodian under specific circumstances);
– establish a separate individual account for each scheme member;

[1] Source: Gadbury et all

– ensure that each member's account is kept in such a manner that the market value of the accrued benefits of a member can be ascertained at least once a month.

Trustees can obtain approval to operate form MPFA contingent upon their permanent residence in Hong Kong and proof of good conduct without incidents involving fraud or dishonesty. *A registered trust company* incorporated in Hong Kong which applies for approval as trustee must:

– comply with the prescribed capital adequacy requirements;

– have at least five directors of which all must be individuals;

– have sufficient presence and control in Hong Kong;

– satisfy the MPFA that it is capable of carrying out the business of administering registered schemes for which purpose the MPFA may enter and inspect premises intended to be used by the company carrying out the business of administering registered schemes;

– not do any other business than trust business;

– satisfy the MPFA that all of the controllers of the company are persons of good reputation and character and, in particular, ..

– satisfy the MPFA that the chief executive officer and a majority of directors of the company have the skill, knowledge and experience that are necessary for the successful administration of provident fund schemes.

The licensing and approval procedure for trustees, financial intermediaries and other relevant entities is done jointly with the other three regulatory and supervisory agencies: The Hong Kong Monetary Authority; The Office of the Commissioner of Insurance and The Securities an Futures Commission.

On-going Supervision:

Monitoring

The MPFA works toward the goal of protecting member's interests and securing their welfare in retirement by setting up mechanisms of monitoring the activity of the relevant parties that are efficient, given the functional structure of the schemes.

The stringent criteria on capital adequacy, financial soundness, fitness and propriety as well as the internal control standards required for trustees are the first mechanisms used by MPFA in the monitoring activity. Since trustees play such an important role in the system of private pension provision in Hong Kong, they are the primary target for the regular monitoring activity undertaken by the supervisor. Fund Managers and other service providers fall under the responsibility of the trustees. Trustees monitor their compliance with the requirements, standards and guidelines of MPF.

Trustees are required to submit returns, financial statements and internal control reports on a regular basis. The MPFA also conducts field inspections to ensure trustees comply with requirements and enable early detection of deficiencies. In cases where there is suspected non-compliance with the requirements, the MPFA conducts detailed investigations to establish the caused and restore compliance.

In instances of minor non-compliance, MPFA can issue warnings, order the trustee to take remedial action or even impose financial penalties. In serious cases, the MPFA can ask the trustee to conduct a special audit and investigation. The MPFA has the power to suspend the trustee form administration of a MPF scheme, or even revoke its approval or take prosecution action in a court of law for serious non-compliance.

Application of Sanctions and Compliance Enforcement

Depending on the circumstances of each case, the MPFA takes different enforcement measures in the handling of complaints. Factors to be considered include whether the interests of scheme members have been protected, and whether the enforcement measures have an adequate deterrent effect.

Since trustees play such an important role in the administration of the pension schemes in Hong Kong, most of the sanctions and penalties that the MPFA applies are directed towards them. Sanctions that can be imposed on trustees for minor penalties include reminders, written warnings to take remedial actions, surcharge notices, pursuance of claims on behalf of the members or fines. The penalties for more serious problems include revocation of approval; mandatory audits; substantial fines, or even prosecution in a court of law.

The MPFA conducts investigations into all complaints received. Complainants' identities and information provided are kept confidential. The MPFA notifies complainants of the results upon completion of the investigations. Employees are encouraged to report to the MPFA as early as practicable when suspecting that their MPF rights are infringed upon. Apart from acting on complaints, the MPFA also conducts proactive on-site inspections. Legal actions will be taken against those non-compliant employers to protect the interests of scheme members.

From this perspective, MPFA assumes an active role in protecting the interests of members. The scope of the authority of MPFA of applying sanctions is primarily remedial, with instruments of correction applied when rights or interests of members have were affected.

NOTES

1 Data source: Jeremy Gadbury, Alan Taylor, Jonathan Watkin, Pensions and Retirement Funds in Hong Kong, 2003

2 In Hong Kong there are 299 schemes approved as Master Trust Schemes, 12 Industry Schemes and 10 employer sponsored schemes in the Mandatory Provident Fund pillar out of 48 existing in 2004.

3 Trustees have to submit annual balance sheets, profit and loss accounts, auditor's reports and director's report. They also have to submit an annual statement of any changes of significance in the performance of service providers or changes in the investment policy.

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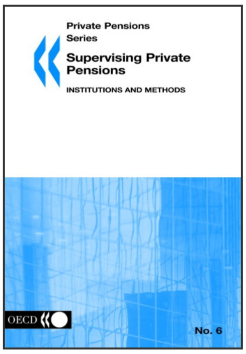

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