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Asian Corporate Governance Association (ACGA)

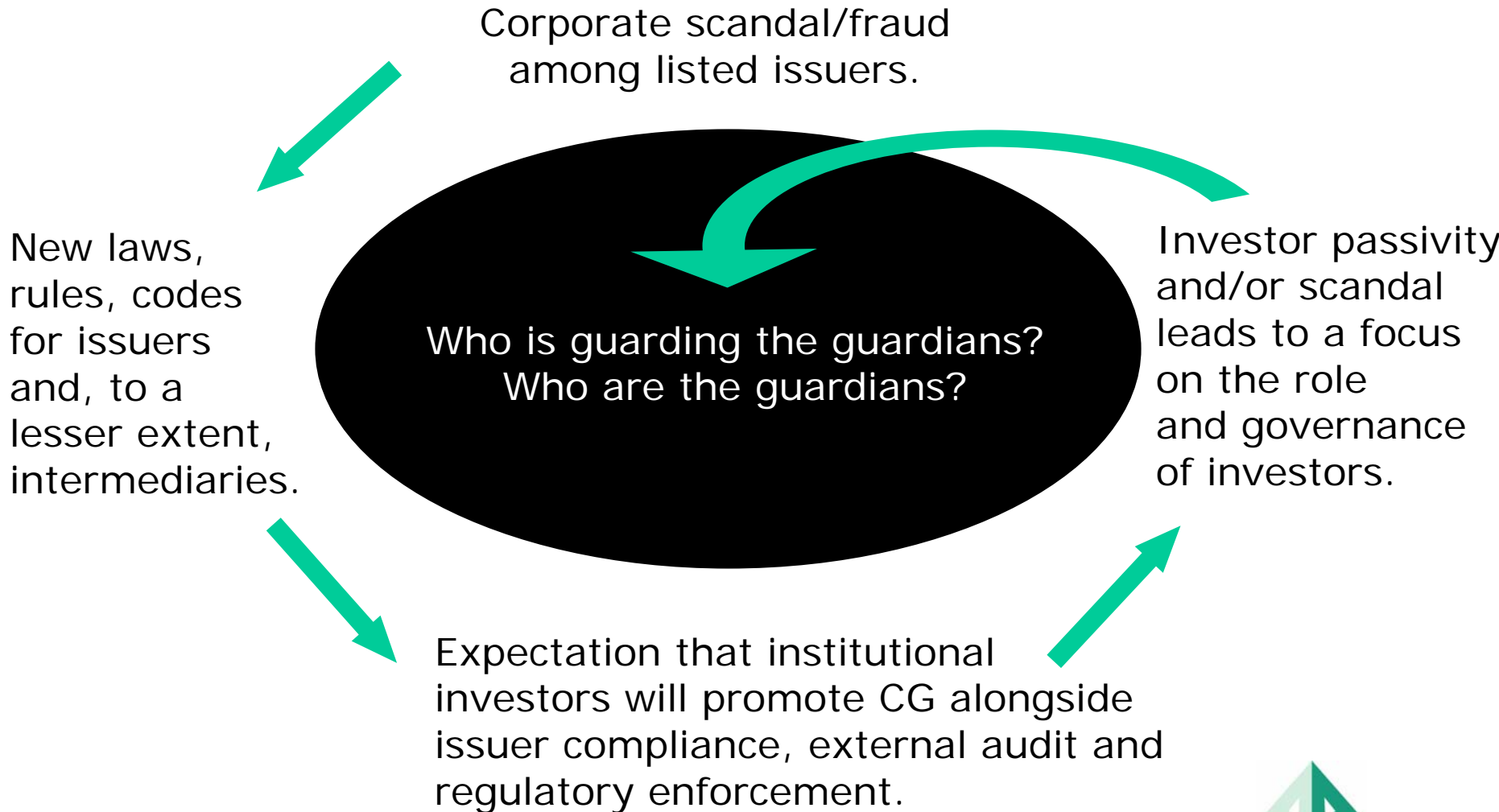
“The Changing Role of Trustees in Corporate Governance”

Presentation by
Jamie Allen, Secretary General, ACGA
at the
Hong Kong Trustees' Association, Hong Kong
May 25, 2006

Agenda

1. Why is more expected of trustees within the pension and investment industries today?
 - How corporate governance is changing in Asia and which trustees are becoming more interested.
2. Legal obligations of Hong Kong trustees over the governance of the pension and investment funds they supervise.
 - Why does this seem like a black box to outsiders?
3. Practical pointers on how trustees can improve governance standards.

“The Corporate Governance Cycle”



Cause and effect: Pressure is building

Corporate, financial and mutual fund scandals in the US since Enron in 2001 (ie, post bubble).



New SEC rules (June 2004): Mutual fund boards must have 75% independent directors and independent chair. Plus voting disclosure.

Rapid growth of DC pension schemes in the UK, volatile returns, plus decline of DB.



NAPF* argues there is a "governance vacuum" in DC schemes and major problems in DB ones. (July 2005)

Emergence of CG as a major issue in Asia in recent years, volatile stock returns.



Some Asian state pension funds adopted voting policies; Japan PFA** becomes an active voter.

*National Association of Pension Funds, UK.

**Japan Pension Fund Association

Dollars requires sense

NAPF, UK:

- “With assets topping £700 billion, and touching the lives of some 20 million Britons, good governance for all the UK’s pension schemes is just too important to ignore.”

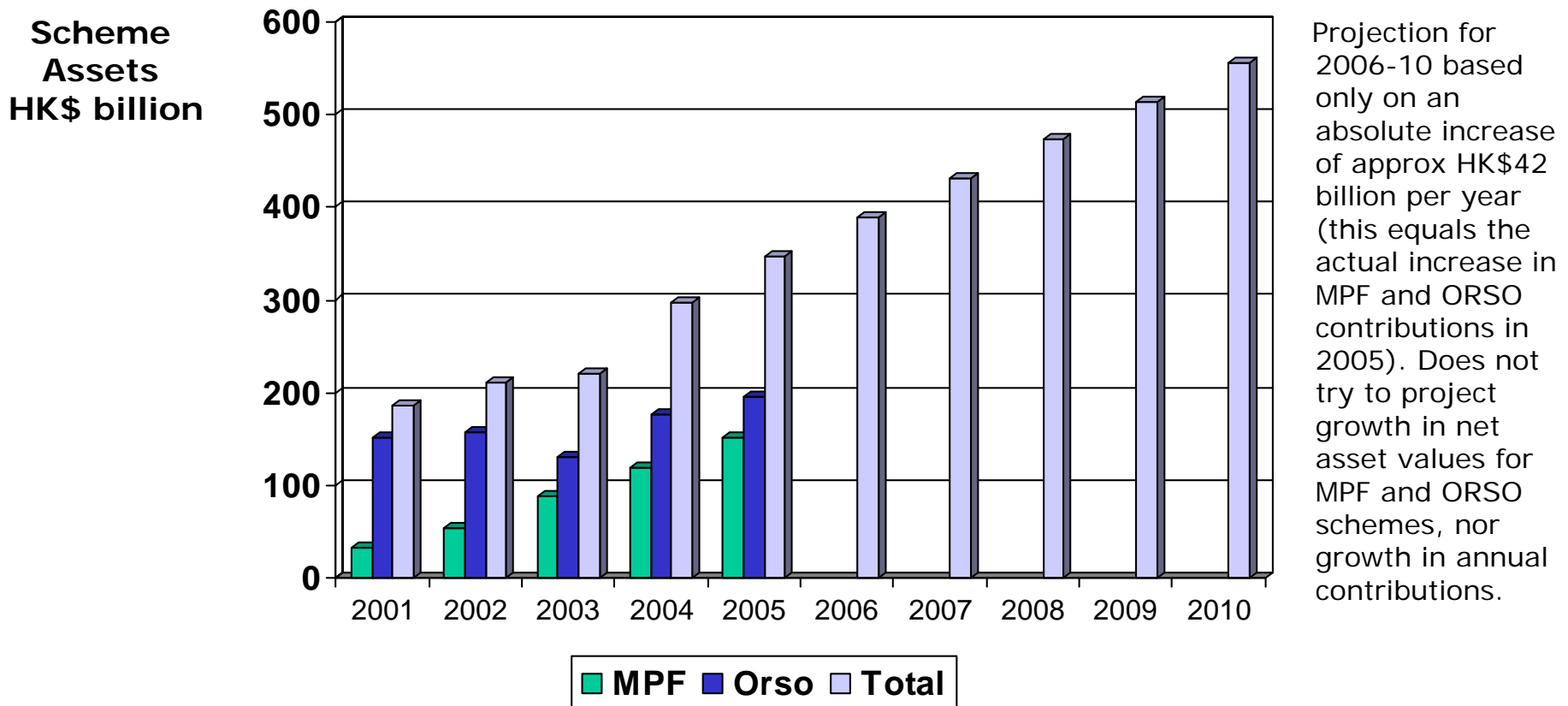
*“Pension Scheme Governance – fit for the 21st century”
(July 2005)*

Hong Kong fund data:

Type of fund	Number	Net asset value (end-2005)
Unit trusts & mutual funds	1,998 authorised funds	US\$668 billion
MPF	46 registered schemes (several hundred funds)	US\$19 billion
ORSO	5,722 registered schemes	US\$25 billion

HK pension assets growing fast

- Even a conservative estimate of the growth in pension assets here produces a tripling over 10 years.



Sources: MPFA statistics for 2001-5 (year-end data); ACGA estimates for 2006-10.

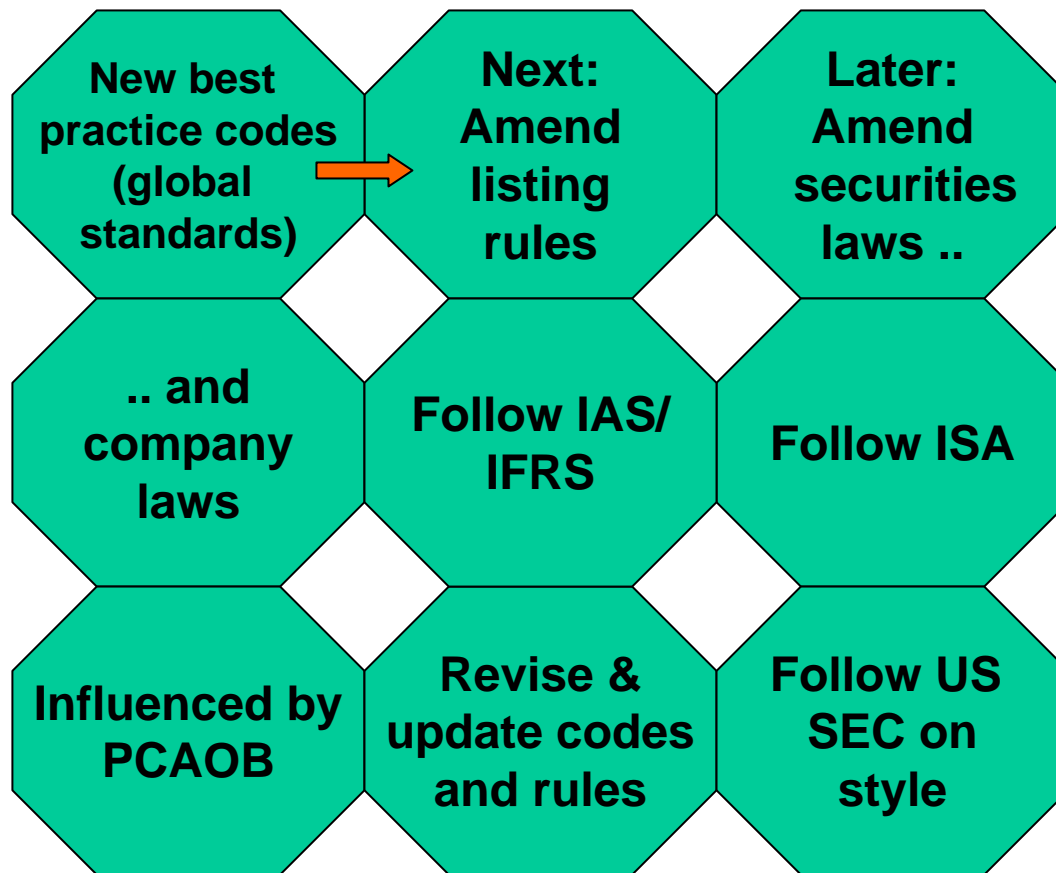
Why is more expected of trustees?

- Fund governance* has become an issue of concern worldwide for other reasons too:
 - Corporate bankruptcies/insolvencies (eg, Enron, US airlines): Pension monies disappear.
 - Ageing of the population.
 - Privatisation of pension funds and reduced government responsibility.
 - Concept of fiduciary duty to ultimate beneficiaries. Includes the idea that voting rights are an asset that should be used wisely.
 - Stock market volatility: The need to match assets to liabilities.

*Note: The term “fund governance” in this presentation primarily refers to the ways in which pension and investment funds are themselves governed. Implicit in this is the notion that a well-governed fund will actively execute its fiduciary duties and shareholder rights (eg, vote its shares, engage with companies, attend shareholder meetings where necessary and so on).

Corporate governance reform in Asia since 1998

Convergence in Asian CG reform



New codes: A timeline of implementation

National codes

	Japan (JCGF)*	India (CII)*	Korea Thailand India	M'sia	JCGF (revised)	Indonesia Singapore	China Phil Taiwan	Korea (revised)	HK (revised) Japan	India & Singapore (revised)
1997										
1998										
1999										
2000										
2001										
2002										
2003										
2004										
2005										

Related guidelines (selected)

China
INEDs

Phil
INEDs

India
IPOs

China
bank
boards

China
bank
boards
(revised)

*Private-sector codes:

JCGF = Japan Corporate Governance Forum

CII = Confederation of Indian Industries

How is Asia doing? “CG Watch” country scores

Note: Lower scores a result of stricter methodology.

Country ¹	2000	2001	2002	2003 ²	2004 ³	2005 ⁴
Singapore	75	74	74	77	75 ↓	70 ↓
Hong Kong	71	68	72	73	67 ↓	69
India	56	54	59	66	62 ↓	61 ↓
Malaysia	32	37	47	55	60	56 ↓
Taiwan	57	53	58	58	55	52 ↓
Korea	52	38	47	55	58	50 ↓
Thailand	28	37	38	46	53	50 ↓
Philippines	29	33	36	37	50	48 ↓
China	36	34	39	43	48	44 ↓
Indonesia	29	32	29	32	40	37 ↓

1. Ranked in descending order according to 2005 score.
2. First year in which ACGA collaborated with CLSA.
3. Introduced more rigorous scoring methodology in 2004.
4. Enhanced methodology further in 2005.

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Source: “CG Watch”, a joint report by CLSA Asia-Pacific Markets and ACGA

CG Watch 2005: Category scores

(2004 scores in brackets)

Country	CG Rules ¹	Enforcement ²	Political/ Regulatory	IGAAP ³	CG Culture
Singapore	74 (79)	56 (65) ↓	73 (81) ↓	95 (95)	57 (58)
Hong Kong	64 (66)	58 (58)	78 (75)	91 (90)	54 (46)
India	66 (66)	56 (58)	65 (63)	75 (75)	43 (50) ↓
Malaysia	59 (71) ↓	49 (50)	60 (50)	75 (90) ↓	38 (46) ↓
Taiwan	53 (63) ↓	49 (46)	65 (63)	59 (70) ↓	33 (35)
Korea	51 (61) ↓	40 (50) ↓	43 (50) ↓	82 (80)	39 (50) ↓
Thailand	58 (61)	40 (38)	50 (50)	73 (85) ↓	35 (35)
Philippines	53 (58)	22 (31) ↓	50 (50)	82 (85)	31 (31)
China	43 (53) ↓	40 (42)	50 (50)	68 (75) ↓	22 (23)
Indonesia	33 (53) ↓	29 (27)	30 (38) ↓	68 (60)	28 (27)

1. Rules and their implementation by companies.
2. Regulatory and “private” enforcement by the market.
3. International accounting and auditing standards

Pension systems in Asia with CG policies

- Malaysia: Employees Provident Fund
 - Japan: Pension Fund Association
 - Korea: National Pension Corporation
 - Thailand: Government Pension Fund
 - China: National Social Security Fund
- All are state systems, except for Japan.
 - All are from countries in the middle and lower levels of “CG Watch”.

2. Obligations of trustees in Hong Kong

MPF Ordinance*	Code on Unit Trusts & Mutual Funds
Duty to exercise care, skill, diligence and prudence.	Take into its custody all the property of the scheme and hold it in trust.
Duty to use all relevant knowledge and skill that the trustee may be reasonably expected to have.	Take reasonable care to ensure that the sale, issue, etc, of units/shares are carried out in accordance with the constitutive documents.
	Take reasonable care to ensure that the methods adopted by the management company in calculating unit/share value are adequate.
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.	Carry out instructions of the management company on investments unless in conflict with offering or constitutive documents.
Duty to act in the interest of scheme members and not in the trustee's own interest.	Take reasonable care to ensure that investment and borrowing limitations are complied with.
	Issue report to holders on whether the management company has managed the scheme in accordance with the constitutive documents.

*General duties of trustees (Cap 485A, Sec 43)

Comparisons

- Legal obligations of trustees with regard to MPF funds are more onerous than the general obligations of trustees/custodians towards unit trusts & mutual funds.
 - Because pensions are seen as inherently more important and complex than voluntary investment trusts? Perhaps, but note: HK has US\$44 billion in the former, yet US\$668 billion in the latter.
 - Because the MPF is a mandatory system, forcing the providers into a quasi-state role?
 - Is this good for the long-term development of the unit trust and mutual fund industry? Given rising awareness of corporate governance, the answer is almost certainly “no”.
 - Look at governance issues in the MPF system

Differing perceptions

How the government views
the governance of MPF
schemes.....



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



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.

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.*

Reasonable concerns

MPF Ordinance: Trustee duties	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?

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 be 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 an economic crisis, it could lead to problems.
 - Note: Identical language in the Code on Unit Trusts and Mutual Funds (Chapter 4.7 & 4.8)

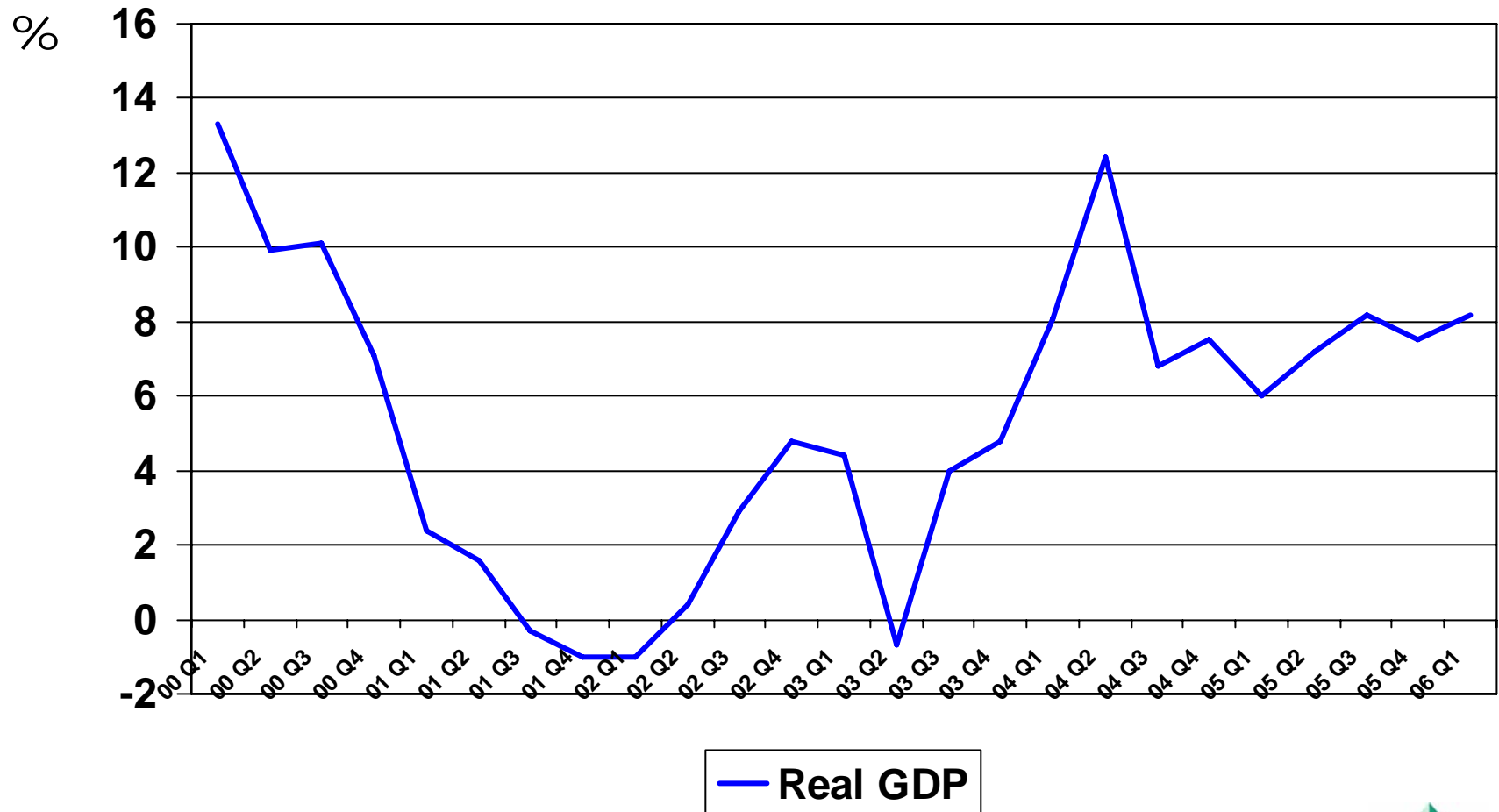
Impact on pensions?

- Voluntary MPF contributions are low and quite static. This is no doubt in part due to lack of provider choice (for employees), high charges and unexciting returns. But issues of trust and opaque governance are likely to be strong contributing factors too.

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%

- And this during a period of strong economic growth....

Hong Kong quarterly GDP growth, 2000-2006



3. Practical pointers for improving governance

MPF Funds

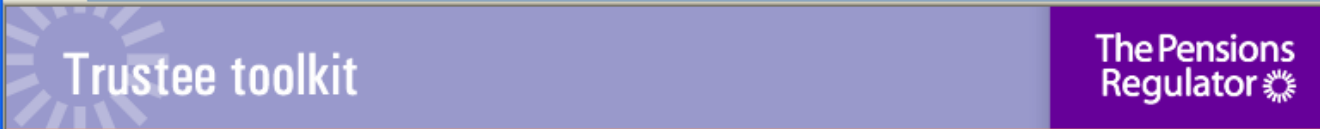
1. Create independent and experienced “boards of trustees”.
2. Trustees develop explicit policy on corporate governance.
3. Ditto for share voting:
 - Ensure managers vote all shares. See voting as an ownership right and duty.
 - Ask managers to report on how they have voted and why.
4. Encourage or require fund managers to set up dedicated CG units to coordinate voting and support CG analysis.
5. Investigate dedicated CG “focus funds”.

Unit trusts & mutual funds

1. Discuss independent boards with the UT/MF industry.
2. Promote benefits of explicit corporate governance policies.
3. Ditto for share voting.
4. Discuss benefits of dedicated CG units with fund managers.

Resources

- Australian Council of Super Investors:
 - www.acsi.org.au
- National Association of Pension Funds, UK:
 - www.napf.co.uk
- Mutual Fund Directors Forum, US:
 - www.mfdf.com
- The Pensions Regulator, UK:
 - www.thepensionsregulator.gov.uk
 - See the “Trustee toolkit” at —
<http://www.trusteetoolkit.com/arena/index.cfm>



Welcome to the Trustee toolkit

The Trustee toolkit has been developed to help trustees (and anyone else who is interested in occupational pension schemes) meet the requirements for trustee knowledge and understanding, introduced by the Pensions Act 2004. You can find [more information about these requirements](#) on the Pension Regulator's website.

If you have already signed up, simply log in.

Otherwise, **sign up now** by clicking on the button below.

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Conclusions

- Hong Kong may rank higher in corporate governance terms than most Asian economies, but it falls below world-class standards in many areas. Our financial sector may be large, liquid and successful, but opting for second best is not in our best long-term interests.
- Despite the heavy compliance burden imposed by the MPFA, the perception that there is a “governance vacuum” at the top will linger for as long as opacity issues remain.
- Now is a good time, while the MPF is still young, for trustees and investment managers to institute explicit policies on corporate governance. This can only be good for business, as customer trust will rise. Doing nothing exposes you to more risk.

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