



# STUDY GUIDE

**ASHK Examinations**

June 2018 Edition

## PENSION

- ❖ *Role of actuaries in pension market in Hong Kong*
- ❖ *Main type of retirement schemes available in Hong Kong*
- ❖ *Overview of retirement market landscape in Hong Kong*
- ❖ *Regulations, professional standards, guidelines and industry standard practice*
- ❖ *Recent industry developments*

*Note: Market & industry statistics shown in this study guide are to be updated prior to the May 2019 examination diet as most up to date.*



ACTUARIAL SOCIETY  
of  
HONG KONG  
香港精算學會

## 3.3 Pension<sup>1</sup>

### 3.3.1 Role of Pension Actuaries in Hong Kong

For defined benefit schemes, actuaries have a statutory role to perform valuation at least once every 3 years and prepare an actuarial certificate to the regulator within 6 months after the expiration of the period. This helps to determinate whether the schemes are adequately funded and the future funding plan sound (see ORSO section below for more details). Actuaries may also play other specific roles in some ORSO schemes as determined in the corresponding trust deed and rules, in the events such as mergers and acquisition or scheme restructuring.

Hong Kong Accounting Standards almost follow exactly the same as the International Accounting Standards. Under IAS 19 and HKAS 19, employers are required to accrue their defined benefit liabilities and assets in their books and report the cost of these benefits under the accounting methodology (instead of cash). In Hong Kong, actuaries prepare these valuations for employers in respect of their defined benefit pension plan.

For Class G long term business of insurance companies (i.e. guaranteed funds under pension business), GL 7 – “Guideline on the Reserve Provision for Class G of Long Term Business” from the Office of the Commissioner of Insurance (OCI) (now taken over by Insurance Authority)<sup>2</sup>,<sup>3</sup> also demands a report that is certified by the appointed actuary to be submitted to the Insurance Authority. The report should document the methodology and assumptions upon which the provisions for Class G business are calculated and demonstrate that the guideline is being followed (see GL 7 for more details).

### 3.3.2 Main types of Retirement Schemes Available in Hong Kong

This section aims to provide some useful background information on the retirement scheme markets.

Under the multi-pillar system recommended by the World Bank in 2005 as a reference framework, the Hong Kong Mandatory Provident Fund (MPF) system is designed as a second pillar system (i.e. mandatory, privately managed, fully funded contribution system). MPF is intended to complement the other pillars of retirement support, such as Government social

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<sup>1</sup> Common terminology used with the pension market in Hong Kong could be found: <http://www.mpfa.org.hk/engm/main/glossary/index.jsp>.

<sup>2</sup> The new Insurance Authority (IA) took over the statutory duties of regulating insurance companies from the OCI on 26 June 2017.

<sup>3</sup> All Guidance Notes promulgated by the OCI have been renamed as Guidelines, and the abbreviation have been changed from “GN” to “GL”.

security and individual saving arrangements to provide for total retirement savings adequacy for the population.

ORSO was designed as a third pillar system (i.e. voluntary saving). Larger employers tend to offer ORSO schemes as a supplement or top-up towards MPF schemes.

This section will also review trends and developments in retirement protection systems in Hong. Like all other developed economies, Hong Kong has an ageing population and ensuring a reasonable standard of living after retirement for the entire population is a major item on the agenda of the Government.

### **Birth of MPF schemes<sup>4</sup>**

The issue of establishing a compulsory retirement scheme was brought up again in 1991. At the LegCo meeting on 10 July 1991, a motion was moved to “take immediate steps to re-examine the setting up of a Central Provident Fund or other forms of compulsory retirement schemes in order that workers in Hong Kong are provided with comprehensive retirement protection”. The motion was voted down by 29 votes to 11 (Legislative Council Secretariat, 2005).

In November 1991, the Executive Council decided that a retirement protection system should be introduced (Chow, 1998). Subsequent to the decision of the Executive Council, an interdepartmental working group on retirement protection was established in November 1991. The working group was responsible for studying possible options that would enable workers to secure better retirement protection (Education and Manpower Branch, 1992).

A consultation paper entitled “A Community-wide Retirement Protection System” was issued by the working group in October 1992 (Education and Manpower Branch, 1992). The consultation paper proposed the introduction of a retirement protection system, which entailed a privately managed mandatory contributory retirement scheme for all full-time employees under the age of 65.

### Controversies on different proposals

Both trade unions and employers’ associations were of the view that the involvement of the Government in the proposed contributory retirement protection system was too little. Some of them would have liked to see the Government having greater responsibilities in the proposed system, and felt it should take the form of a Central Provident Fund (Chow, 1998).

There had been a lot of debate in the community since the proposal of 1992 was put forward. On 15 December 1993, the Government instead proposed to LegCo the introduction of a

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<sup>4</sup> Extract from MPFA Publication “Towards Retirement Security”.

social insurance programme called the Old Age Pension Scheme (Education and Manpower Branch, 1994).

Subsequently, the Government issued a consultation paper entitled "Taking the Worry out of Growing Old – An Old Age Pension Scheme for Hong Kong" in July 1994. Under the proposed pension scheme, both employers and employees would have been required to contribute a monthly amount equivalent to 3% of an employee's wages. All Hong Kong permanent residents aged 65 and over would have been eligible to receive a flat-rate retirement pension, fixed at HK\$2,300 a month at 1994 price levels. The amount would have been indexed annually to the Composite Consumer Price Index (Education and Manpower Branch, 1994).

The proposal aroused intense discussions. While trade unions generally welcomed the idea, it was opposed by the business sector which perceived it as a fundamental change in Hong Kong's welfare policies. In view of the divergence of opinion among different stakeholders, the Government decided at the end of 1994 to withdraw the proposal (Chow, 1998).

#### Consultation and Legislative Process of MPF

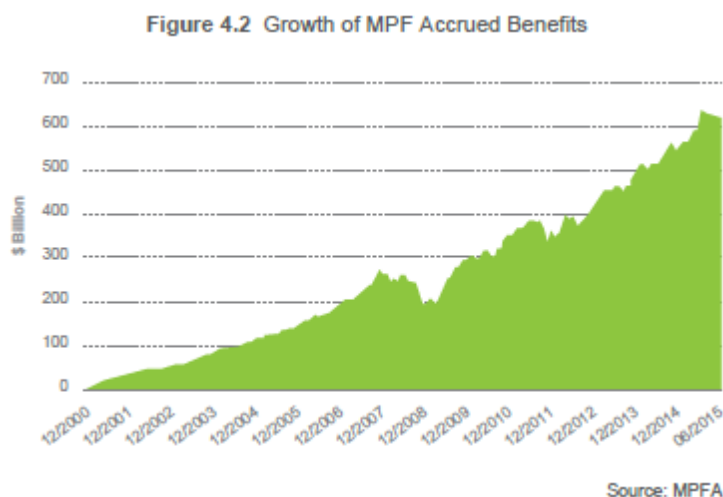
According to the Government, in the consultation exercise for an Old Age Pension Scheme in 1994, the public's submissions indicated greater acceptance of a mandatory, privately managed scheme, particularly if it could be set up by 1997 (Legislative Council Secretariat, 2005).

In 1994, the World Bank released its publication entitled "Averting the Old-Age Crisis: Policies to Protect the Old and Promote Growth" which suggested a three-pillar approach for retirement protection. The Government studied its recommendations carefully and considered that, given the nature of the population in Hong Kong and the traditional financial and saving habits of its people, as well as its well-established and sound financial infrastructure, a mandatory system for saving for retirement was a good fit. In particular, Hong Kong had the Comprehensive Social Security Assistance Scheme (CSSA) as its first pillar of retirement protection and the population had a high saving rate for third-pillar protection. A mandatory employment-related contributions system would thus complete the three-pillar approach. At that time, meetings were convened by the Government with LegCo members, trade union leaders and representatives of the business community. Through these meetings, the Government was more confident that the introduction of the MPF would be regarded as a practical way forward to help the retired (Legislative Council Secretariat, 2005).

Consequently, the Government moved the following motion in LegCo in March 1995: "That this Council urges Government to introduce as expeditiously as possible a mandatory, privately managed occupational retirement protection system with provision for the preservation and portability of benefits" (Legislative Council Secretariat, 2005). LegCo voted in favour of the Government's motion to introduce a mandatory, privately managed occupational retirement scheme. The Government then introduced a bill into LegCo in June

1995 related to the establishment of the MPF in Hong Kong. The Mandatory Provident Fund Schemes Ordinance (MPFSO) was passed by LegCo in July 1995 and supplemented by detailed subsidiary legislation in 1998. The Mandatory Provident Fund Authority (MPFA), the statutory body charged with regulating and supervising the MPF schemes, was set up in September 1998. The MPF System commenced operations in December 2000.

Below is the growth of MPF market from year 2000 to 2015.

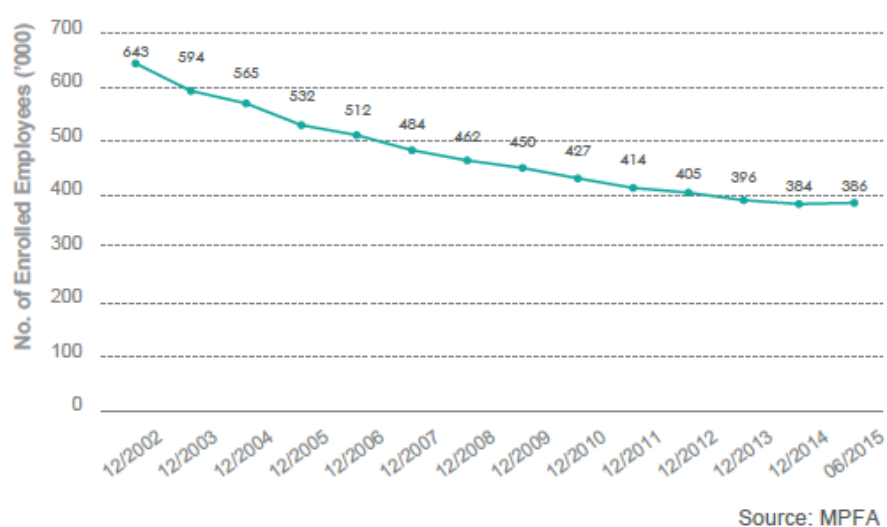


### ORSO schemes

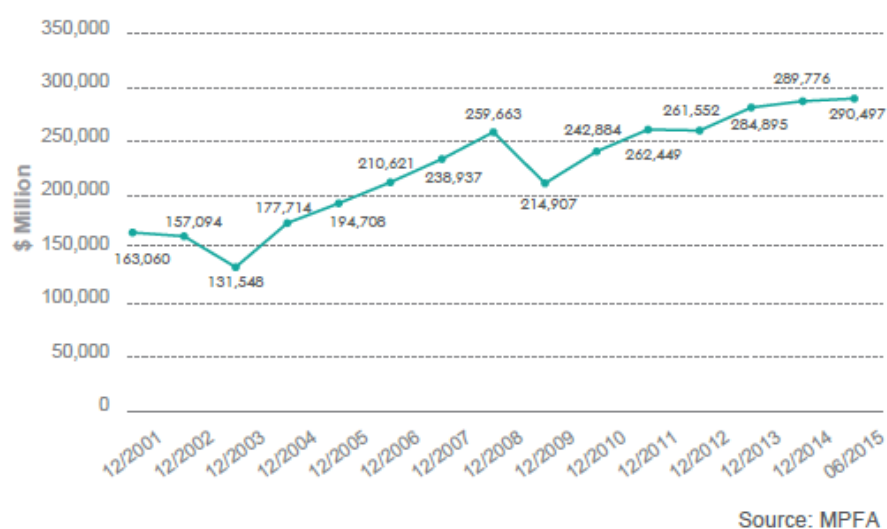
For a long time, quite a number of employers in the private sector offered retirement schemes to their employees voluntarily, and these employers could obtain profit tax deductions on their contributions to an approved retirement scheme. To ensure that such schemes were properly regulated and to provide greater certainty that retirement scheme benefits promised to employees would be paid when they fell due, the Occupational Retirement Schemes Ordinance (ORSO) was enacted and came into operation in 1993. The ORSO aims to regulate occupational retirement schemes through a registration system. It applies to all occupational retirement schemes operated in and from Hong Kong. It also covers offshore schemes (i.e. schemes whose domicile is outside Hong Kong, where the scheme or trust is governed by a foreign system of law) which provide retirement benefits to members employed in Hong Kong. For an occupational retirement scheme to be registered under the ORSO (thus becoming an ORSO registered scheme), it must fulfil certain criteria regarding the scheme terms, which are mainly designed for better protection of the employees' benefits. An occupational retirement scheme may be exempted from the ORSO registration requirements if it is an offshore scheme registered or approved by a recognised overseas regulatory authority or a scheme with not more than either 10% or 50 of their members, whichever is less, being Hong Kong permanent identity card holders. Such a scheme is referred to as an ORSO exempted scheme. The launch of the MPF System was complemented by interface arrangements between ORSO schemes and MPF schemes, allowing for the exemption of eligible existing ORSO schemes from MPF requirements. The objective of the

interface arrangements is to minimise the interference with existing ORSO schemes and avoid upsetting the contractual relationship between employers and existing employees. To protect the rights and interests of employees, employers of MPF exempted ORSO schemes are required to give eligible employees a one-time option to choose between joining MPF schemes or MPF exempted ORSO schemes. While MPF schemes have gradually become the mainstay of the second pillar of Hong Kong’s retirement protection, ORSO schemes continue to contribute significantly to the retirement savings of a large number of employed persons. With the implementation of the MPF System, enrolment of employees in ORSO schemes has been declining. Despite this, assets accumulated in ORSO schemes recorded steady growth, which reflects that on average ORSO members have seen substantial growth of savings in their ORSO accounts.

**Figure 4.3** Number of Enrolled Employees in ORSO Registered Schemes



**Figure 4.4** Growth of Assets of ORSO Registered Schemes



### 3.3.3 Overview of Retirement Market Landscape in Hong Kong

This section aims to provide useful information on the competitive environment as well as some recent industry developments.

#### MPF market

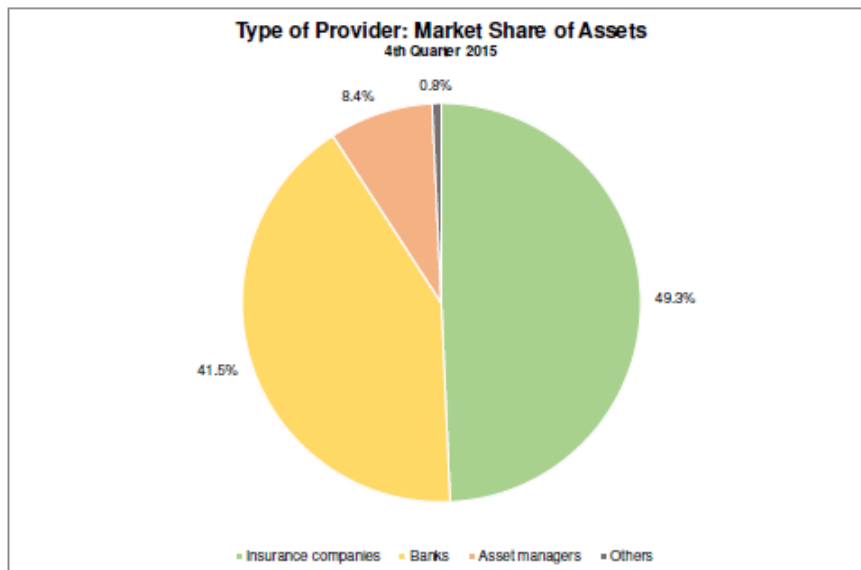
As of 31 December 2015, there were about 276,000 employers, 2,549,000 employees and 205,000 self-employed persons under the MPF system with total asset values of HK\$591 billion. There were 38 registered schemes with 459 constituent funds. The annualised internal rate of return of the MPF system was 3.0% from the inception of 1 December 2000 to 31 December 2015.

Below are the top 10 market players from 2012 to 2015 in terms of asset under management (sourced from the Gadbury MPF Market Share report):

Current rank	Product provider	Current AUM HK\$ million	Assets as % of MPF total		
			December 2015	December 2014	December 2012
1	HSBC / Hang Seng	172,640	29.2	30.1	32.0
2	Manulife	114,540	19.4	18.5	17.3
3	AIA	57,415	9.7	9.7	9.6
4	BOCI-Prudential	45,166	7.6	7.8	8.0
5	Principal	37,003	6.3	6.4*	6.4*
6	BCT	34,978	5.9	6.1	6.2
7	Sun Life	29,806	5.0	4.5	3.1
8	Fidelity	27,054	4.6	4.6	4.5
9	BEA	19,156	3.2	3.3	3.5
10	Standard Chartered	14,944	2.5	2.7	2.9

\* Including AXA

The MPF providers are largely made up of insurance companies, banks and asset managers. Below is the split amongst these players as at 31 December 2015 (sourced from the Gadbury MPF Market Share report):



Banks typically distribute through their relationship with employers and bank branches. They tend to upsell to their existing customers and offer one-stop services.

Insurance companies usually distribute through their agents and third party brokers. They may focus more on the product innovation and fund performance.

Asset managers distribute directly to larger employers and sometimes through the asset consultants. They focus on investment capabilities.

There are two types of accounts – **contribution accounts** and **personal accounts**. Contribution accounts refer to those into which employers and/or employees are contributing. Personal accounts are created when an employee changes job and then there is an option for the employee to choose to transfer the MPF money to his/her own personal account or the contribution account under his/her new employment. As of 31 December 2015, there were 3,778,000 contribution accounts and 5,120,000 personal accounts (i.e. total of 8.8 million accounts). With only around 2.7 million individuals in the system, it means, on average, each individual appears to have more than 3 accounts.

All MPF schemes are defined contribution schemes. Total contributions to MPF system in 2015 were close to HK\$70 billion, including HK\$15 billion of voluntary contributions. For the same year, the total withdrawal was about HK\$21 billion.

Majority of employers provide mandatory contributions only but larger employers are more likely to provide additional voluntary contributions (a total contribution of 8% to 10% of salaries is not uncommon) to protect its employer branding and to attract and retain talents. Employers have the right to choose the service providers for their employees' contribution



accounts, whilst the members have the right to choose the service providers for the personal accounts.

The average fund expense ratio of MPF fund was around 1.5% per annum of total asset size in 2016. The public and the local media tend to view MPF as “high fee low return”.

Some actuaries work for MPF providers to play active roles in the pricing of the schemes as well as case specific pricing where fee discounts may be given in the form of bonus rebates. The considerations for the pricing could include the salary increase, increase of voluntary contribution rates, increase of staff headcount for employer cases, employee turnover, employer lapse, retirement, other staff decrement, the chance of transferring to personal accounts after leaving employment, investment returns of the funds, switching of funds, fixed and variable costs (e.g. internal administration, external fund managers, external custodian), potential regulation changes and fee squeeze in the future. They are also responsible for the design and costing of the distribution compensation. Actuaries are playing an important role to support the financial sustainability of the MPF market.

Some actuaries work in employee benefit consulting to support employers to monitor and review the MPF providers. This type of work tends to be less technical. Actuaries support the retirement planning education as well as help negotiate with MPF providers.

### **ORSO market**

There were 3,978 registered ORSO schemes covering 6,285 employers and about 380,000 employees with total asset values of HK\$302 billion.

There are no public ORSO market share statistics. The market is also dominated by banks, asset manager and insurance companies. Insurance companies typically provide guaranteed return funds. The guaranteed return rate could be close to 5% per annum for the contributions made 10 to 20 years ago but the guaranteed return rate could drop to 1% per annum or even zero for more recent contributions.

Many ORSO schemes are legacy schemes and closed to new participants. Only the larger employers are still offering ORSO schemes to their staff for the purpose of employer branding to attract and retain talents. Most defined benefit schemes are closed to new entrants. If employers offer an MPF-exempted ORSO scheme to new employees, the MPF regulations require a one-off choice to be provided between such ORSO scheme and the employer’s MPF scheme. When members leave the ORSO scheme, some or all parts of their benefits need to be preserved in the MPF system until they satisfy the payment criteria imposed by the MPFA.

Similar to MPF market, some actuaries work for ORSO providers while others work in employee benefit consulting firms providing advisory services to the employers.

For defined benefit schemes, actuaries are playing a much more important role to safeguard the adequacy of funding and the soundness of the funding plan, as well as the suitability of liabilities (or assets) recognised in the employers' balance sheet, thereby having potentially significant influence on the employers' financial results.

Following global trend, quite a lot of defined benefit schemes in Hong Kong were converted or are being considered to be converted to defined contribution schemes. Actuaries are playing an active role to determine and to decide the adequate treatment of the employees' benefit under the defined contribution structure (e.g. the value assigned to each individual in exchange of his/her previous defined benefit entitlement, future contributions and vesting scale).

### **Projection of the MPF market size to 2035**

The Pensions and Employee Benefits Committee of the ASHK has conducted a study of the projected MPF market size over the next 20 years (see link below). Projected 2035 MPF market size is HK\$2.6 to 3.2 trillion, which is close to 5 times of that of 2014.

While the pension actuaries in Hong Kong do perform projection of MPF market sizes for business planning or other purposes, based on their own judgment of assumptions. The Committee believes this is beneficial to the MPF community as a whole to publish a study on the MPF market size projection with an independent view of assumptions for the projections.

The projections are naturally not definitive and the actual market size will deviate in the future depending on the outcome of the various factors assumed within the projects. For example, for 1% difference in investment return p.a. the MPF market size is expected to differ by HK\$300 billion in 2035.

### **Regulation of intermediaries** (principal and subsidiary intermediaries)

MPFA bears primary responsibility for supervising approved trustees and MPF intermediaries. This section contains information on the following:

- Supervision of trustees
  - Registration requirements
  - Proactive supervisory approach including offsite and onsite monitoring
- MPF intermediaries
  - Principal intermediary and subsidiary intermediary
  - What is defined as regulated activities
  - Guidelines on conduct requirement
  - Registration requirements and approval criteria for responsible officer
  - Intermediaries examination

### MPF fees comparison

MPFA offers a fee comparative platform which allows the general public to compare the fees and charges for all MPF funds in the market.

### MPF member protection

- Ongoing disclosure requirements through Fund Fact Sheets, Fund Expense Ratio and Annual Benefit Statement etc.
- Enforcement measures, complaints handling, inspection, financial penalty and prosecution
- MPF Compensation Fund

**Other useful links for this section are listed below for additional background information:**

- <http://cplatform.mpfa.org.hk/MPFA/english/index.jsp>
- <http://tscplatform.mpfa.org.hk/scp/eng/index.jsp>
- **MPF market statistics** (including participation rate, number of members, Asset Under Management, contribution amounts, benefit withdrawal amounts, investment return, asset allocation etc.)  
[http://www.mpfa.org.hk/eng/information centre/statistics/mpf schemes statistical digest/index.jsp](http://www.mpfa.org.hk/eng/information%20centre/statistics/mpf%20schemes%20statistical%20digest/index.jsp)
- **ORSO Schemes Statistics** (including the market size, AuM, number of members breakdown by trust and insurance arrangement)  
[http://www.mpfa.org.hk/eng/information centre/statistics/orso schemes statistics/index.jsp](http://www.mpfa.org.hk/eng/information%20centre/statistics/orso%20schemes%20statistics/index.jsp)
- See below a list of circulars related to MPF intermediaries for background  
[http://www.mpfa.org.hk/eng/supervision/mpf intermediaries/circular letters press releases/index.jsp](http://www.mpfa.org.hk/eng/supervision/mpf%20intermediaries/circular%20letters%20press%20releases/index.jsp)

### 3.3.4 Regulations, professional standards, guidelines and industry standard practice

This section focuses on the key regulatory requirements in the market.

#### 3.3.4.1 Funding requirement under ORSO legislation

For the purpose of protecting members of defined benefit schemes against the failure of meeting the promises in the scheme rules, actuaries are required under the ORSO to perform periodic actuarial valuations and make recommendations to the trustee about the funding status as well as the funding plans. ASHK publishes the Professional Standard 2 (PS2) to govern the standard of performing the actuarial valuation under such purpose.

There are two key measures – solvency and on-going funding.

Solvency means whether the assets of the scheme are sufficient to cover the liability assuming all members leave the scheme on the valuation date. The ORSO is targeting a solvency ratio of 100% and expect the employers to make up the shortfall within 3 years.

On-going funding means whether the assets of the scheme are adequate to cover the actuarial past service liabilities. The most common funding method is attained age normal.

Some defined benefit schemes in Hong Kong are simple – lump sum payment with benefits linked to years of service and final salaries. The typical multiple ranges from 1 to 2 of final monthly salaries per year of service and hence the typical future employer funding rates (ignoring surplus and deficit) could be 8% to 15%. The most important actuarial assumption is the gap between investment return and salary increase. For funding purpose, the gap could typically be 0% to +2%.

#### **3.3.4.2 Accounting requirement (HKAS 19)**

Hong Kong Accounting Standards follow very closely to the International Accounting Standards and hence HKAS 19 is almost identical to IAS 19. Actuaries are required to determine the P&L expense and the liabilities (or assets) to be booked under the employers' financial statements.

Majority of pension actuaries are working for employee benefit consulting firms which provide valuation services to employers.

#### **3.3.4.3 Tax requirement**

Actuaries are sometimes requested to provide input on the potential tax implications, especially when this is relating to the defined benefit schemes. Inland Revenue Department Hong Kong issued a Departmental Interpretation and Practice Note for Recognised Retirement Schemes.

Tax concessions also apply as follows:

- Employees can claim tax deductions for their employees mandatory contributions made subject to a maximum amount of HK\$18,000 for the year of assessment 2015-16 and each subsequent year of assessment
- Employees voluntary contributions are not tax deductible

- Employers can claim tax deductions for mandatory and voluntary contributions made for their employees, to the extent that they do not exceed 15% of the total employee's total emoluments

#### **3.3.4.4 GL 7 on Reserve Provision for Class G of Long Term Business**

Insurance companies provide guaranteed return funds to their clients' pension plans. These policies are classified as Class G under the legislations. The IA requires the reserve provision to be determined stochastically. The minimum benchmark for the provisioning for investment guarantee maintained in the Class G business fund in aggregate is that the provision should cover most of the adverse situations with a 99% level of confidence. It is expected that an insurer shall use the stochastic approach in determining the provision unless there are circumstances which justify the application of the deterministic or factor approach.

GL7 provides the guidance on how to calculate the provision for Class G business.

#### **3.3.5 Recent industry developments**

The enrolment into ORSO schemes is clearly in decline while the MPF market in Hong Kong is relatively young (having come into being only since 2000), we expect the retirement market specifically in the MPF space to continue to see innovation and progressive evolution in the coming years.

##### **3.3.5.1 Ernst & Young cost study**

This is a study on the breakdown of administrative cost of the Hong Kong MPF system with comparisons against other retirement markets overseas

The 5 key recommendations from the study are as follows:

- 1) Drive industry-wide initiatives to deliver end-to-end online and electronic payments and data processing, to reduce costs and streamline processing
- 2) Introduce measures to facilitate account consolidation, to reduce costs associated with member support activities for personal accounts (formerly known as preserved accounts), while transitioning to full member choice to promote competition
- 3) Facilitate industry consolidation of MPF schemes, investment funds, trustees and administration platforms
- 4) Clarify MPF system objectives (e.g. low cost vs full service) to guide future reform, which may lead to the consideration of more fundamental changes to the MPF system

- 5) Improve governance and transparency to facilitate ongoing cost reduction, promote competition and increase public confidence in the system

### **3.3.5.2 Employee Choice Arrangement (ECA)**

ECA came into effect since Nov 2012 and it gives employees the choice to transfer their accrued benefits derived from their mandatory employee contributions to a scheme of their choice (once per year). The actual number of transfer under the ECA has been lower than the original market expectation.

**Other useful link for this section are listed below for additional background information:**

<http://minisite.mpfa.org.hk/eca/en/>

### **3.3.5.3 Default Investment Strategy (DIS)**

The Government and the MPFA propose to require each MPF trustee to provide in each MPF scheme, a Default Investment Strategy. Under this premise, if MPF scheme members do not make any choice on their MPF investment, their MPF benefits will be invested according to the DIS of their respective scheme. The objective of the DIS is to address public concerns about the difficulty of selecting MPF funds.

<sup>7</sup>This is announced to be launched in April 2017 and each MPF scheme has to offer a DIS from this date. The DIS is an investment solution consisting of two mixed assets funds: the Core Accumulation Fund (CAF) and the Age 65 Plus Fund (A65F). Each DIS has three features: globally diversified investment, automatic reduction of investment risk as scheme members approach retirement age, and fee caps.

The law requires the CAF to hold 60% of its assets in higher risk assets, which generally means global equities, and the remaining 40% in lower risk assets, which generally means global bonds. The A65F is required to hold only 20% of its assets in higher risk assets. Both funds should be invested in a globally diversified manner and in different asset classes, with the aim of reducing and diversifying investment risk.

Once scheme members choose to invest their MPF in the DIS, the benefits they accumulate at or before age 49 will be fully invested in the CAF. When they reach the age of 50, the trustee will automatically adjust their portfolio every year, reducing their holding in the CAF and increasing their holding in the A65F. When they reach age 64, all their benefits will be held in the A65F.

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<sup>7</sup> Extract from MPFA website.

Regarding the fee caps, the management fees must not be over 0.75% of the net asset value of the funds per year, and the recurrent out-of-pocket expenses must not be over 0.2% of the net asset value of the funds per year.

**Other useful links for this section are listed below for additional background information:**

<http://minisite.mpfa.org.hk/eca/en/media/>

<http://minisite.mpfa.org.hk/eca/en/faq/>

[http://www.mpfa.org.hk/eng/legislation\\_regulations/legulations\\_ordinance/guidelines/current\\_version/mpf\\_intermediaries/files/VI\\_2\\_Final\\_20120914.pdf](http://www.mpfa.org.hk/eng/legislation_regulations/legulations_ordinance/guidelines/current_version/mpf_intermediaries/files/VI_2_Final_20120914.pdf)

<http://minisite.mpfa.org.hk/DIS/en/faq/index.html>

<http://minisite.mpfa.org.hk/DIS/en/resource/index.html>