The evolving MPF system: an objective assessment

Study on fees, fund options and fund performance in the Hong Kong Mandatory Provident Fund sector

Commissioned by the Joint Industry Group

HKFi The Hong Kong Federation of Insurers 香港保險業聯會

HK IFA 香港投資基金公會

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The Mandatory Provident Fund system ("MPF") is in its 12th year of operation. Its implementation underpins the Hong Kong Government's determination to help its workforce save for retirement.

As a pension system for Hong Kong's working population, MPF has one of the world's highest enrolment rates of 99% of all employees (Source: MPFA). Despite two major market crashes in 2001 and 2008, MPF assets have continued to grow steadily and reached HK$356 million[1] at the end of 2011.

Increasing MPF balances have drawn the public's attention to returns achieved on monies invested and the fees charged to their accounts.

In November 2012 the MPF system is expected to enter a new phase, when it will allow members to choose any scheme in the MPF market for their own contributions. Surveys suggest that in choosing a provider, one of members' main concerns will be whether the scheme has sufficient investment options for them to pick from.

The size and penetration of MPF, the greater understanding by members of investments and fees, and the increased flexibility being added to MPF signal that MPF has progressed from infancy to adolescence.

To help MPF members better achieve their long term retirement savings, the Joint Industry Group comprising Hong Kong Federation of Insurers, Hong Kong Investment Funds Association and Hong Kong Trustees' Association Limited appointed Ernst & Young to review where the MPF stands today relative to other defined contribution pension systems, in terms of fund performance, fees and investment options. More importantly, how we may learn from predecessors to continuously improve the current system.

Hong Kong has also gone through many changes. After eleven years, it is an opportune time to review what we have achieved, to revisit the fundamental objective of MPF as an occupational pension system and to leverage on relevant lessons from other systems to improve ours.

This report shows that the MPF system has done at least as well as some of the relevant international peers in terms of fund performance, fees and investment choices. Referencing to the progress of other peer systems, it also shows that there are challenges to be overcome as the MPF system matures.

As key parties to the MPF industry, our three associations are fully committed to working with all relevant stakeholders in improving and enhancing MPF, making it a more effective retirement system and leading to better long term retirement savings for MPF members.

[1] *Source: MPF Schemes Statistical Digest, Dec 2011*

Foreword by Ernst & Young

Pension systems around the world are a matter of great public interest. Few tasks are more important for a civilised society than securing dignity for its members in old age, and retirement income systems are a key element of that. From their earliest beginnings in the late nineteenth century, when Otto von Bismarck embarked on social reform in Germany that culminated in the landmark Old Age and Disability Insurance Bill in 1889, and soon after, when the United Kingdom introduced the Old Age Pensions Act in 1908, the general public has taken a keen interest in the role and scope of retirement income schemes. There is often, it is true, a tendency for the general public to focus on the short term because of the complexity of the economics involved and a reluctance to think to long-term horizons, but few would deny the reality of demographic change and the need for provision for retirement.

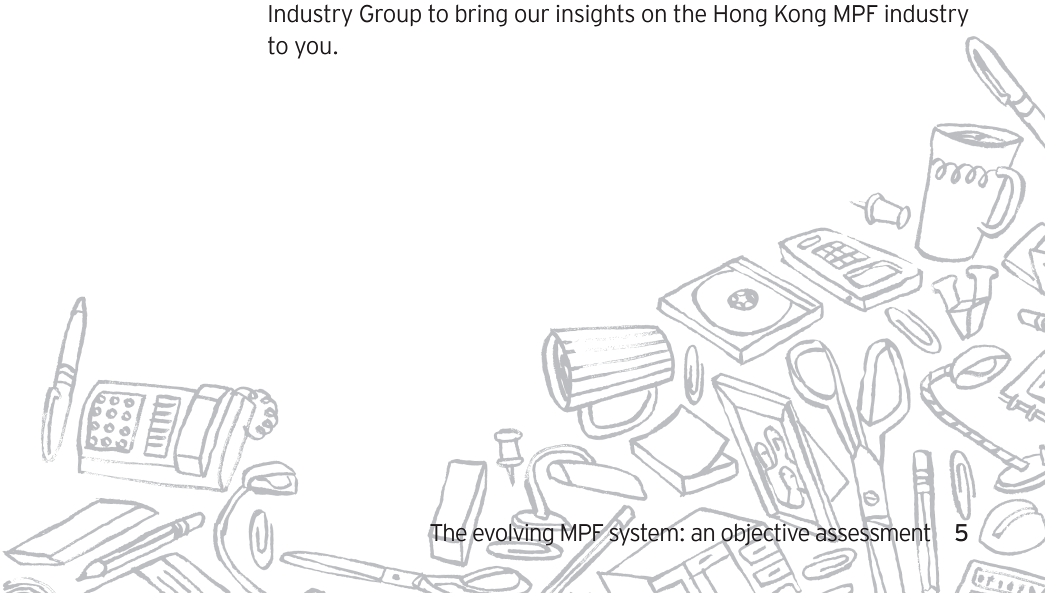
The experience in Hong Kong with the Mandatory Provident Fund system has been no different, and indeed, such is the current level of public interest (whether prompted by short-term or long-term considerations) that the present time represents an opportunity for the industry and its stakeholders to seek a way forward in the common pursuit of excellence. Retirement schemes evolve over time to meet changing needs and circumstances. In the MPF's comparatively young existence, it has already had to contend with external shocks such as the SARS outbreak and the global financial crisis. Our research shows the MPF system has been remarkably robust in this context but, like any retirement income system, has both strengths and weaknesses. The challenge now is to build on the system's considerable strengths to develop its fitness for the future. Radical change is risky and probably unnecessary – targeted changes are less likely to destabilise what has already been achieved. The key, then, is to identify, plan and implement smoothly those changes that are required. Determining what those changes should be is the first challenge for the industry and its stakeholders.

Our discussions with industry executives suggest that MPF stakeholders have two things in common. Firstly, stakeholders share a desire to do what is in the best interests of MPF members. Secondly, stakeholders agree that changes or refinements to the current system may be necessary in order to maximise members' long-term retirement savings. There is thus broad-based willingness to consider refinements to achieve a shared goal.

We currently see active debate as to the direction of the MPF system. It is natural for retirement schemes to face a period of critical scrutiny, but usually they have been established for longer when this occurs. Perhaps hastened by the onset of the global financial crisis, the MPF system is under debate earlier. Hong Kong has an opportunity now to refine the goals of the system and take decisive steps towards achieving those goals.

Our objective was to assess what the MPF system has achieved to date. There is scope for the industry to explore in greater detail some of the themes we have laid out. However we believe that there is already a case for cooperative action within the MPF industry to commence evolutionary change. We acknowledge that change invariably involves a degree of pain – at least in the short term – as adjustments to business operations may be needed. However the gains may justify the effort. For the industry, the winners in this process will be those who are able to manage the changing landscape of retirement savings. Many employers will benefit through reduction in the effort needed to fulfil their regulatory MPF obligations. The ultimate winners though, should be MPF members' long term retirement savings which should increase due to the benefits of scale and improved efficiency.

We would like to thank all the participants for their valuable time during the course of this project. We are proud to have been appointed by the three industry associations forming the Joint Industry Group to bring our insights on the Hong Kong MPF industry to you.



Executive summary

The global financial crisis and the consequent high level of long term government debt are now forcing many developed countries to address the pension challenges posed by their ageing populations. Hong Kong embarked on this journey more than 11 years ago. The Hong Kong Mandatory Provident Fund (MPF) system is intended to evolve over time into a mature and robust long term retirement savings system for the majority of MPF members.

This report sets out the findings of a study performed by Ernst & Young for the Joint Industry Group, comprising the Hong Kong Federation of Insurers, the Hong Kong Investment Funds Association and the Hong Kong Trustees' Association Limited. We looked at levels of fees and investment performance in the MPF sector, comparing these to pension systems in other selected countries and other investment options in Hong Kong. The purpose of our report is to assist understanding of certain aspects of the Hong Kong MPF system, via comparison to pension systems in Singapore, Australia, Chile and the United Kingdom (collectively referred as "Reference Systems").

Our research found that the Hong Kong MPF industry performed comparatively well against its peers during a period of unprecedented adversity in the investment markets and depressed interest rates. The Hong Kong MPF system has made substantial progress on its maturity journey in its 11 years of existence. The industry and its stakeholders have the opportunity now of building on those achievements to take the next step towards industry maturity.

We present the following insights from our research under five key tenets which may be useful when discussing future enhancements to the Hong Kong MPF system:

Tenet	Insights
The MPF system has worked well over the past decade	‣ Hong Kong MPF system has made considerable progress in its 11 years of existence. The high penetration rates among employers and employees and the scheduled introduction of employee choice of scheme providers are examples of sound achievements, which have taken many peers much longer to achieve.
Assets performed comparatively well during adverse times: ‣ Selected asset allocation ‣ Range of fund investment choice	‣ The MPF system has performed comparatively well against its peers over the medium term despite unprecedented investment market adversity and depressed interest rates. ‣ Members' selected investment fund choices are overweight in high risk and low risk categories, with a strong home bias. This investment profile is exposed during periods of high volatility and market downturn. ‣ The range of investment choices is similar to that found in more mature retirement systems, but does come at a cost in terms of relatively higher fund management fees as a percentage of assets under management.
Fees show grounds for optimism: ‣ Achieving economies of scale ‣ Efficiency and effectiveness of MPF scheme administration	‣ Means to increase mandatory/voluntary contributions and contribution caps should be considered to enable faster growth of AUM so as to achieve scale benefits and enable further reduction of management fees for MPF members. ‣ Costs of MPF scheme administration and efficiency drivers should be analysed to get a better understanding of the challenges and areas for possible improvement. Messages of the 'fixed' nature of administrative charges due to the comparatively small size of the industry (AUM and member numbers) and limited short-term improvement opportunities should be communicated to MPF members.
The MPF system offers opportunities for refinement: ‣ Vision, objectives and guiding philosophy on investments of the MPF system ‣ Regulatory investment restrictions of the MPF ‣ Setting of default investment funds	‣ A review of the MPF system to set the strategic vision, objectives and investment beliefs will provide clarity for all stakeholders on desired retirement levels and the means to achieve this result. ‣ Current investment restrictions and the provision of further guidance to the industry on suitable investments for a long term retirement system should be reviewed to provide more clarity and streamline the investment process. ‣ A framework for default fund selection should be developed which identifies who has responsibility, what the process will be and what will be suitable investment options for a default member to maximise his long term retirement savings.

Tenet	Insights (Continued from page 7)
Additional factors affect MPF members' retirement savings ‣ Absence of personal financial advice to enhance MPF members' informed choice ‣ Risk definitions and classifications	‣ Review the need for an affordable, high quality, mass market financial advisory infrastructure that is attractive for providers to offer and which members will use to maximise their long term retirement savings. ‣ The development and implementation of a standardised, industry-wide framework for investment fund labelling and risk categorisation should be considered.

The Hong Kong MPF system benefits from the status of Hong Kong as a major asset management centre. We found that the MPF industry achieved better investment performance over a five-year horizon in two of four risk categories including the highest risk category in which the majority of MPF funds are placed, and had lower fund management charges than expected based on the size of the MPF asset pool. Management fees and direct charges to MPF members of 1.74% of assets under management (AUM) contain two major components which have different drivers: a) fund management fees for the management of the assets; and b) operating fees that cover aspects such as scheme administration, trustee and sponsor activities plus direct charges such as fund audit expenses. Average fund management fees of about 0.57% of AUM were lower than expected given the small asset pool of the MPF industry. We believe that the reason lies in providers leveraging benefits from the size of their operations in the institutional asset management market in Hong Kong to cross subsidise lower fees for MPF members. In terms of fees, our research suggests that on average MPF savings attract lower fees than retail investment funds in Hong Kong.

The fixed nature of the cost to operate the MPF system results in relatively high operating fees and direct expenses estimated at 1.17% of AUM. However, these are to be expected given the small number of contributing members and a small asset pool. MPF members do not pay additional sales fees and charges which can add a further of 1% of AUM per annum in other Reference Systems.

In addition, the mechanism of charging fees as a percentage of AUM means that members with larger account balances "subsidise" those members with smaller account balances as well as the large number of preserved accounts with often smaller account balances. An average of 10 fund options per scheme positions MPF at the higher end of, though still within, what is globally generally considered an appropriate range.

We identified a number of areas which we believe should be addressed in order to further improve the effectiveness and efficiency of the system as a vehicle for long term retirement savings. In particular, we recommend:

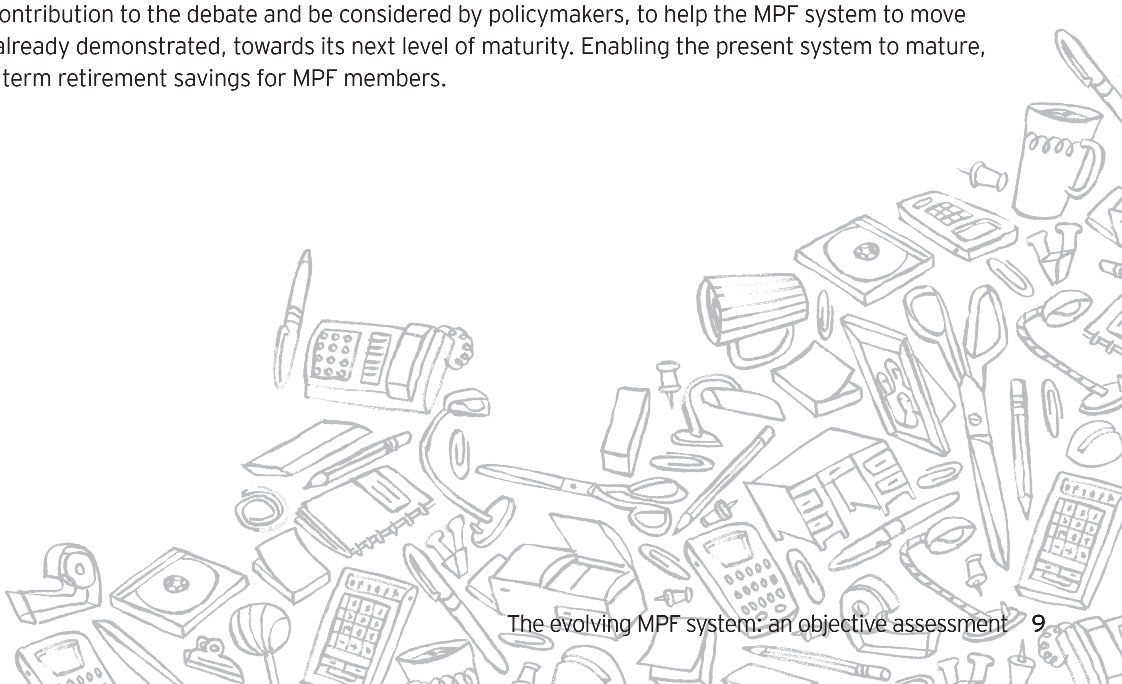
- to consider actions to facilitate scale in the system to reduce the impact of administration costs of a fixed nature;
- to provide additional clarity in certain aspects of the regulatory system to improve efficiency and provide greater certainty for trustees and fund managers; and
- to provide greater decision support and personal financial advice to members to enable them to make informed choices.

In some respects, these matters are outside the control of the MPF industry itself and require debate with policymakers, however in other respects the industry has a role to play in refining market-led approaches.

We have presented five principal elements necessary for the MPF system to adopt in moving to the next level of industry maturity:

Evolution elements	Consideration
Communicate the MPF journey and benefits to members	The MPF system has performed comparatively well which may not necessarily be reflected in recent public perception. We suggest enhancing communication to members and stakeholders of a) the journey and objectives of MPF as a long term retirement savings system, and b) the comparative advantages of the Hong Kong MPF system.
Pursue scale and efficiency to reduce cost and fees as a percentage of AUM	It is a pervasive factor in our findings that the Hong Kong MPF system is small in comparison to the Reference Systems in terms of AUM which limits opportunities to benefit from economies of scale. Scale in assets under management comes from increased contributions. Therefore, we recommend considering ways to increase mandatory and voluntary contributions, in particular by further increasing the current cap.
Improving MPF system clarity and vision including guidance around investment beliefs	For any organisation — as for a retirement savings system – the vision, objectives and other aspects provide vital strategic guidelines and encourage certain behaviours. Further clarity around fiduciary duties of each stakeholder, and principles on what constitutes the best interest of MPF members and what are "suitable" investments in the maximisation of long term retirement savings are vital components.
Improving personal financial advice and decision support	MPF members must currently make an informed investment choice with limited decision support and without any regard to their financial literacy. The current challenge lies on both the demand and supply sides. Therefore, we recommend reviewing the need for an affordable, mass market personal financial advisory framework and solution that can be used by members with a view to maximising their long-term retirement savings. Such a solution must be attractive for providers to offer. The long lead time needed to establish and implement a practical and mutually attractive solution indicates this process would benefit from a swift commencement.
Implement operational refinements of some regulatory features	During our assessment we observed a number of additional opportunities to clarify and streamline regulations. We recommend addressing some operational refinements including but not limited to: a) default investment fund setting; b) fund and risk labelling framework and c) simplifying consolidation of existing legacy investment funds.

We hope that this report will make a contribution to the debate and be considered by policymakers, to help the MPF system to move beyond the significant achievements already demonstrated, towards its next level of maturity. Enabling the present system to mature, we believe, will lead to enhanced long term retirement savings for MPF members.



Context for this review

The purpose of our report is to assist understanding of certain aspects of the Hong Kong Mandatory Provident Fund (MPF) system, via comparison to similar systems in other countries.

Ernst & Young was appointed by the Hong Kong Federation of Insurers, the Hong Kong Investment Funds Association and the Hong Kong Trustees' Association Limited to perform a comparative study of specified aspects of MPF schemes with a selection of comparable arrangements in overseas markets. The aspects specified are aggregate fees, investment management fees, other administration charges and expense ratios, and returns. A major objective of the study was to identify features that may be responsible for differences in the returns and in the costs of running different pension systems.

The Reference Systems selected were located in Singapore, Australia, the UK and Chile. While Singapore has some significant design differences to the MPF system it is one of the leading Asian pension systems, therefore we included Singapore to provide a broader comparability in Asia. In each case the comparison was necessarily restricted to the specified aspects or relevant areas of the Reference Systems in order to facilitate meaningful comparison with Hong Kong. Our study was also limited to publicly available information, though we have supplemented this information with interviews with industry executives.

Our research and findings were performed at a high level and must be regarded as indicative. It is important to note that no two pension systems are alike, due to different stages of maturity, market forces, market environment, taxation systems, regulatory structures and focus, among other factors. There are also differences in the definition and the transparency of fees and returns. This heterogeneity among the MPF system and the Reference Systems significantly constrains our ability to perform a 'like for like' comparison as well as the ability to generate granular findings. All comparative findings must be interpreted in this context. Notwithstanding these constraints, significant lessons can be learned from this research.

Presentation of findings

We have produced two versions of this report to cater for the needs of different users.

- This summary version is intended for those users who require a high level understanding of our research findings and recommendations.
- The full version provides additional information regarding the selection of the reference pension systems, detailed research findings, supporting evidence and conclusions as well as considerations for the future.

Copies of the full report can be obtained on request or downloaded from the respective websites of the three industry associations, and that of Ernst & Young.

The Hong Kong MPF system

The Hong Kong MPF system was launched in December 2000. It is a mandatory occupational pension system. The management of the schemes is carried out by the private sector. It operates on a defined contribution basis, whereby members and their employers make contributions to a scheme, which invests those contributions until the date of retirement, when the accumulated contributions and investment earnings are available for the employee to fund retirement. The investments of MPF schemes are subject to pre-approval by the industry regulator, the Mandatory Provident Fund Schemes Authority (MPFA), as well as by the Securities and Futures Commission (SFC).

The current rate of contribution is 10% of relevant income (5% payable by each of the employer and employee), though there is a cap on the amount of earnings on which these rates are levied. The revised cap is HK$25,000 per month, which will come into effect on 1 June 2012. Members are at liberty to make additional contributions. Employee contributions are deductible for salaries tax purposes, and the tax deductible limit for contributions will be increased to HK$15,000 per tax year. A one-off contribution of HK$6,000 was made by the Government to eligible MPF accounts in 2009. Apart from this, the total amount of net contributions displays slow growth.

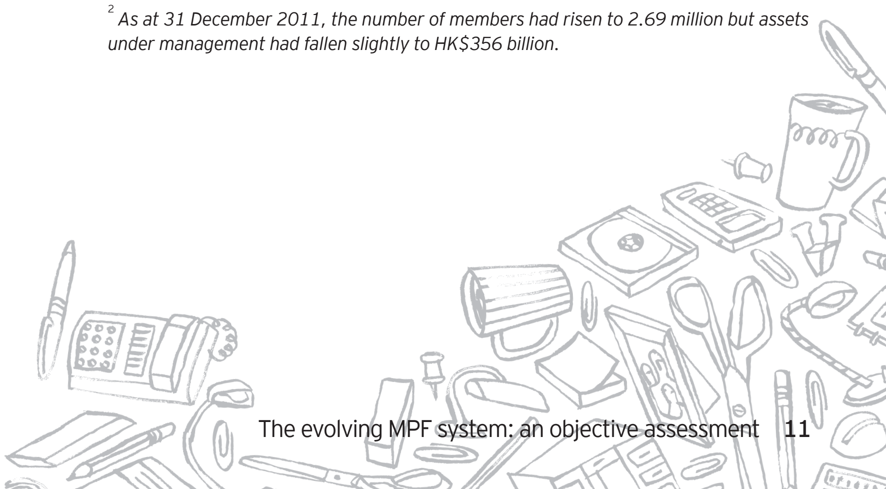
With low rates of employers changing providers, providers have limited commercial opportunities to affect their market share. The scheduled employee choice arrangement is aimed at changing this limitation to some degree with employees expected to exercise their new choice of provider.

Assets in defined contribution schemes accumulate over time, the rate of growth depending on factors such as levels of contribution, the performance of the funds invested in and the rate at which new entrants and contributions are offset by members reaching retirement age and realising their funds. The net asset value of the MPF has increased each year, with the exception of 2009. Although the MPF system is 11 years old, this is still a very young scheme in the context of retirement systems. Systems at a similar stage of development are typically still building their scale and are some distance from maturity.

Hong Kong is a global centre for institutional asset management services, being of similar size to Australia, Singapore and the UK. The assets of MPF schemes represent only a small portion (approximately 5%) of the total asset management market in Hong Kong.

As at 31 December 2010, the Hong Kong MPF system had 2.52 million members[2], and assets under management of HK$365 billion[2], representing an average per scheme member of HK$145,000. The average assets per scheme are less than HK$9 billion which is relatively small when compared with peers with assets under management of up to HK$1 trillion.

[2] *As at 31 December 2011, the number of members had risen to 2.69 million but assets under management had fallen slightly to HK$356 billion.*



Figures 1 to 4 below outline some key statistics (2010) of the MPF system compared to its peers.

Figure 1: AUM per scheme member by Reference System

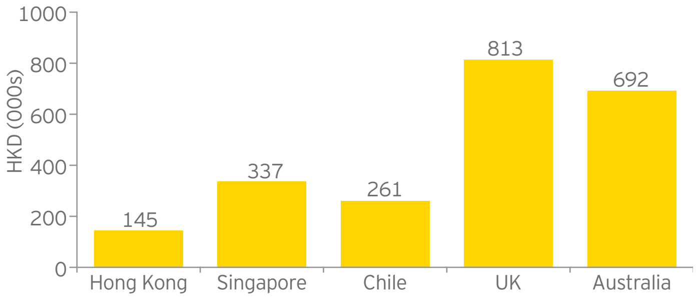


Figure 2: Number of contributors by Reference System in millions

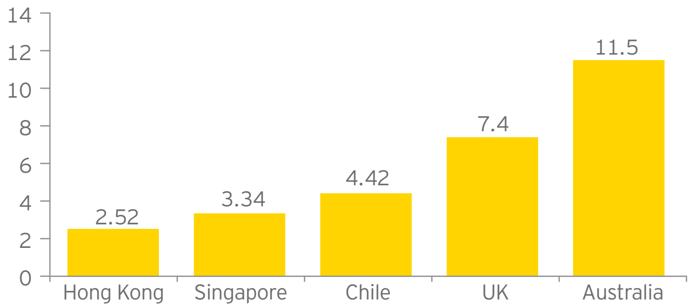


Figure 3: AUM size of Reference Systems (HKD)

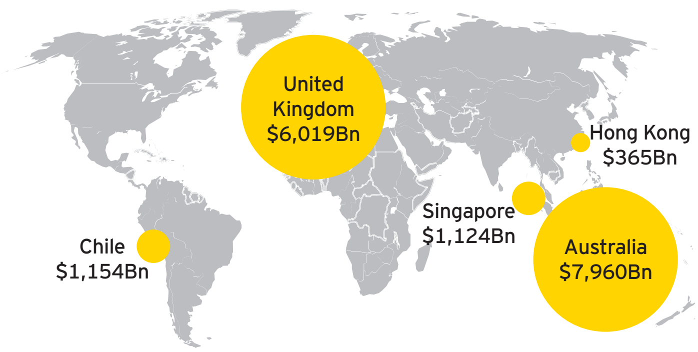
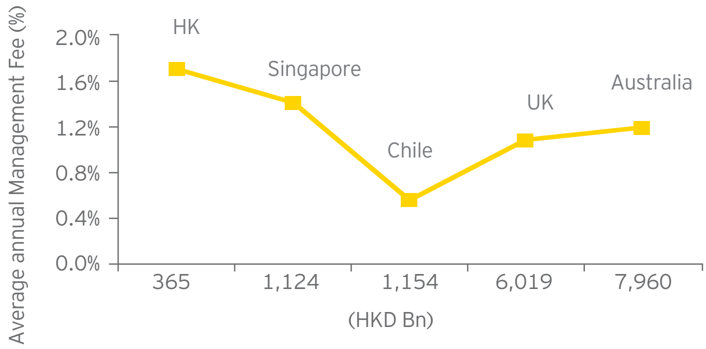


Figure 4: Average annual management fees by Reference System (% fo AUM)



Five key tenets of our review: an independent perspective

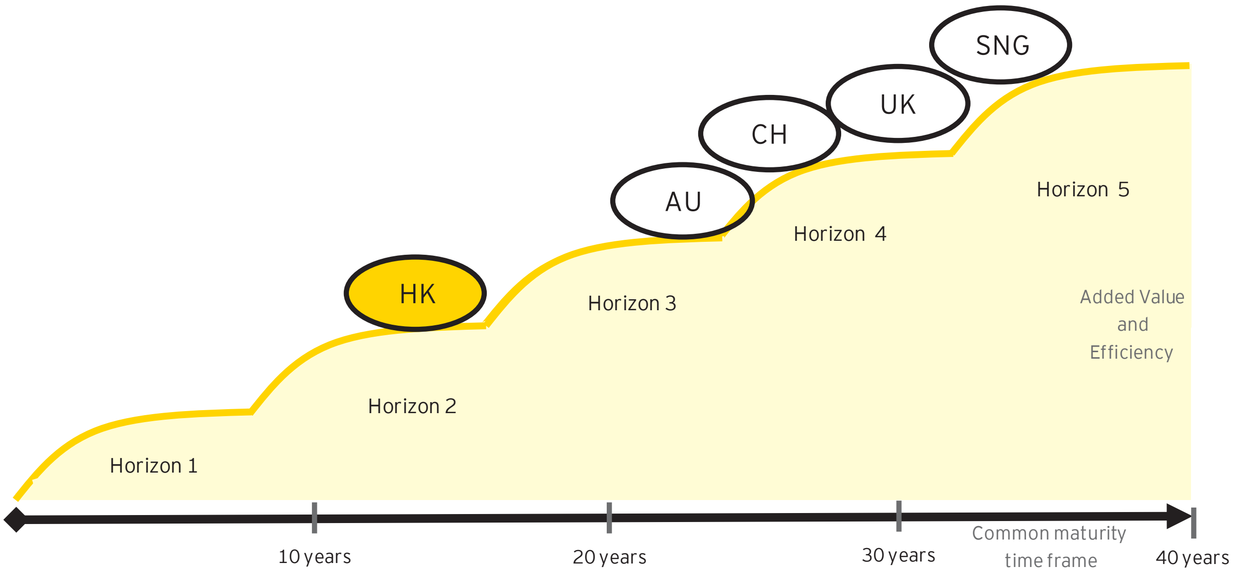
Our review identified and tested key hypotheses or tenets. We summarise here these tenets and related key findings, as they relate to asset returns, fees and other system features.

Tenet one: The MPF system has worked well over the past decade

The global financial crisis and long term government debt have forced many developed countries to start dealing with their ageing populations and pension challenges. Hong Kong embarked on this journey more than a decade ago. The MPF system is planned to evolve over time into a mature and robust long term retirement savings system for MPF members.

The Hong Kong MPF system has made considerable progress in its 11 years of existence. This is a short timeframe for any pension system, which can take up to 40 years to mature.

Figure 5 below shows five horizons of pension system maturity. We developed this curve based on our experience working with pension funds and pension systems in different parts of the world. The MPF system sits on level two of the pension system maturity curve. The MPF position compares well given that the system has only operated for a relatively short period of time. Like its peers, the MPF system is expected to mature over about 40 years. This timeframe is required to enable members and employers to make sufficient contributions according to their income, which together with robust investment performance should generate retirement savings to provide the desired income replacement ratio.



Strategic focus	Infrastructure setup and penetration of employers and members	Enhance product choice and system equity	Enable provider choice and focus on fees	Focus on efficiency for all stakeholders and introduce customer experience	System refinements & incentives to contribute more
Secondary focus	Equity across members	Delivering value through good returns	Member and employer disengagement	Outcome transparency	Integration of retirement and ageing
Key challenges	Balancing of upfront planning and setup versus immediate needs	Short term returns versus long term growth	Choice for some versus system simplicity for the majority of members	Economies of scale versus economies of scope	Accumulation versus asset consumption focus while retaining system focus

Figure 5: Five development horizons of pension system maturity

The MPF industry has been well established for some time with a robust legal framework, operating model and significant employer and member penetration. The contribution rate of 10% is aimed at providing a satisfactory ratio of income replacement, but we have not found an explicitly defined target ratio (OECD best practice is about 60% of income). The comparatively low contribution cap also challenges this aim, particularly for higher income earners. Broader employee choice is scheduled to commence shortly. The progress to date is a sound achievement which has taken many peers considerably longer to achieve. For example, even after 30 years, Chile has a significantly lower employer and member penetration rate. Australia introduced choice of provider for employees, and Singapore introduced choice of investment funds, only after more than 15 years of operations.

These achievements offer all MPF stakeholders an opportunity to take the next step on the journey to pension system maturity: the third horizon. The speed of such an evolution of the MPF system would compare favourably to other Reference Systems. Collaboration of all key stakeholders is now needed to enable the MPF system to take this next step. However, the outcome of this change process will create benefits for most stakeholders and is expected to maximise long term retirement savings for MPF members.

Tenet two: Assets performed comparatively well during adverse times

The asset allocation profile of the Hong Kong MPF system differs considerably from the Reference Systems, in terms of the distribution between high risk and less risky assets. For the purposes of our study, we divided investments into four risk categories, ranging from very conservative (1) to highest risk (4). Risk category 1 contains no equity component; risk category 2 has between 0% and 30% equity investments; risk category 3 has between 30% and 70% and risk category 4 has more than 70% equity investments. We allocated the so called mixed funds which can range across multiple risk categories to one risk category based on our understanding of the fund investment guidelines. There is no globally accepted categorisation framework and it was therefore necessary to make approximations. In addition, many funds contain a mixture of investments of different risk profiles. International pension systems vary quite widely in the investments and investment options that they offer.

Figure 6 shows that Hong Kong MPF assets under management were allocated approximately two-thirds to high-risk investments.

This proportion is high compared to other Reference Systems. This appears to reflect a higher propensity for MPF members to make use of the ability to invest in high risk assets, compared to more paternalistic systems that limit exposure to high risk/high growth assets by various means (for example, in Chile where only lower risk investment was permitted for much of the 30 years that the scheme has existed).

Relevant key assessment findings

Investment choices are overweight in high risk and low risk categories with a strong home bias. The investment profile is exposed during a period of high volatility and market downturn, but has in fact performed better than peers over the medium term.

The range of investment choices is similar to that found in more mature retirement systems, but does come at a cost in terms of relatively higher fund management fees as a percentage of assets under management.

Figure 6: % of assets in each risk category by Reference System

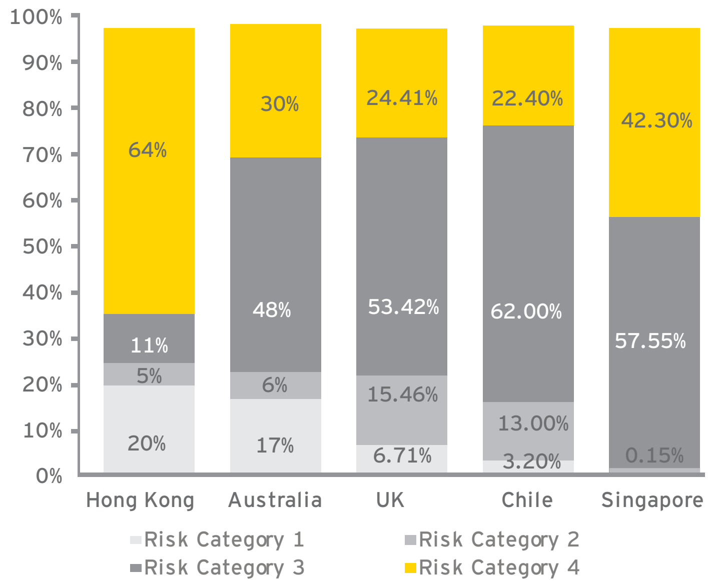
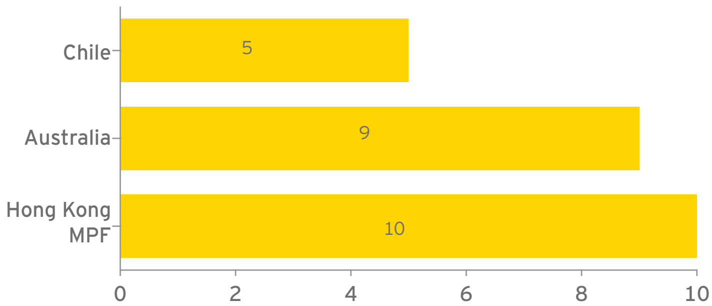


Figure 7: Average investment options per scheme by Reference System



Hong Kong MPF outperformed its peers for both of the two highest risk categories and was at least comparable in the remaining two based on this asset allocation and over a five year horizon.

Figure 7 shows that the average number of investment options available for Hong Kong MPF members is 10, which is at the upper end of what is internationally considered optimal for an occupational pension system, and a level that is usually associated with more mature retirement systems. However some 'retail' pension schemes in Australia or Singapore offer considerably more. Chile, by contrast, provides only five options in its prescriptive system.

By comparison to the Reference Systems, investment choice appears largely self-directed in Hong Kong. Many MPF members appear to have a strong appetite for higher-risk investments combined with a low level of financial literacy regarding long term retirement savings.

The Hong Kong MPF system also has comparatively high holdings of very low risk and low return investments such as cash and cash equivalents. Fewer than 20% of members in Hong Kong choose the default investment fund, compared with 50% in Australia. However, the default fund in Hong Kong is often invested in low-risk category funds, whereas in Australia trustees generally select risk category 3 as their default to comply with their legal fiduciary duty to act in the best interest of members. A default investment strategy that is more growth oriented generally leads to higher long term investment returns and to increased long term retirement savings for default members.

In the MPF system, there is no detailed guidance available to sponsors and trustees on the selection of the default investment fund, unlike, for instance, in the UK where detailed guidance is issued by a cross-disciplinary committee.

Additionally, some members who are risk-averse or not well-informed on retirement savings matters may deliberately select low-risk investments to limit their downside risk. This would increase the percentage related to default investments in low risk categories.

The MPF system also has a strong bias for investments in Hong Kong in general and Hong Kong equities in particular. This limits the benefits that MPF members could derive from international diversification as well as diversification across different asset classes.

Figure 8: Relationship between risk category and investment returns (%) over five years

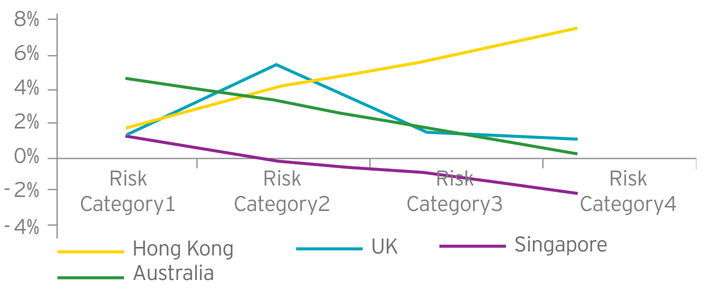


Figure 9: Relationship between risk category and investment returns (%) over one year

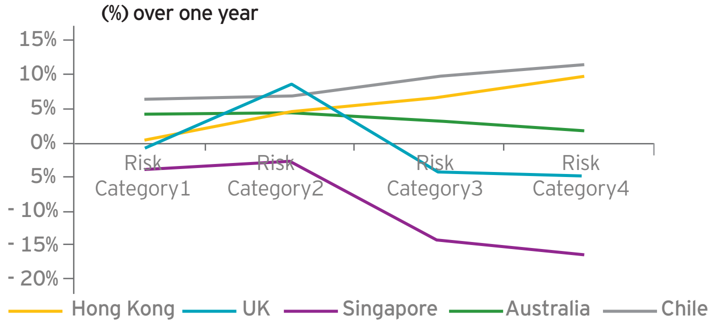


Figure 10: Asset allocation of HK MPF funds by region and asset class

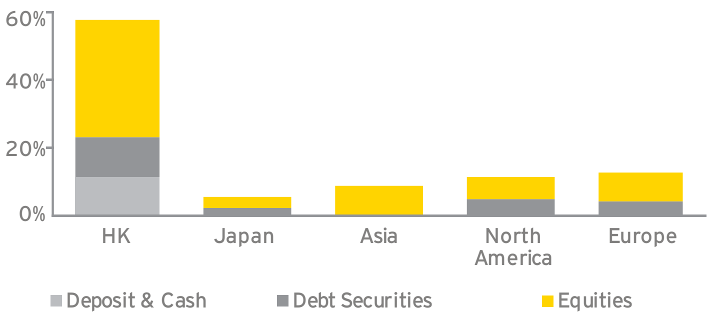
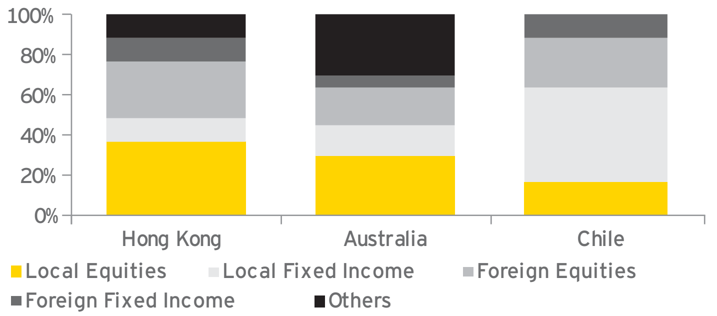


Figure 11: Asset allocation of funds by Reference System



We analysed returns for one, three and five years. We were unable to analyse returns for 10 years as this information was unavailable for certain of the Reference Systems. Data of 5 years returns for Chile is not readily available. Our analysis indicates that Hong Kong MPF performed worse than almost all the Reference Systems in all categories over a three-year time frame. Hong Kong was comparable to its peers but toward the lower end for the lowest risk category, and toward the higher end for the highest risk category, over a one-year time frame (Figure 9) (p.16). However, Hong Kong outperformed its peers for both of the two highest risk categories and was at least comparable in the remaining two over a five-year time frame (Figure 8) (p.16).

The five-year performance, particularly in risk category 4, combined with the strategic asset allocation in the MPF system, indicates that the MPF system has, by comparison with its peers, invested to maximise long term retirement savings in the medium to long term. This is notwithstanding that many MPF members appear to apply a relatively short term investment performance horizon when focusing on their strategic asset allocation.

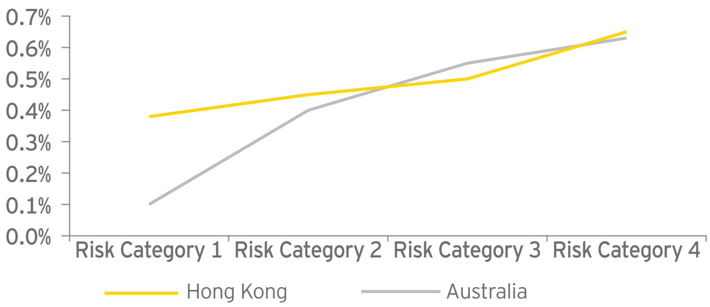
With hindsight, this particular asset allocation shown in Figures 10 (p.16) and 11 (p.16) has in fact assisted them to outperform the selected peers. We further stress this achievement when we acknowledge that most of the Reference Systems have specific circumstances and aspects that influenced their average investment performance over our analysis period to varying degrees. The Chilean economy benefited from a long resources boom. Chilean pension schemes performed strongly as they were required by law to invest a significant proportion of their assets in Chilean securities, which performed very well. Australia and Singapore have similar pension system and economic aspects that affect the average investment performance of the pension schemes in their systems.

Our assessment period was, where possible, from 1 January to 31 December 2010. As this report was being finalised, performance figures were released for the Hong Kong MPF system for 2011, and these show a less than satisfactory asset performance for that year. Revising our analysis to include this new data would not have been practicable, as comparable data was not available for peers. We acknowledge that including the average 2011 MPF investment returns would have affected the average return of the MPF system over three and five years outlined above. However, the emphasis of a long term retirement savings system should focus on long term rather than short term returns.

Tenet three: Fees show grounds for optimism

Our review found that notwithstanding the relatively small scale of the MPF system (in terms of both assets under management and number of employees covered) compared with the Reference Systems, fund management fees are comparatively low. The limited benefits available from economies of scale for MPF schemes and fund managers in terms of AUM did not result in higher fund management fees charged to schemes. This suggests that other factors were at work. In particular, we believe that MPF members benefit significantly from the overall size and sophistication of Hong Kong as a leading global investment centre through lower fund management fees and broad investment choices. Figure 12 below shows that the rate of fund management fees does not differ greatly between the four categories of risk, whereas in the Australian system fees are significantly lower for the lower risk categories.

Figure 12: Fund management fees (%) by risk category of fund



By contrast, the fees charged for trustee services, administration and sponsor services, plus other charges such as custody, appear more in line with expectations based on the early stage of development of the industry and the limited assets currently under management. These charges are typically approximately 1.17% of AUM (based on interviews with industry executives). In dollar terms, the cost per member was comparable to Australia, though representing a higher percentage of assets under management. In addition, the fee charging mechanism as percentage of AUM means that members with larger account balances "subsidise" those with smaller account balances as well as a large proportion of preserved accounts which often have smaller account balances.

Relevant key assessment findings

Although the relatively small size of the MPF system compared with the Reference Systems would be expected to limit the benefits from economies of scale, resulting in higher fees and lower investment performance, in fact, fund management fees are lower than expected. MPF members seem to benefit significantly from the overall size and sophistication of Hong Kong as a leading global investment centre, through lower fund management fees and broad investment choices.

Administrative costs charged, expressed as a percentage of assets under management, appear more in line with expectations based on the early stage of development of the industry and the limited assets under management. These costs are predominantly either fixed or member-driven and this is inevitable given the small scale of the system. There is evidence to suggest that in dollar terms the costs are comparable.

Although the MPF system is too restrictive for sophisticated investors looking to invest substantial wealth to maximise short-term performance, it offers to many an open, attractive vehicle for retirement savings with the availability of choices and at relatively low cost.

Figure 13: Breakdown of total management fees by Reference System (% of AUM)

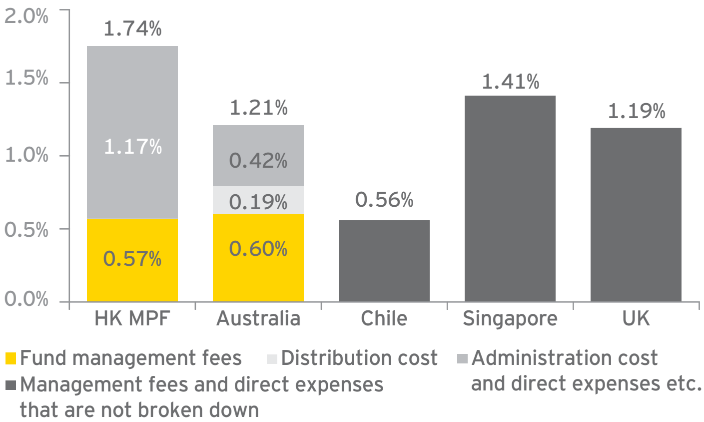


Figure 14: Up front and total management fees (%) by risk category

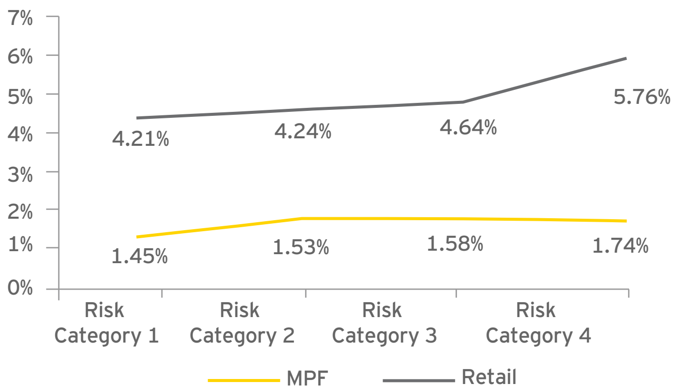
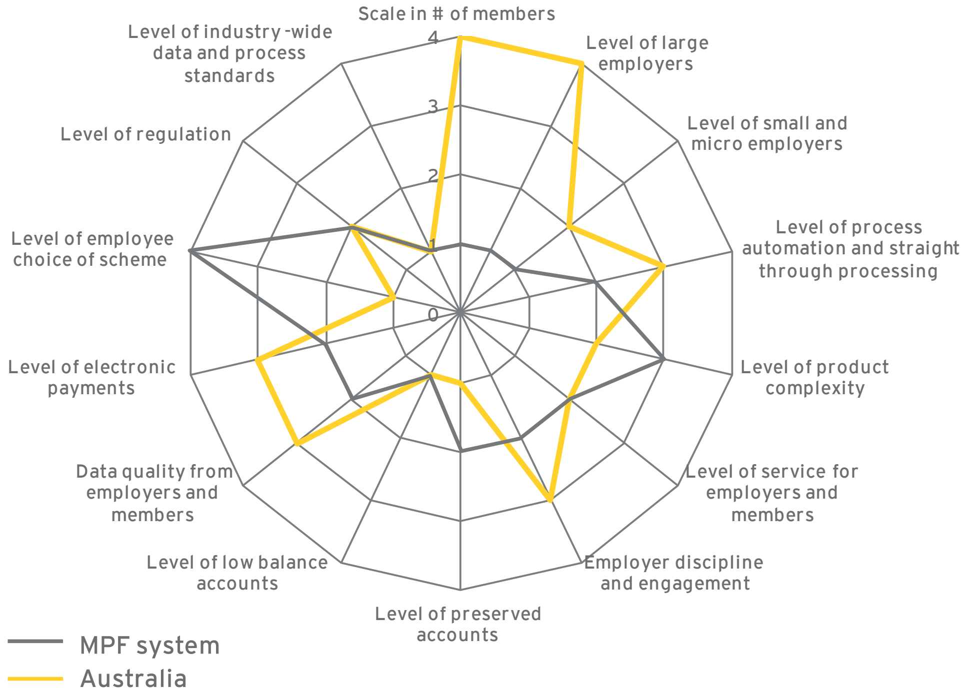


Figure 13 shows that total management fees and other charges at 1.74% were higher in Hong Kong than for any of the Reference Systems. However, members in other Reference Systems and Hong Kong retail investors may pay additional one-off upfront or ongoing other charges. These other charges may be substantial. (Other Reference Systems: Up to 1% of AUM per annum. Hong Kong retail market: Up to 4% of AUM) (Figure 14). These additional charges are not included in these statistics. MPF members pay only a very small component for those aspects which are already included in the trustee/administrator/sponsor fee component. Detailed analysis is not available, and while the result of this comparison is not unexpected, it must be approached with caution. The Hong Kong MPF system is the smallest of the five Reference Systems in terms of assets under management, and in terms of contributors.

Figure 3 (p.12) shows that, the UK and Australia are about twenty times larger than MPF in terms of relevant AUM and three to four times larger in terms of number of contributors. In an industry that benefits from economies of scale, such fundamental scale differences have significant implications. The number of contributors and the number and size of employers, rather than assets under management, are important drivers of cost, and some administration and infrastructure costs are of a fixed or semi-fixed nature.

Figure 15 (p.19) outlines a qualitative and high level assessment of several criteria that influence operating costs and administrative efficiencies of relevant pension systems. A high score indicates more opportunities for efficiency gains while a low score suggests only limited efficiency opportunities. The figure benchmarks the MPF system and the Hong Kong context against the Australian pension system and the Australian market context. The figure indicates that the MPF system has comparative disadvantages, many of which are beyond the control of individual schemes and fund managers. The current absence of full employee choice in Hong Kong provides MPF schemes with an efficiency related advantage compared to Australia where full choice was introduced a few years ago. The absence of complex taxation and life risk insurance components also provides the MPF system a comparative advantage.

Figure 15: Key drivers that positively affect administrative industry efficiency and lower fees (1 : very low score – 4: very high score)



The figure above indicates that other things being equal, the Hong Kong MPF industry faces efficiency constraints compared with the Australian pension industry due to several factors, some of which are beyond the control of the MPF system or its stakeholders. As detailed quantitative information of all these aspects is not publicly available we can only make qualitative comments. Industry stakeholders may consider collecting these types of information to ascertain the impact of each aspect and suggest measures as to how they could be addressed.

We compared the management fees charged by MPF providers with those applicable to a sample of retail funds available in Hong Kong. While we caution that our findings are based on a sample, and therefore care should be taken in interpreting them, we found that up front and total management fees charged for our sample of retail investment funds significantly exceeded the equivalent for MPF funds, across all categories of risk. The retail investment market offers a much greater choice of investments and does not have the access restrictions of the MPF system, allowing flexibility to sophisticated investors with substantial wealth who seek unrestricted choice and want to maximise their short-term performance. Our findings suggest that this flexibility comes at a price. The MPF system offers lower overall cost to members due to the absence of up-front and back-end fees that are common in most Reference Systems, and it offers certain scale benefits for larger employers similar to some other reference markets. Based on this finding, the MPF system is generally an attractive long term retirement savings vehicle for many Hong Kong members.

Tenet four: The MPF system offers opportunities for refinement

We identified three key findings regarding the evolution of the MPF system which indirectly have an impact on investment performance, fees and investment options. These three areas have emerged as the MPF system has developed since its establishment, and require further refinement and clarity of: a) the vision and objectives of the MPF system; b) the investment restrictions that are "suitable" for a long term retirement system; and c) a framework to select a default investment fund for those MPF members that do not make an active investment choice. All three areas are key planks of the MPF system that significantly influence stakeholder behaviour. We believe that it is important to re-align different interpretations in each area. These will help address some existing system inefficiencies and maximise MPF member long term retirement savings.

The MPF system has not explicitly defined its vision and objectives as a long term retirement savings system in Hong Kong. Such a statement generally also specifies the pension system's investment beliefs and philosophy on investments suitable to maximise long term retirement savings. All key stakeholders compensate for this lack of certainty with their own diverging interpretations, as to what, in particular, constitutes "suitable" investments. This situation has contributed to higher management fees, as well as comparatively less than satisfactory overall investment performance over a three-year time frame for MPF members, as many members chose higher risk investment funds which generally have the propensity to attract higher fees. In addition, the situation led to a lack of clarity around principles or definition of what constitutes "in the best interest of members" and their long term retirement savings.

Many MPF members in Hong Kong have a higher appetite for high risk investments as well as lower financial literacy regarding long term retirement savings and they seek choice. As a consequence, many members demand to invest their MPF savings in higher risk investments. MPF schemes, sponsors and fund managers have responded to this demand. They developed their interpretation of "suitable" investments to reflect member demand, resulting in an approach based on members' experience with the liberal and innovative retail and institutional investment market in Hong Kong. On the other hand, the MPFA developed its own interpretation of how to safeguard members' interests and their long term retirement savings. These diverging interpretations create friction between stakeholders and uncertainty for the industry in developing new funds and/or investment choices, which may lead to missed investment opportunities.

Relevant key assessment findings

There is insufficient articulation of the vision and objectives of the MPF system in general, and the philosophy of the system in relation to investments suitable for long term retirement savings.

The MPF schemes, fund management providers, MPF members and the MPFA have different interpretations of what constitutes investments suitable for long term retirement savings. This creates uncertainty for the industry in developing new funds and/or investment choices which may lead to missed investment opportunities and increased costs.

In the absence of an explicit industry-wide framework to govern and guide selection of a suitable default investment option, in the best interests of members for long term retirement savings, a significant proportion of assets is being directed to highly conservative investments yielding lower returns.

In this context, existing MPF investment regulation appears restrictive to the liberal industry providers while it may appear necessary from the MPFA's perspective given its aim of protecting members' long term retirement savings interests. Our review does not provide a clear conclusion from analysis of the Reference Systems. Chile has very restrictive and prescriptive investment regulation. Compared to Chile, the MPF investment regulation appears liberal. Australia has little restrictive investment regulation. However, Australian pension scheme trustees have a legal fiduciary duty to act in the best interests of their members, a duty which includes suitability of investments. In addition, due to a combination of system design and member inertia, Australian trustees have up to 50% of their member contributions flow into the default investment option. Compared to Australia, the MPF investment regulation shows some level of restriction. However, Australia has other, very effective mechanisms for investment governance. Overseas academic and industry research views also vary considerably as to what are suitable investments for a long term retirement savings system.

We believe that better industry and regulatory clarity would assist in managing the expectations of all the relevant stakeholders.

For those MPF members who do not make an informed fund choice, the decision of determining the default investment fund rests generally with the sponsor and endorsement from the trustee. Unlike the Reference Systems, no explicit MPF industry wide framework currently exists to determine either a) the process of default fund selection or b) a suitable investment option that is in the best interests of members for long term retirement savings.

Significant academic and research evidence as well as market guidance exists in other countries for pension funds setting their default investment fund. Australia and the UK generally follow such guidance leading to the default investments being typically risk category 3. In the UK, it is based on detailed guidance issued by a cross-disciplinary committee. In Australia, the setting is a response to the trustee's fiduciary duty to act in the best interest of members and their long term retirement savings. The Chilean and Singaporean regulators set their default investment options as a lifestyle and a minimum guarantee investment respectively.

In Hong Kong, the default fund decision of sponsors apply to less than 20% of members (representing less than 10% of assets) as compared to Australia, where 50% of members are allocated to a default lifestyle fund. Whilst in recent years, some MPF schemes have been re-setting their default investment fund to be a lifestyle fund, the still prevalent conservative investment philosophy of the remaining funds, combined with a level of member inertia and in some cases financial literacy constraints, limits growth of the long term retirement savings of those MPF members who do not make active investment choices. Administration, trustee and sponsor fees generally remain unchanged.

Our research and overseas experience indicates that an adjustment of the default investment funds to a lifestyle or higher risk category is expected to create higher long term retirement savings for the default members. Overseas experience shows that members in the default funds are often those with lower financial literacy and lower incomes. This characteristic may make an adjustment a matter of social policy.

Tenet five: Additional factors affect MPF members' retirement savings

Our review identified three additional aspects of the MPF system which warrant attention, as they indirectly affect MPF members' retirement savings. These are: a) a lack of a personal financial advisory solution for MPF members; b) an absence of an easy to understand, industry-wide defined and applied standard to define investment funds and investment risks; and c) difficulties with the MPF "approval" process for new investment funds and major changes to existing funds. Addressing these three aspects immediately may only marginally improve retirement savings outcomes for MPF members in the short term. However, increasing average account balances is likely to magnify the impact of these deficiencies quickly, creating a larger incentive for all stakeholders to address them today.

In many ways, the MPF system has been "built" into the existing financial services landscape, with reference to the financial needs and behaviours of MPF members in Hong Kong. The success of the MPF system therefore is based on its ability to tap into Hong Kong's fund management industry, which is known for its depth and maturity. This includes the existing personal financial advisory infrastructure and legal framework which is currently focused on the sophisticated high net worth investor segment. For the mass market, however, there is currently no infrastructure and appropriate legal framework for a scalable or focused personal financial advisory solution. The key reasons for the absence of such a mass market solution are the lack of incentives for providers to offer advice and the perceived lack of demand for such services from members. By contrast to Singapore, Chile or Australia where schemes or advice providers can charge up to 3% per annum of advisory fees as upfront or ongoing fees, under the MPF system sponsors and schemes can currently only request nominal compensation for "sales and service" that are provided to members. The small average account balances prevalent today in the MPF system may make this challenge a low priority today. However, growing account balances will increasingly highlight the absence of a relevant mass market personal financial advisory solution for MPF members. Multiple research sources indicate that in some reference markets, personal financial advice can add more than HK$ 600,000 to the retirement savings balance over the active working life of a 30 year old member. The absolute amount of the additional savings significantly depends on the retirement system specifics and the market context. However, such benefits seem to warrant the attention of all MPF stakeholders to implement a solution that provides a similar opportunity for MPF members.

Relevant key assessment findings

A lack of propensity to buy, or incentive to deliver, MPF focused investment advice, tends to affect the quality of investment decisions and hence investment performance and overall costs. Increasing account balances are likely to accentuate this problem in the future.

The industry currently uses multiple and non-standardised investment fund and risk classification frameworks, which could expose members to investment risks that are not aligned to their appetite. While we did not identify instances of confusion, there appears to be potential for this.

At least as perceived by the industry, the approval process for innovative investment funds and major adjustments is challenging and restrictive. The absence of a guiding framework exacerbates the issue.

The MPF industry uses multiple, non standardised and tightly defined investment fund and risk classification frameworks. This may result in risks for members who can find themselves exposed to some investment risks that are not aligned to their risk and performance appetites. We found no specific evidence that the use of non-standardised fund and risk classification frameworks exposed members to investments and investment risks that are not entirely consistent with what the product members thought they purchased. However, we identified risks where this may have led to higher or lower fees or investment performance based on the discretion of the fund manager who determined the exact composition within the approved asset allocation. Members may not have understood that this asset allocation covered multiple risk categories.

Relevant Hong Kong regulation and existing standards appear to focus on well informed investors who can look beyond the fund or risk label to understand their risk exposure. Such an approach may expose less experienced MPF members who have to make decisions without being sufficiently equipped to do so. As MPF is a mandatory retirement savings system, industry consensus elsewhere would suggest that there is an additional fiduciary duty to protect less sophisticated members. Therefore, a solution that is better tailored to the mass market assuming less investment market experience may be desirable to enhance member protection.

We discussed the clarity gap around the MPF system vision and the definition of beliefs of suitable investments. The providers and the MPFA have developed their interpretations of investment suitability with a view to safeguarding members' interests. Industry and MPFA interpretations of suitability appear to differ. However, many industry executives raised concerns that these well substantiated, but diverging interpretations lead to friction during approval processes for innovative investment funds and major adjustments to funds. The industry believes that it restricts them from maximising market opportunities and investment performance for MPF members. Other industry stakeholders consider that the safeguards protected MPF members against certain risks that arose during the global financial crisis. We understand the basis for both interpretations. However, regulatory clarity and industry guidance in the area of "suitability" of investments and approval processes may assist in aligning the views of the different stakeholders.

Building on the MPF system strengths and advantages to achieve the next level of maturity

The MPF industry performed well during a time of significant adversity and the MPF system has made significant progress since its establishment in 2000. We found no reason to question the fundamental planks of the MPF system. However, the MPF industry and the MPF system would benefit from taking the next step and evolving to the next level of maturity to further enhance members' long term retirement savings.

We identified five principal elements necessary for this next step. They include: a) improved communication of the comparative benefits and the journey of the MPF system; b) pursuing industry scale through more contributions and improving industry efficiency; c) enhanced MPF system clarity and vision; d) enhanced personal financial advice to enable informed choice; and e) operational refinement of a number of regulatory aspects that currently appear to challenge efficiency and effectiveness.

Co-operative action is necessary for this next step to occur for the system as a whole, with not only the industry and employers but the regulator and potentially also the legislature involved in developing a strategy designed to address the interests of members for the next ten years, and which providers and employers can implement on a practical level.

Ultimately, MPF members will benefit from such evolution through higher retirement savings and improved customer experience. This warrants change and investment from which all stakeholders will benefit in different forms and degrees.

We suggest action in the following areas to build on the performance as well as the strengths and advantages of the MPF system and MPF industry to achieve the next level of pension system maturity.

Communicate the MPF journey and benefits to members

The MPF system has performed comparatively well, which may not necessarily fully reflect the recent public perception. We suggest enhancing communication to members and stakeholders in two respects:

Firstly, communicating the journey and objectives of MPF as a long term retirement savings system. Long term retirement and saving sufficiently for retirement is a topic many people in reference markets grapple with. Many academic sources highlight the impact of financial literacy as one key aspect for understanding the need to save for retirement. This is only one part of the equation. The second part is an appreciation of the need to commence the savings process early. Many research sources indicate that an appreciation of the need to save for retirement comes for many members around the age of 45 – 50 years, when retirement becomes more tangible. The third part is an understanding that a long term retirement system focuses on long term growth rather than short term performance. Some overseas peers communicate the need for retirement savings through different means including inclusion in school curricula, government media campaigns and tailored seminars for people approaching retirement. Personal financial advice is also a means to change behaviour. These measures do not generate quick results, however, over time will lead to sustainable behavioural change.

Secondly, the MPF stakeholders may communicate regularly the comparative advantages of the Hong Kong MPF system, in particular the role of Hong Kong as a global asset management centre and the attractiveness of the MPF system as a savings mechanism for many residents of Hong Kong.

Both aspects together will over time change the perception and appreciation of the benefits of the MPF system and the need for long term retirement savings.

Pursue scale and efficiency to reduce cost and fees as a percentage of AUM

It is a pervasive factor in our findings that the Hong Kong MPF system is small in comparison to the Reference Systems in terms of AUM. Underlining the early stage of development of the MPF system, the average assets under management per member are less than half of the average in the more mature system in Singapore, and less than a quarter of that in Australia. The average assets under management per scheme are less than HK$9 billion in Hong Kong, compared with HK$25 billion in Australia and HK$38 billion in the centralised Chilean system. As the pension industry generally is a scale industry, the MPF system requires scale and benefits from economies of scale to reduce cost and fees. This is confirmed by our research regarding the low MPF fund management fees resulting from the scale of Hong Kong as a large financial centre.

The relatively small size of the MPF system in terms of number of employees covered and assets under management significantly limits the benefits from scale in purchasing power and scheme operations. Operating costs, as discussed, are predominantly member-driven, and MPF sponsors and their trustees have to absorb these costs across a small number of members and a small asset pool. In addition, there is a high ratio of administration costs and fees to assets under management, even though the actual dollar amount charged to members may in comparative terms be moderate.

In addition, recent academic research indicates that scale in pension systems also has a positive impact on overall investment performance of 30 – 80 basis points per annum, so scale affects return as well as fees.

Scale in assets under management comes from increased contributions. Therefore, we recommend considering ways to increase mandatory and voluntary contributions, in particular, by further significantly increasing the current cap on earnings subject to mandatory contribution, with a view to accelerating the achievement of benefits from economies of scale in fund management and operations. This process will take some time to show progress. In the meantime at an industry level, this aspect may lead to industry consolidation and strategic adjustments to existing operating models to access economies of scale while retaining separate brands.

In most cases, operations are viewed as a necessary component to invest assets and maximise members' long term retirement savings. At later stages in pension system maturity when the "customer experience" becomes more important, this view often evolves. Consequently, most schemes and sponsors emphasize cost reduction and efficiency. Therefore, we recommend attention be given to the cost and efficiency drivers of MPF provision at a scheme and industry level, in order to gain a better understanding of areas of possible improvement. A concerted effort by all key stakeholders to refine the operation of the MPF system may enable sustainable cost reductions. Those cost reductions may lead to qualitative and quantitative benefits for providers as well as MPF members and employers.

Improve MPF system clarity and vision including guidance around investment beliefs

For any organisation, the vision, objectives, culture, governance principles and outcome transparency are vital strategic guidelines that determine the direction, implicitly inform decisions and encourage certain behaviours that assist in achieving the agreed vision. Many research sources outline that vision, objectives, investment beliefs and governance principles are of similar vital importance for pension systems. Our research suggests a need for greater clarity and guidance around these aspects for the MPF system and all its key stakeholders. Clarity around fiduciary duties of each stakeholder, principles and roles on what constitutes the best interests of MPF members and what are "suitable" investments in the maximisation of long term retirement savings are vital components. Greater clarity will over time lead to better alignment and less friction of how to achieve an appropriate replacement ratio for MPF members.

Improve personal financial advice and decision support

MPF members must currently make an informed investment choice with limited decision support and without any regard to their financial literacy.

Although there is a broad selection of investment choices available, our research suggests there is currently insufficient trusted personal financial advice and investment decision support that either MPF members request, or MPF schemes and sponsors offer. The challenge lies in demand and supply. Therefore, we recommend reviewing the need for an affordable, mass market personal financial advisory framework and solution that can be used by members with a view to maximising their long-term retirement savings. Increasing average account balances will accelerate the need to address this challenge. The extensive lead time needed to establish a suitable framework and to implement a practical and mutually attractive solution indicates this process would benefit from a swift commencement. For this to be attractive, such advice must be transparent, of high quality and free from conflicted remuneration. Experience from countries such as the UK, Singapore, Chile and Australia shows pitfalls that can and should be avoided. Without question, providers must receive financial reward for offering such a service. Many industry and academic sources document the benefits for members from requesting and receiving personal financial advice. A transparent and adequate remuneration for the provider of such advice would seem to be a highly sensible investment for members to maximise their long term retirement savings.

In addition, we suggest that all key stakeholders including sponsors, trustees, employers and MPFA should be encouraged to provide further practical decision support tools and education for scheme members to encourage improved financial literacy. This approach accommodates those members who feel well informed and can leverage modern technology and media solutions which may make the benefit of long term retirement savings even more tangible.

As outlined above, the value of transparent, high quality personal financial advice for pension members is well documented. We encourage all stakeholders to commence the review and implementation process as soon as practicable, as the effort required to put such a system in place is likely to have an extended lead time. The opportunity to generate significant additional long term retirement savings per member as shown in other Reference Systems seems a worthwhile benefit for commencing the process to determine an additional target savings figure that could be generated from a mass market pension-focused personal financial advisory solution in Hong Kong. This aim should be for a proven solution and tested infrastructure to be put in place by the time average MPF member account balances are of such size that would necessarily call for such action. Commencing early will minimise the risks of less than satisfactory solutions which several Reference Systems have had to deal with.

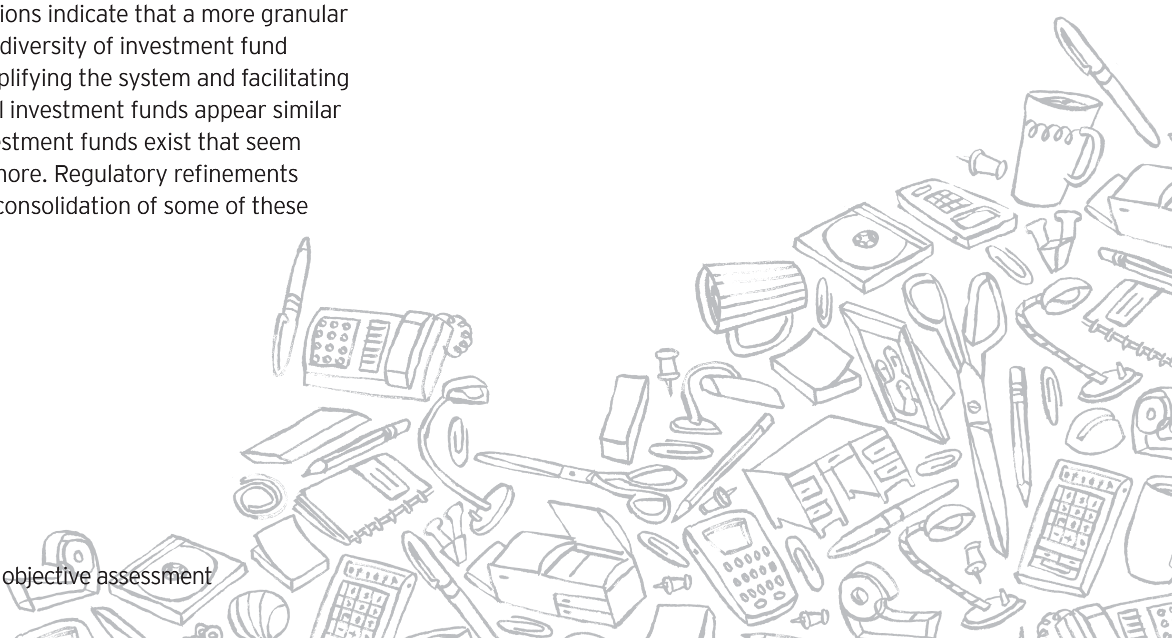
Implement operational refinements of some regulatory aspects

For the MPF system to take the next step towards maturity we recommend addressing operational refinements in three areas: a) default investment fund setting; b) the fund and risk labelling framework; and c) consolidation of existing legacy investment funds.

We suggest establishing a framework for the determination of default investment funds to allocate responsibility and provide protection for decisions reasonably made. It is important that such framework is embedded in a clear pension scheme governance framework to ensure actions are taken in the best interests of MPF members and their long term retirement savings. A broad range of academic and industry research and guidance exists on these topics and may offer useful insights and lessons learned from peers.

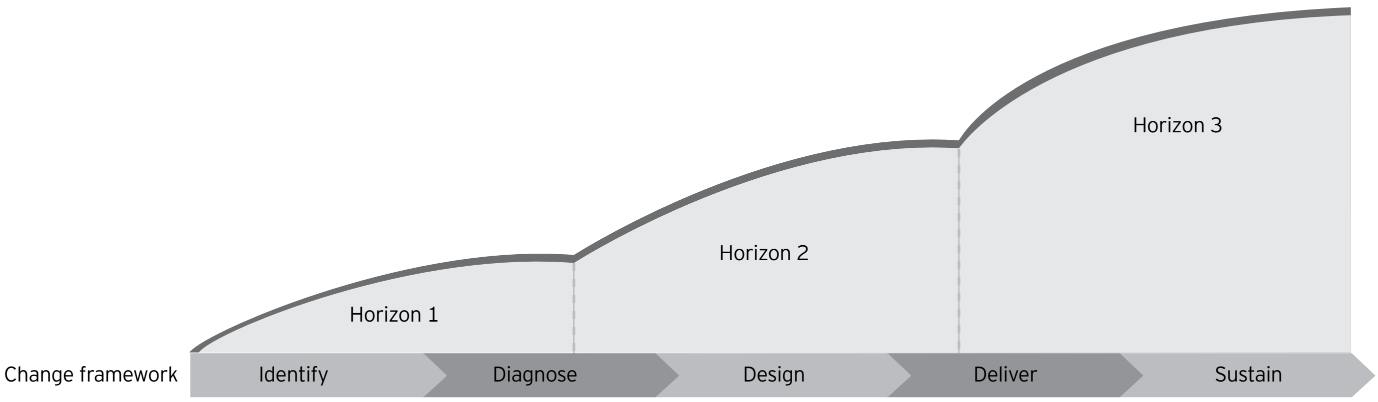
We recommend the development of an industry-wide standardised framework for investment fund labelling and risk-categorisation, to improve transparency and comparability. Such development appeals to pragmatic, industry-led self-regulation focused thinking. We acknowledge that the industry has developed such a framework, but broad and consistent application is absent. In addition, we encourage a review of the framework in light of the key objectives of informing and protecting MPF members, particularly less experienced ones. This may require a standard communication that assumes limited investment experience and financial literacy. To become an industry-wide standard we assume that regulatory change has an essential role to enable the adjustment of disclosure documents.

The MPF system shows an adequate average number of investment fund options when compared with overseas best practice. However, our analysis and industry discussions indicate that a more granular review of the number, range and diversity of investment fund choices may assist in further simplifying the system and facilitating better investment choice. Several investment funds appear similar and a number of legacy MPF investment funds exist that seem neither needed nor wanted any more. Regulatory refinements may be needed to enable easier consolidation of some of these investment funds.



Three practical steps for building the future

Our review shows that the foundation of the MPF system is sound. This means that, to enable the system to take the next step towards maturity, system refinement and evolution are required, rather than a change to the fundamental tenets underpinning the MPF system. Like its overseas peers, the MPF journey to pension system maturity requires an evolutionary approach to adapt to changes in the market as well as to refine regulations to enable the maximisation of long term retirement savings for members. Any evolution means change, but to drive this process a clear vision and objectives are required. In our experience, others have used a systematic improvement framework that is based on cooperation between all stakeholders using an open and systematic analysis. Figure 16 below shows a widely used framework with three development horizons. Three key ingredients are vital for success: a) systematic analysis and pragmatic prioritisation of challenges and measures; b) regulatory certainty to enable private sector providers to make long term investments, and other stakeholders to adopt the changes and adjust their behaviours; and c) sustainability measures and outcome transparency to secure progress over the longer term.



Strategic focus	Focus on the pragmatic key aspects that provide the greatest long term benefits for MPF members	Provide regulatory confidence to allow providers to build and implement	Implement a continuous improvement framework and necessary stakeholder transparency to make improvement sustainable
Key challenge	Agree necessary key enhancements and improvements	Develop and implement according to an agreed timeframe	Make system enhancements and improvements sustainable

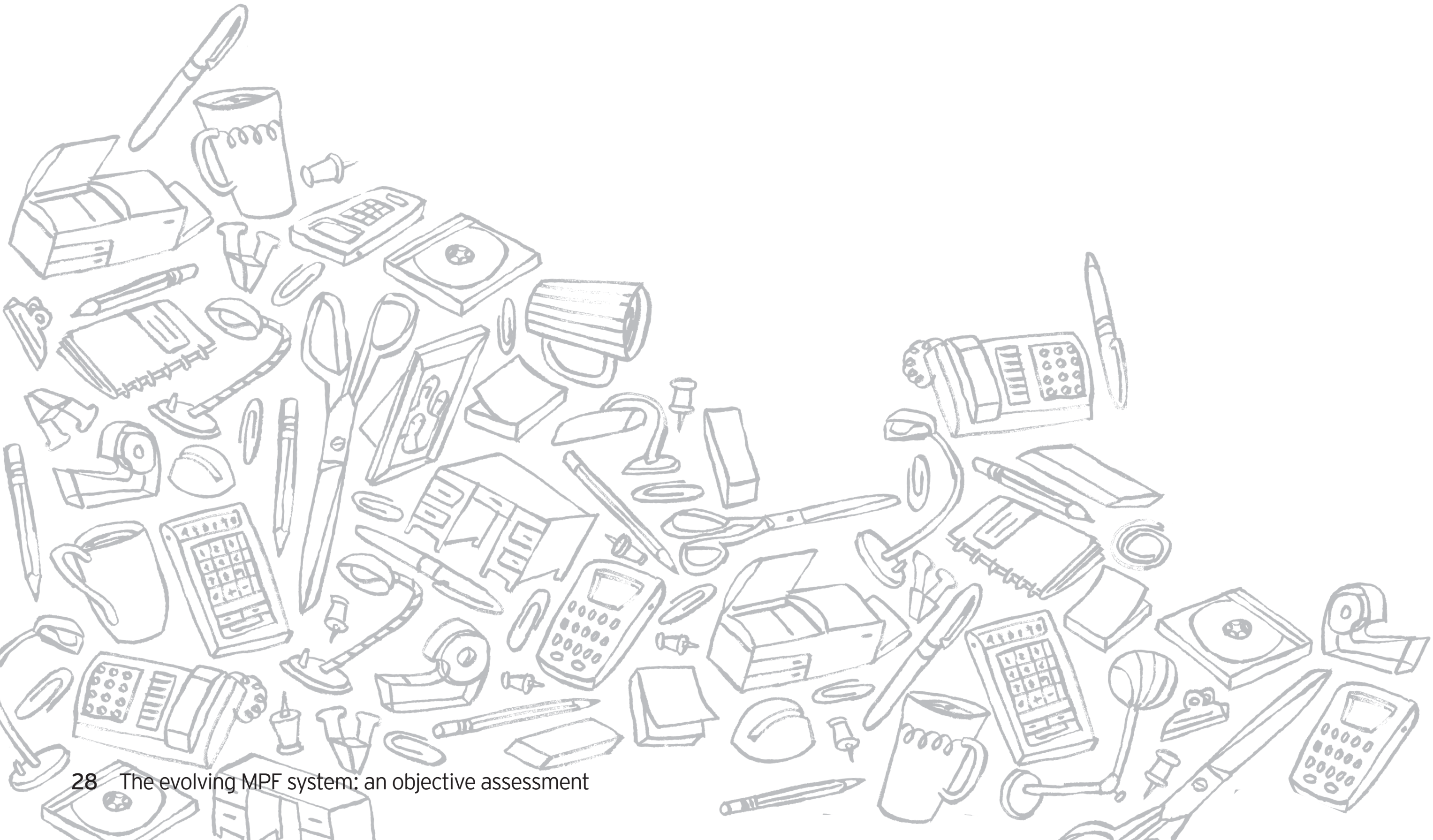
Figure 16: Framework with three development horizons

During our review we experienced significant interest from all key stakeholders in taking the MPF system to the next level of maturity and maximising long term retirement savings for MPF members. This may create a unique opportunity for change. Inevitably, such change will lead to some short-term pain for some stakeholders. The winners of this process will be those who embrace the changing landscape of MPF pensions with an ability to manage the complexity of that change.

In our opinion, Hong Kong is at the first step, of identifying potential actions to carry the system forward and to take the next step towards system maturity. Experience from other Reference Systems indicates that achieving the next level of system maturity may take up to a decade.

Whatever decisions are made as a result of debate, we believe from our global experience that regulatory certainty is a vital element for any evolution in long-term retirement income savings. Certainty provides sufficient economic and changes predictability for sponsors, trustees and employers to develop and implement the necessary technology and behavioural changes. For the regulator and for the Government it allows sufficient time to monitor the expected emergence of benefits from prioritised and pragmatic change measures.

The benefits of this change are clear: enhanced qualitative and quantitative benefits for many stakeholders and larger long term retirement savings for MPF members.



Scope, reference pension systems and limitations of our report

Scope and approach

Figure 17 below summarises our approach.

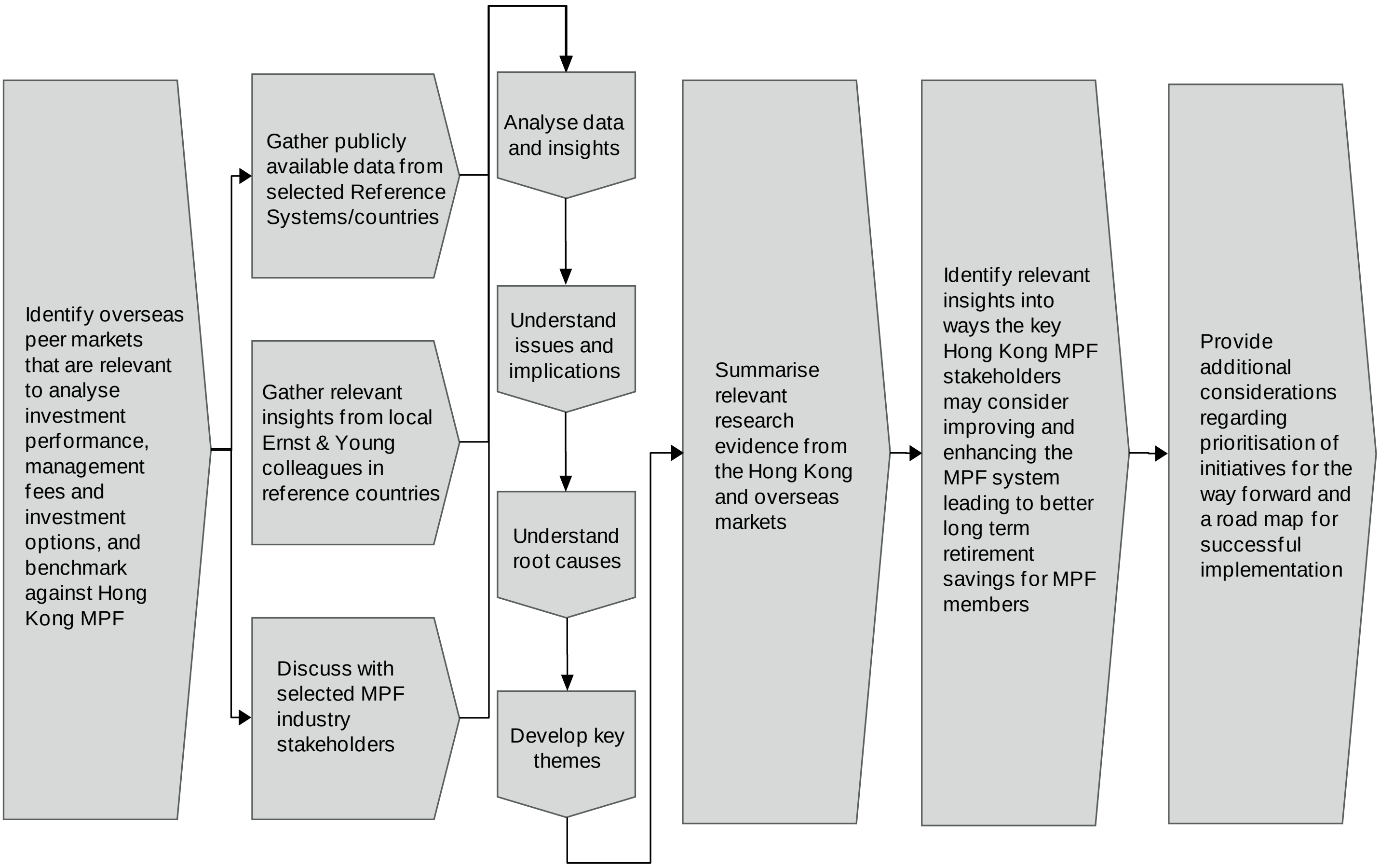


Figure 17: Flow chart outlines the approach and key steps we undertook to prepare this report

Reference Systems

MPF is a mandatory occupational defined contribution pension system which is "outsourced" to the private sector to operate. MPF has a limited amount of assets under management and number of contributing members, in comparision with other relevant pension systems around the world.

We analysed relevant reference countries and their pension systems on the basis of pension system nature, industry operating model, size of assets under management and system maturity to identify a sample of five potential countries worthy of further consideration.

The pension system nature is a critical aspect as defined benefits and defined contribution pension systems and hybrids thereof have fundamentally different dynamics which impact investment performance, fees, investment options and other relevant aspects. The same applies to the industry operating model where we differentiate between government or centrally operated pension systems and those that are operationally decentralised in the private sector. System maturity is an important aspect to enable sufficiently robust data that allows meaningful conclusions.

It is important to note that no two pension systems are alike, due to different stages of maturity, market forces, tax systems, regulatory structures and focus, among other factors. There are also differences in the definition and transparency of fees and returns. This heterogeneity among the MPF system and the Reference Systems significantly constrains our ability to perform a 'like for like' comparison, as well as the ability to generate granular findings. We identified three Reference Systems, the UK, Australia and Chile that fit our selection criteria comparatively well. We also identified Singapore as an additional country to consider as it represents a leading pension system in Asia. We considered, but did not include, a number of other potential Reference Systems such as Mexico, Sweden, Denmark and the Netherlands. These systems have many individually attractive features which are highly regarded among pension professionals globally. However, for various reasons these systems were not suitable for the purpose of the review.

Reference Period

Our reference period was where possible from 1 January to 31 December 2010. When we performed comparison of MPF features with other Reference Systems, we used the most recent data of the Reference Systems to ensure comparability where feasible. In some cases, where data of the same periods is not available for some Reference Systems, we chose the earliest available data for comparison.

Data availability and comparability challenges across all the reference markets limit the accuracy and completeness of evidence in several areas of our research. We therefore supplemented the research in these areas with limited additional research, discussions with industry executives and application of professional judgement to support our conclusions.

Development of key findings

For the purposes of our analysis, we identified eleven key findings, which we consider of relevance to investment performance and fees and costs, and in particular to the ability of the Hong Kong MPF system to continue to develop to the next stage of maturity. We grouped these eleven key findings under five tenets.

We assessed each key finding, the underlying challenges, implications and root causes. This assessment was based on our professional judgement and understanding of the respective Reference Systems and our interpretation of the research evidence which we outline in the respective areas of this report.

Caveats, limitations and legal disclaimer

While we have taken reasonable care in obtaining and processing of the third party information reflected in this report, we have relied on that information and we express no opinion as to its accuracy. Opinions expressed by third parties are their own.

Our research and findings were performed at a high level and must be regarded as indicative. It is important to note that no two pension systems are alike, due to different stages of maturity, market forces, tax systems, regulatory structures and focus, among other factors. There are also differences in the definition of key components such as fees and returns. This heterogeneity among the MPF system and the Reference Systems significantly constrains our ability to perform a 'like for like' comparison, as well as the ability to generate granular findings. All comparative findings must be interpreted in this context.

Data availability and data comparability challenges limit the accuracy and completeness of publicly available evidence in several areas of our research. We therefore complemented the research in some areas with limited additional research we conducted, discussions with industry executives and our professional judgement to support the findings. We indicate the different levels of "strengths" of the evidence we found in our research conclusions.

Further details relating to restrictions and legal disclaimers are included in Appendix I which forms an integral part of this report.

Appendix I: Legal disclaimer

Disclaimers applicable to all users of this Report

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The observations and comments have been derived from high-level information and samples taken from each individual country. The observations and conclusions drawn by this review on fees and performance will not be a wholly accurate reflection of the pension system in each individual country.

The observations and comments contained in this document are based on information obtained and some are considered "forward-looking statements". They are based on best efforts at the time this research was compiled. Actual future results, however, may prove to be different from expectations. Furthermore, these views are not intended to predict or guarantee the future trend or performance of the MPF or pension systems in any reference countries.

Data such as total assets under management, portfolio composition, investment returns, and commissions and fees charged were collected from regulators and pension service providers.

Data on investment returns are only available on an annual basis and the available data on commissions and fees is limited. Except for Australia, supervisory entities do not provide breakdown of fees at a granular level.

- Data on investment returns was based on aggregate performance of a group of pension funds at the end of a period using data from funds existing as at the period end. Funds that did not survive over the period analysed were not included
- The approach to reporting investment returns varies across countries. Chile has detailed regulations defining the methodology for calculating returns. Definitions of and criteria for calculating and reporting total return in Australia, Hong Kong, Singapore and the United Kingdom are stated in the investment policy established by the asset managers

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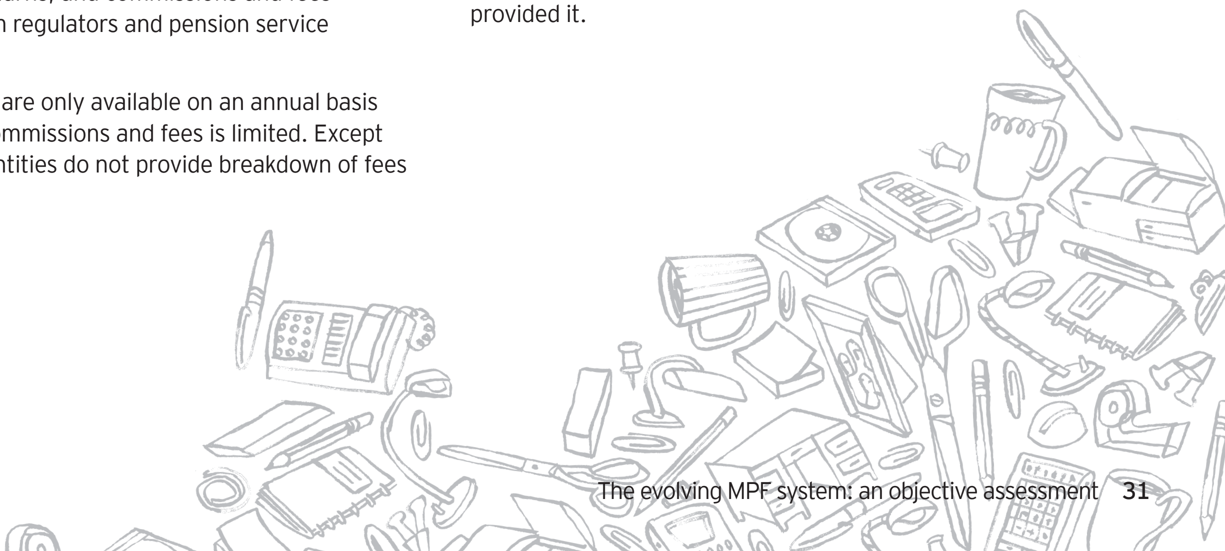

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