Asian Corporate Governance Association (ACGA)

"The Hong Kong Retirement Schemes Industry: Is there a Governance Vacuum?"

Presentation by
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at the
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Agenda

1. Why a “vacuum”?
2. Pension-fund governance—*and the growing involvement of pension funds in corporate governance:*
   - International examples
   - Asian examples
3. Changing expectations of pension funds in Hong Kong
   - Practical suggestions for differentiating your scheme in corporate governance terms.

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Differing perceptions

How the government views the MPF scheme……



How many of us would view the governance of MPF funds (if we were looking)……



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Why a black box?

- Not because there are no checks and balances in the MPF system. On the contrary:
  - MPFA Mission Statement: “an effective and efficient system of prudential regulation and supervision of privately managed provident fund schemes”.
    - “Four-tier protection” system: approval; monitoring; PI insurance; and compensation fund.
    - Investment restrictions
    - Regulation of MPF intermediaries
  - Mandatory Provident Fund Schemes Ordinance (Cap 485) and MPFS (General) Regulation (Cap 485A), etc: Extensive regulations governing all aspects of the MPF scheme and the duties of trustees, investment managers, custodians.
  - Code on Disclosure for MPF Investment Funds (June 2004).
    - “Performance Presentation Standards” submitted by the HKTA and HKIFA in March 2005.

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But opacity at the top …

- Trustees
  - Who are they and what do they do?
  - Are they really independent of investment managers (especially in one-stop shop pension schemes*)?
  - Do they in fact appoint investment managers (as the MPFSO says)? Or vice versa? Who is working for whom?
  - Do they have an explicit policy on corporate governance—that is, in terms of exercising the ownership rights of the funds they supervise?
  - Do they require their investment managers to vote their shares?

**Schemes where the trustee, custodian, administrator and investment manager are all subsidiaries of the same financial holding company.*

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General duties of trustees (Cap 485A, Section 43)

Formal functions	Reasonable questions
Duty to exercise care, skill, diligence and prudence.	How do I know whether or not my trustee is acting in this manner? How can I hold my trustee accountable?
Duty to use all relevant knowledge and skill that the trustee may be reasonably expected to have.	How do I know whether or not my trustee has sufficient depth of skill? How can I find this out?
Duty to ensure the scheme is invested in different investments so as to minimize the risk of losses, unless it is prudent to do otherwise.	Do trustees employ people with the expertise to make such investment policy decisions?
Duty to act in the interest of scheme members and not in the trustee's own interest.	How can I verify this? Why should I believe this in the context of one-stop shop schemes?

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And opacity in the middle …

- Investment managers
  - Must be “independent of the trustee and of the custodian of the scheme assets” (Cap 485A, Sec 44)
  - However: Where all three are subsidiaries of a substantial financial institution, they may regarded as independent if—
    - Neither is a subsidiary of the other; and
    - No person is a director of both of them; and
    - Both of them give a written undertaking to the MPFA to act independently. (Cap 485A, Sec 46)
  - In governance terms, this is prima facie an inherently weak structure and lacks credibility. In a crisis, it could lead to problems.

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2. Pension-fund governance

- Why such an issue of concern worldwide?
  - Corporate scandals (Robert Maxwell) and bankruptcies/insolvencies (US airlines).
  - Demographics: Ageing of the population.
  - Growth of mandatory and voluntary pension funds. Huge expansion in scheme assets.
  - Shift from paternalistic corporate DB to self-selected individual DC.
  - Privatisation of pension funds and reduced government responsibility.
  - Yet remaining state pension funds seen as having a leadership role in governance.

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Why pension funds engage in CG

- A belief—and growing evidence—that governance contributes positively to corporate performance over time.
- For some, especially state pension systems, passive indexing does not allow the selling of shares.
- Greenmail in the US in the 1980s.
- Voting rights increasingly seen as an asset that should be properly utilised.
- Concept of fiduciary duty to ultimate beneficiaries.
- Some pension funds have became significant owners of listed companies.
- Economics: The need for better returns in a stagnant market (eg, in Japan).

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Pension systems with explicit CG policies

UK/North America:

- bcIMC, Canada
- CalPERS, US
- CalSTRS, US
- Hermes, UK
- LACERS, US
- Ontario Teachers, Canada
- TIAA-CREF, US

Asia:

- Employees Provident Fund, Malaysia
- Japan Pension Fund Association
- National Pension Corp, Korea
- National Social Security Fund, China
- Thai Gov't Pension Fund

Note: A selected list only.

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Japan Pension Fund Association

- Manages more than US$100 billion for 28m members. A private association.
- After strong returns in 1999, it suffered negative returns over 2000-2002 (reaching about -12% in 2002). Serious asset-liability mismatch, hence initial interest in using CG to boost returns.
- Developed a proxy voting policy for its own assets and encouraged its members to do the same. Has had a significant impact on voting patterns in Japan.
- Started a “good-CG fund” in 2004. Managed by Nomura and only invests in well-governed companies.
- Planning to set up a “bad-CG fund”.

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National Social Security Fund, China

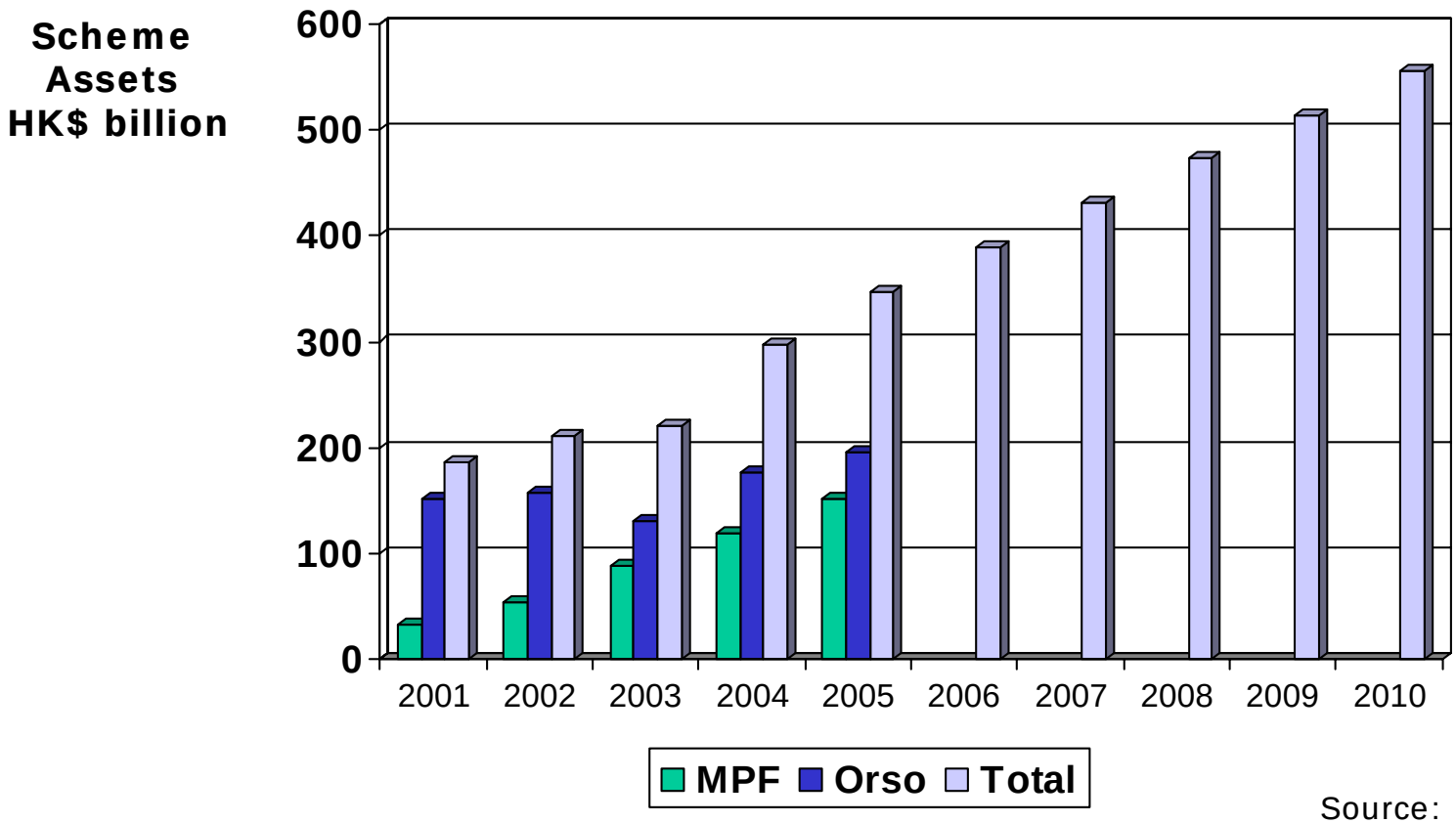
- A US$24+ billion “strategic reserve” fund formed in 2000. It began seriously investing in the Chinese stock market in June 2003 and has quickened the pace recently. It is taking strategic stakes (eg, a US$1.2 billion stake in the Bank of Communications, China’s fifth largest bank, in 2004) and is becoming a more active and engaged owner.
- It has both CG guidelines and voting policies for its external fund managers. Mostly votes with management, but in some cases has voted against.

National Social Security Fund: Changing asset mix				
Asset type	**2001**	**2002**	**2003**	**2004**
Cash equivalents	64.9%	46.4%	17.3%	19.8%
Fixed income	33.8%	52.9%	78.4%	60.3%
Stocks	1.3%	0.7%	4.3%	10.7%
Equity (strategic) investment	-	-	-	6.8%
Forex	-	-	-	2.4%

Source: National Social Security Fund

3. Changing expectations in Hong Kong

- Premise: Demand among beneficiaries for their pension providers to engage in CG may be low right now, but is likely to change over the next 5-10 years as assets under management continue to grow.



Projection for 2006-10 based on an absolute increase of approx HK$42 billion per year (based on the actual increase in MPF and ORSO contributions in 2005). Probably an underestimate.

Source: MPFA statistics for 2001-5. Year-end data.

Caveat

- The total assets of Hong Kong pension funds may be growing, but the market is highly fragmented: 46 registered MPF schemes and 5,722 registered ORSO schemes. Hence, average asset size of each scheme is small.
- To put the MPF scheme into a regional context:

Fund	Size (US$ billion)
National Pension Corp, Korea	124
Japan PFA	> 100
Employees Provident Fund, Malaysia	64
Central Provident Fund, Singapore	62
Thai Gov't Pension Fund	7
Hong Kong MPF (aggregate)	19

Sources: Various, including pension funds and AsianInvestor magazine. 2005 data.

On the other hand…

- Some MPF schemes are larger than others.
  - You don't need to be huge to make a difference.
- Certain MPF schemes (eg, HSBC) may be under pressure to set an example.
- The value of MPF investments as a proportion of each individual's wealth is likely to rise.
- Another financial crisis could bring much greater pressure to bear on trustees to act as fiduciaries for scheme beneficiaries.

Some suggestions on how to be prepared…

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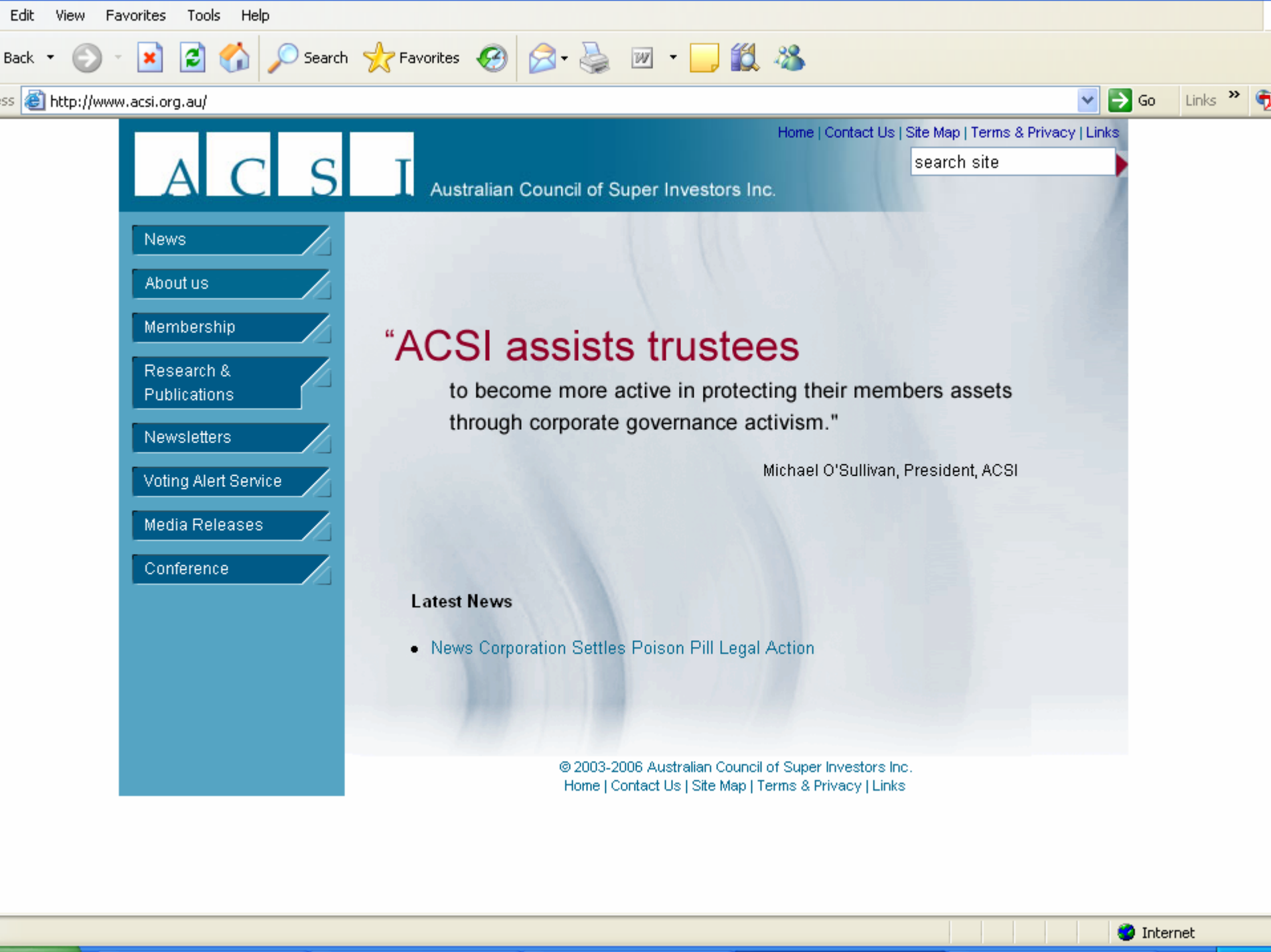
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Practical suggestions

1. Create an independent and experienced board of trustees, with a range of skills.
2. Develop a policy on corporate governance.
3. Develop a policy on share voting:
   - Vote all shares as a matter of policy. See voting as an ownership right and duty.
   - Have a clear rationale why you have voted in a certain way.
4. Create a dedicated CG unit.
5. Consider establishing dedicated CG funds.
6. Look to the Australian Council of Super Investors for ideas.

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Finally, is this success?

- Voluntary MPF contributions are low and do not seem to be increasing. Wouldn't a reputation for good governance enhance the confidence of your beneficiaries and lead to higher voluntary contributions?

MPF Contributions, 2005 (HK$ billion)				
Quarter	**Mandatory**	**Voluntary**	**Total**	**Voluntary as % of Total**
Q1 2005	5.97	0.66	6.6	9.9%
Q2 2005	5.84	0.66	6.5	10.1%
Q3 2005	5.85	0.63	6.5	9.8%
Q4 2005	5.96	0.65	6.6	9.8%

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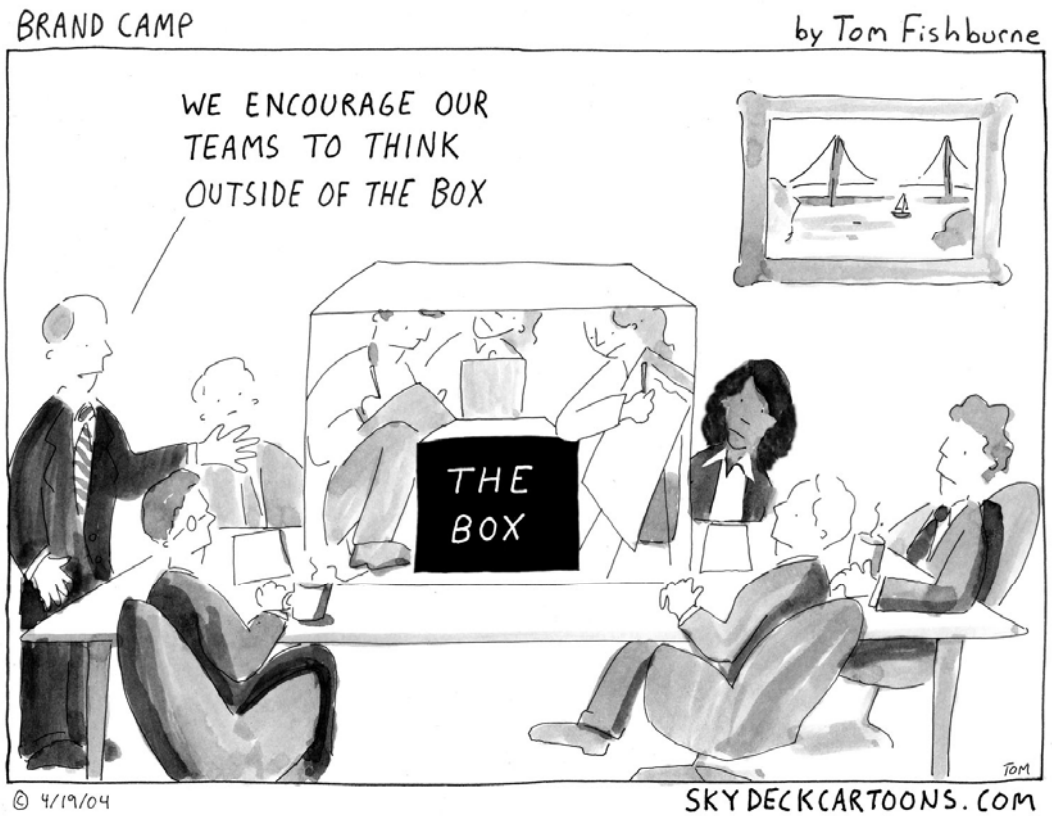
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Conclusion

- Despite the numerous regulations and checks within the MPF system, the perception that there is a “governance vacuum” at the top is likely to linger.
- The importance of pension-fund governance is unlikely to decline in Asia in the coming years. If anything, it will increase.
- Now is a good time, while the MPF is still young, for trustees and investment managers to institute explicit policies and practices on corporate governance. This can only be good for business as the benefits will outweigh the costs.

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A final thought …



- *It is easy to replace one box—read mindset—with another. That is not the point of this talk! Corporate governance is a dynamic process.*

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