A POWERFUL PERSPECTIVE

COMMENTARY ON THE GAI-PPI ISSUE BRIEF

Meeting Hong Kong's Retirement Challenge

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Dr. Jackson's issue brief gives a broad overview of retirement security in Hong Kong. It is noteworthy in particular that the design of the benefit system in Hong Kong does not include any Pillar I, i.e. a non-means tested old-age pension for the general retired population. Dr. Jackson is correct to point out the schism between the "universal pension" activists and those who would prefer to expand means tested benefits. Of course the biggest single weakness of the Mandatory Provident Fund (MPF) is the fact that there is no provision for converting a member's MPF lump sum at retirement into a lifetime monthly pension. So the individual after retirement is left to personally cope with the three risks of investment, longevity and inflation.

MPF is not popular in Hong Kong. There are too many regulations and restrictions, and Dr. Jackson points out the fixation by the MPF Authority over fees. What is more important is to educate Hong Kong citizens as to the investment characteristics of different funds and the fact that achieving a meaningful retirement benefit will take about double the MPF's current contributions of 10% of salaries accumulated for 40 years. The original belief was that competition would force down fees, but the MPF market is very imperfect. Some 30 years ago the Hong Kong Government pledged to introduce "a community-wide retirement protection system" – unfortunately Hong Kong did not then introduce an old age pension system. Looking ahead, in 30 years' time Hong Kong will revert to becoming an integral part of China – China of course has a Pillar 1 old-age pension, but on an unfunded pay-as-you-go (PAYG) basis.

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Richard Jackson has accurately assessed the Hong Kong Mandatory Provident Fund (MPF) system in the context of international best practices, with some excellent choices of words describing the features.

Filled with Chinese refugees from the 1950's onwards, Hong Kong has become the classic example of laissez-faire capitalism. We rely on ourselves, and we are the invisible hand. Pay-as-you-go (PAYG) just had no market in Hong Kong. However, like the rest of today's world, Hong Kong is now deeply divided between those who have and have not benefited from globalization. Hong Kong also has one of those pension systems that needs to be reformed in this politicised environment. Against this backdrop, I would like to elaborate on three issues Richard has touched on in his comprehensive analysis:

1. The "offsetting" mechanism which allows employers to defray the cost of severance pay benefits. It is unjust and probably was a compromise made 15-20 years ago when we didn't have minimum wages which were introduced only in 2011. However, this could also be the moral high ground to be taken first in order to restore some trust and consensus within the society so that other reforms can come with it.
2. The "unusually high fees" that consume savings, but why are they so high? It is another legacy created when the government shied away from a consultant's recommendation to build a central administration system before the launch of MPF in 2000. The fragmented market of a population of eight million is costly to administer, especially at the beginning. The subsequent idea of driving a high level of "consumer choices" to reduce cost through competition may also have exacerbated it.
3. The "Hong Kongers that are highly engaged with the financial markets" – are not a substitute for a CIO (chief investment officer) of a well-run pension plan. This is the same problem around the world created when the US 401(k) member choice model was replicated in many places.

However, there may be a silver lining in the "full service" retirement savings system which has now been built in Hong Kong. With the right product design of a "low-cost default" possibly in the form of target date funds with little or no flexibility of switching out, we may be able to unleash a chain effect that solves the problems with the invisible hand. Arguably, this would make MPF less laissez-faire, and there is nothing wrong with it. If the MPF system becomes a trusted and effective way to save and invest, more money will then flow through it naturally. Other issues such as contribution rates or replacement ratios would then be taken care of by themselves. The fact that over 90 percent of respondents say that they would support workers to save more for their own retirement is going to be self-fulfilling because the respondents are also the workers. We Hong Kongers just need the right tools.

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Hong Kong's longstanding history of laissez-faire government has contributed to the city's overall economic prosperity and its current position as Asia's financial centre. However, it has also inadvertently resulted in a pensions system which is unlikely to fulfill the long-term requirements of many of its future retirees.

Statutory minimum contributions – both for employers and employees – are low for a developed economy, and there are challenges in raising either of these. Political and business appetite for raising employers' contributions is limited, especially given the large number of small and medium-sized enterprises that may be unable to bear the increased costs. Likewise, there is limited leeway to increase employees' contributions for those who most need to do so: Hong Kong has high levels of income inequality, and median income is materially lower than what the GDP per capita figures would suggest. Additionally, the low effective income tax rate means that there is limited scope for tax incentives to encourage increased pensions savings.

These structural challenges are exacerbated by demographic trends (Hong Kong's life expectancy is now one of the longest in the world) and the realities of a low interest rate environment that result in likely returns from Mandatory Provident Fund accounts – let alone pensions lump sums – being lower than the pace of increase in the cost of living.

As with pensions systems globally, there is no single silver bullet solution; instead, a viable long-term solution will require a cocktail of incremental measures. Clearly one key component is to enable a mechanism for MPF accounts to access allocations to higher-return asset classes such as private equity in order to maximise long-term pensions returns. More innovative structured multi-asset class investment solutions should also be considered. Finally, Hong Kong does have one additional advantage: the healthy governmental budget and accumulated reserves suggest a greater theoretical ability to cover shortfalls than many systems elsewhere in the world.