<u>Comments on the Consultation Paper “Providing Better Investment Solutions for MPF Members” (“Consultation Paper”)</u>

As recommended by the World Bank, the Mandatory Provident Fund (MPF) system acts as the second pillar of the multi-pillar retirement protection model. At Fidelity Worldwide Investment (Fidelity), we believe that the MPF system - a mandatory, privately-managed defined contribution, employment-based and fully-funded pension system - is a preferable model. It serves well as a complement to other sources of retirement savings, such as government social security programmes and individual savings arrangement. Under the current framework, the government is responsible for providing a robust regulatory framework; and the private sector, via competition, designs products and services that best cater for the retirement needs of scheme members. This was developed after careful deliberation and consultation, including detailed studies of various overseas second pillar retirement models. As in any system, there remains an ongoing process to make improvements to the system to enhance the contribution that this second pillar could make to our retirement protection system. As a scheme sponsor and an investment manager, Fidelity values the opportunity to respond to the Consultation Paper.

In response to the Consultation Paper, we support the direction that the Mandatory Provident Fund Schemes Authority (MPFA) and the Financial Services and the Treasury Bureau (FSTB) are taking to enhance the regulation of default arrangement in MPF schemes for a more consistent outcome across schemes for MPF members who choose not to make an investment selection. To achieve this, we believe that a guided approach that outlines the main objectives of the default arrangement is most appropriate for reasons that will be addressed in further details in the response to Q2 to Q5.

Before responding to the consultation questions, we would like to clarify the reference to terminology used in the Consultation Paper. We believe the current terminology, “core fund”, may be misleading as the primary objective of the proposal is to design a better investment choice framework that is consistent with the overall objective of retirement savings for those members who choose not to make an investment selection, and to reduce the variability of outcome of default options across schemes. We believe that the term “default arrangement” should be used instead of “core fund”. As noted in the Consultation Paper, there is the possibility of creating multiple investment choices (e.g. target date fund(s), or a combination of life cycle funds, etc.), which would involve the use of more than one fund. In this case, using the word “arrangement” instead of “fund” would be more descriptive of the proposal that may result in the use of several funds. Meanwhile, the term “default” would more accurately represent the objective of the proposed investment option designed for members who choose not to make an investment decision.

Form for responding to Consultation Questions --

<u>Q1. Do you support the direction of introducing a core fund in the manner set out in paragraph 36 (a) to (d) above?</u>

☐ Yes ☑ No

While we are supportive of the direction of introducing measures to achieve a more consistent outcome of default arrangement across different schemes, there are different considerations that need to be given in relation to the various key elements as set out in paragraph 36(a) to (d).

On paragraph 36 (a) the core fund will be based on standardized default funds

While we agree that default arrangements should be similar in their investment strategies to achieve a broadly consistent outcome in meeting the objective of retirement savings across different schemes, standardized default funds could potentially lead to unintended negative outcome as this would materially increase the systemic risk across the MPF scheme for Hong Kong investors. We believe it is important to allow practitioners to have the room for product / solution innovation to maintain Hong Kong's position as a leading international financial centre. As a result, we would propose the MPFA to consider issuing guidelines around the principles for default arrangement, rather than prescribing standardized default fund(s). More detailed comment on this would be included in the response to Q2 and Q3.

On paragraph 36 (b) as a default fund, the investment approach of the core fund should balance long-term risks and returns in a manner appropriate for retirement savings

We support using an investment approach that automatically reduces risk over time as the member gets closer to retirement age. However, we believe there are many ways to achieve this and we do not subscribe that it would be optimal to have consistency on all aspects of default arrangement across all schemes. It is imperative that providers be given the flexibility and room for innovation to achieve the overall objective of retirement savings. In the response to Q4 and Q5, we have included more details on this aspect of the default arrangement.

On paragraph 36 (c) the core fund should be good value

We fully agree that the default arrangement should be designed in a manner that represents good value. It is important to note "value" should be assessed by various factors which should include investment returns and risk, member services, member education, in addition to fees and expenses. We believe in a market economy such as Hong Kong, the market forces would be the best determinants of the pricing level for the solutions that are provided. In addition, members would also benefit from lower total expense level as better economy of scale is achieved while fund asset accumulates. Whilst we do not subscribe to the introduction of a maximum fee level for the default arrangement, we understand there is an expectation from the MPFA, the government and the general public that the default arrangement should be a lower fee option. As such, we welcome further discussion with the MPFA to address ways to bring the costs down. Further related comments on this will be addressed in response to Q6 to Q9.

On paragraph 36 (d) the core fund is available to all MPF scheme members to choose

We agree that the default arrangement should be made available to all MPF members to choose from. However, over emphasis of the default arrangement as a suitable investment choice for members may be misleading, as the default arrangement might only take into consideration the age of members in its design without consideration to other personal circumstances. We believe it is important to continue to educate members to take the initiative to review their own retirement needs and make appropriate investment choices for their own circumstances.

<u>Q2. Do you agree that the CF that is the default fund should be substantially the same in all MPF schemes?</u>

☑ Yes ☐ No

We understand that a key objective of the proposal is to reduce the variability of investment outcomes of default arrangements across schemes. To achieve this goal, we agree that the CF/CFs that is/are used as default arrangement should be similar in their investment strategies to achieve a broadly consistent outcome in meeting the objective of retirement savings across different schemes. In implementation, there are many ways to achieve a reasonably consistent outcome across schemes without prescribing a standardized approach. Our belief is that the best way to achieve this objective is through broad general guidelines that outline de-risking objectives, within certain limited constraints, while leaving flexibility for investment managers and providers to design innovative solutions.

<u>Q3. Do you agree that it is appropriate that the core fund be based on a standardized default fund?</u>

☐ Yes ☑ No

While standardized default fund(s) may potentially enhance efficiency in the investment management aspect and allows for easy comparison, the implementation can actually increase cost and may also introduce out-of-market risks for members if the implementation model involves multiple service providers such as trustees, administrators, and/or investment managers. In addition, as commented in the response to Q1, a standardized default fund also materially increases the systemic risk across the MPF scheme for Hong Kong investors. We believe it is important to allow practitioners to have the room for product / solution innovation to maintain Hong Kong's position as a leading international financial centre. As a result, we would propose the MPFA to consider issuing guidelines around the principles for default arrangement, rather than prescribing standardized default fund(s).

Q4. Do you agree that the appropriate investment approach of the core fund is one that automatically reduces risk over time as the member gets closer to age 65? If not, what other option would you propose?

☑ Yes ☐ No

We support using an investment approach that automatically reduces risk over time as the member gets closer to retirement age. Evidence suggests that investors make the classic mistakes in trying to maximize their returns: chasing markets up and down, over-reliance on a single asset class and serially failing to rebalance their investments.[1] We believe that age-based investment approach can address these problems for investors and improve people's chances of building sufficient retirement savings for the typical retiree.

However, we caution that such approach may require additional cost to set up new funds, maintain a number of funds on the scheme, and/or enhance administrative system to cater for this approach, thus increasing the challenge to achieve the fee level as proposed in paragraph 57 of the Consultation Paper.

[1] Chan, Kalok (1998) *The Case for Age-based Lifecycle Investing*

Q5. Do you have any preliminary views on the technical issues set out in paragraph 48, in particular whether consistency is required on all aspects of default fund design in all schemes or can some elements be left to the decision of individual product providers?

While we support the goal to achieve a reasonable level of consistency in outcome of the default arrangement across different schemes to meet the overall objective of retirement savings, we disagree with having consistency on all aspects of default arrangement across all schemes. It is important that providers be given the flexibility and room for innovation to achieve the overall objective of retirement savings through different approaches, different investment strategies and different product mixes across different economic cycles. Allowing competition through creativity and innovation is a critical component to any privatized system like the MPF. If the regulatory guidelines on investment strategy or product design are too prescriptive, the default arrangement may deliver unforeseen and unintended outcomes. We therefore propose that the parameters be provided in guidelines rather than through the ordinance or legislation, while allowing individual providers to decide on the technical issues of the default arrangement.

Q6. Do you agree that keeping total fee impact for the core fund at or under 0.75% is a reasonable initial approach?

☐ Yes ☑ No

While we fully agree that the default arrangement should be designed in a manner that represents good value, we <u>disagree</u> with keeping the total fee impact for the default arrangement at or under 0.75% as an initial approach.

We believe that market forces would be the best determinants of the pricing level for the solutions that are to be provided in a market economy such as Hong Kong. Through competition, scheme providers would be driven by market forces to offer more competitive fee, thus driving down the total fee impact to members.

In fact, as noted in the Consultation Paper, the average FER for all MPF CFs has declined by 20% over the past few years as MPFA and the industry worked on improving the MPF system together. As the MPF system matures, we believe scheme providers would be able to achieve even better economies of scale, further driving down the total expense impact to members.

With reference to Ernst & Young's two studies on the MPF system published in May[1] and November 2012[2], we note that the six cost drivers that were identified were mostly result from scalability and operating inefficiencies. In the past few years, providers have invested resources to introduce many e-channels for members and to engage with the MPFA on streamlining administrative processes. However, as process simplification is not prevalent, we do not see how the current stage of regulatory requirement on MPF operation could accelerate any reduction in administration cost to a significantly lower level from the current level observed in the market.

In addition, the introduction of a maximum on total fee impact could potentially lead to unintended adverse impact such as limitation of the level of service provided to members, reduced resources for providers to invest in technological and operational innovation to improve service experience and efficiency for members. Such constraints would not lead to healthy development of the MPF system, leaving members with a negative impression on the system overall.

Since the MPFA published the low fee fund list (i.e. funds with Fund Expense Ratio ≦ 1.3% or management fees ≦ 1%), that fee and total expense level has been widely accepted as the unofficial benchmark of "low fee fund" for MPF. Almost all schemes now offer such low fee funds for members to choose from. Nonetheless, such fee level when compared with the proposed fee and total expense of the default arrangement shows significant negative variance of over 30%. We are concerned with the drastic reduction proposed, without further insights on how the proposed fee and expense level was derived.

While we disagree with keeping the total fee for the default arrangement at or under 0.75%, we understand there is an expectation from the MPFA, the government and the general public that the default arrangement should be a lower fee option. We believe it would be easier for members to understand if only one measure of cost is used. In such case, total expense would be a more representative measure of the cost borne by members.

Considering the aforementioned factors, we welcome further discussion with the MPFA to explore the feasibility of applying a maximum Fund Expense Ratio of 1.3% (which is currently used for categorization of low fee funds) to the default arrangement, subject to the complexities of guidelines and approach to be adopted and the availability of appropriate products.

[1] Ernst & Young *The evolving MPF system: an objective assessment*
[2] Ernst & Young *Managing the changing landscape of retirement savings: Report on a study of administrative costs in the Hong Kong Mandatory Provident Fund system*

Q7. Do you agree that keeping total expense impact (i.e. FER) for the core fund at or under 1.0% over the medium term is a reasonable approach?

☐ Yes ☑ No

We disagree with keeping FER for the default arrangement at or under 1.0%. Considering the factors as indicated in the response to Q6, we welcome further discussion with the MPFA to explore the feasibility of applying a maximum FER of 1.3% (which is currently used for categorization of low fee funds) to the default arrangement, subject to the complexities of guidelines and approach to be adopted and the availability of appropriate products.

Q8. Do you agree that passive index based, investment strategies should be the predominant investment approach in the MPF core fund?

☐ Yes ☑ No

Even though passive index based investment strategies may appear as the appropriate approach to implement the default arrangement as referenced in the Consultation Paper, we believe that there are many ways to achieve the objectives as set out by the MPFA without prescribing any particular approach. Our belief is that the best way to achieve these objectives is through broad general guidelines that outline de-risking objectives, while leaving flexibility for investment managers and providers to design solutions that they deem most appropriate to achieve those objectives using their respective strength and expertise.

We also note that the Index-Tracking Collective Investment Schemes (ITCIS) currently approved by the MPFA may not necessarily fulfil the desired risk/return profile for retirement savings (e.g. there is limited number of ITCIS investing in bonds). In addition, the fees of many of the currently approved ITCIS are comparable to active strategies. While there are less expensive index-tracking vehicles in the market, many of them do not fulfil MPFA's investment requirement (e.g. restriction on the use of derivatives); thus limiting the number of cost-efficient ITCIS.

Q9. Are there particular asset classes which you think would not appropriately be invested on a passive, index based approach?

Referring to our response to Q8, we believe there are many approaches that can be employed for implementing the default arrangement and providers should have the flexibility to design the solutions most appropriate for members within the broad general guidelines from the MPFA.

In the case where providers decide to use passive index based approach, there are certain asset classes that might be more difficult, and hence more expensive, to implement through a passive vehicle under the MPFA's investment requirement, such as global bond funds with customized investment restrictions.

Q10. Do you agree that the name of the core fund should be standardized across schemes? If so, do you have any preference amongst the possibilities set out in paragraph 77 above?

☐ Yes ☑ No

Your preference:

- ☐ "MPF Core Fund" (having regard to its use as a core investment approach for retirement savings)
- ☐ "MPF Basic Investment Fund" (emphasizing its design as a basic investment approach for retirement savings)
- ☐ "MPF Simple Investment Fund" (emphasizing its design as a simple investment process for retirement savings)
- ☐ "MPF Default Investment Fund" (reinforcing that its primary design is built around the default investment strategy for those who do not, or do not want to make an investment choice in saving for retirement)
- ☐ "MPF "A" Investment Fund" (or some other term which removes any implications about the nature of the strategy)

We believe that the term "**default arrangement**" should be used as the primary objective is to design a better investment choice framework that is consistent with the overall objective of retirement savings for those members who choose not to make an investment selection, and to reduce the variability of outcome of default options across schemes. As noted in the Consultation Paper, there is the possibility of creating multiple investment choices (e.g. target date fund(s), or a combination of life cycle funds, etc.), which would involve the use of more than one fund. In this case, using the word "arrangement" instead of "fund" would be more descriptive of the proposal that may result in the use of several funds. Meanwhile, the term "default" would more accurately represent the objective of the proposed investment option designed for members who choose not to make an investment decision.

<u>Q11. Do you agree with the general principle for dealing with implementation and transitional issues as set out in paragraphs 78 and 79?</u>

☐ Yes ☑ No

In terms of communication, we agree that all existing MPF members should be made aware of the new default arrangements as set out in paragraph 78 of the Consultation Paper.

For new members, we agree that for those who do not make a choice / decide not to make a choice that their contributions should follow the new default arrangement as and when it becomes practically possible.

As for the existing members who are currently invested in the default option in their schemes, we note the following issues with regard to the implementation and transition --

- As the administration systems do not necessarily keep track of which members give investment instruction to choose the default fund as their choice versus members who do not elect any investment funds and are by default invested in the default fund of the scheme, accurately identifying existing "defaulters" may not be feasible. One may consider using the written records that are kept for each member to identify the "defaulters," however, this process utilizing records outside of the administration systems could potentially incur extensive cost and time, which would negatively impact the benefits to members.
- For the existing "defaulters", scheme providers are unable to confirm their intention, whether they are invested in the default fund of the scheme because they do not make a choice, do not want to make a choice, they like the default fund of the scheme, or other reasons for having invested in the default fund. Without the members' expressed intent, redirecting their accrued benefits and future contributions (even with a negative consent) to an arrangement that may alter their risk/return profile, may potentially lead to members' dissatisfaction, especially if they have been redirected to an investment that incur losses in their MPF accounts.
- In terms of implementation, there will be cases where members who did not make a choice at the time of joining a scheme (and thus have fallen into the "defaulters" category), but subsequently decided to switch their accrued benefits to another investment option but not the future contribution, whether their future contribution should be directed to the existing default fund or the new default arrangement is subject to consideration. We caution that without the expressed intent of the members, redirecting members' contribution could potentially lead to members' dissatisfaction with the arrangement and the MPF system in general.

<u>Q12. Do you agree with the proposal in paragraph 81 as to how to deal with the transition for existing MPF members of default funds?</u>

☐ Yes ☑ No

As noted in the response to Q11, there are potential issues with the redirection of members' accrued benefits and future contribution (even with a negative consent), as the new arrangement may alter their risk/return profile which may incur losses in their MPF accounts, potentially leading to members' dissatisfaction with the arrangement and the MPF system in general.

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