To: Mandatory Provident Fund Schemes Authority
From:
Subject: Comments to Consultation on Providing Better Investment Solutions for MPF Members

---

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

☐ Yes ☐ No ☑ It depends

Generally, we support the direction of adopting a more uniform approach to setting the default fund. Current MPF companies use different default funds for their schemes. There might be a need to align the default funds. However, we believe the FSTB and the MPFA must first determine what type of a default option is the most appropriate for a retirement plan, and to clarify the intentions of such default option. If intended to address the small minority of members who chose not to make an investment decision, then the default option can be rather simple and straightforward. If the intention is to create a default option to address a broader concern, then the intention needs to be clearer and better communicated to the general public.

Rather than calling the new retirement investment strategy a "core fund", we believe these retirement strategies could be called "default investment fund" or "default option" to avoid any value judgment being imposed onto this product and potentially mislead members.

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

☐ Yes ☑ No

Again, this depends on the intention. If truly a default option, then generally the different MPF schemes can be similar in terms of investment strategy/approach. General guidelines on a de-risking investment strategy (or glide-path approach) should be adequate for the design of a default fund. However, the investment outcome (such as returns) could not be substantially the same.

Q3. Do you agree that it is appropriate that the core fund (default option) be based on a standardized default fund?

☐ Yes ☑ No

We refer to the OECD recommendation and overall objective of the MPFA with regards to default option (i.e., protecting default members from extremely negative outcomes for those approaching retirement) with the default option preferably being an age-dependent, life cycle/target date fund that reduces risk over time. Given that there are multiple ways of achieving this objective and meeting the default option criteria, it will depend on the intention of the default option and the degree of "standardization" to be proposed.

If the default option is going to be under a decentralized approach, only the name, the glide path and the headline fees could be standardized. Other factors such as administration processes, investment strategies and outcomes would be more difficult to "standardize" and potentially introduce added confusion to members.

Similar to Q2, an in-principal general approach plus guidelines for the default option would suffice.

Q4. Do you agree that the appropriate investment approach of the core fund (default option) 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 agree that most retirement planning strategies should strive to reduce risk over time as members get closer to their retirement age. Given the limitation that the most relevant personal data in the records of MPF service providers is the age of members, a fund which reduces risk over time as members get closer to age 65 would be a practicable investment approach. However, this investment approach does not take into account other relevant factors such as an individual's total financial resources, personal circumstances, risk appetite, planned retirement date or income needs. It has also assumed that members aim to retire at age 65.

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?

a. A straightforward default option geared for a small minority of members not electing an investment option could be made more consistent across multiple design aspects.

b. With respect to a broader default fund concept, the industry prefers to have a more flexible approach based on customer desires and needs. Customer expectations and competition should drive the product development process. Life cycle products would reduce the needs to add another series of CFs while allowing a flexible investment strategy. Economies of scale could also be more easily achieved as the building blocks may already exist with AUM. On the other hand, target date CFs do not involve as many redemption and subscription of fund-level transactions. The adjustment to the target mix of equities and fixed income instruments would be seamless to members. Depending on the features of the de-risking glide-path for both approaches, forced redemption for the life-cycle products may not be avoided when the market condition is unfavorable. Additional costs will be incurred to enhance the administration system and/or new fund(s) if the new default option lacks flexibility on the approach.

c. We support having 5-10 year increments in a glide path with sufficient flexibility on the range of asset allocation at each point of the glide path.

d. In general, we agree that the investment strategy should provide professional investment managers with the flexibility to globally diversify among asset classes. Initially, the strategy could focus principally on traditional equities, bonds and money market instruments. The investment building blocks at the underlying fund level could follow the current legislative restrictions and it is not necessary to specify further guidelines or restrictions for the default fund. With the proposed flexibility, MPF service providers could choose to make use of their existing underlying APIFs to achieve better economies of scale. However, over time, additional investment flexibility (and possibly the inclusion of alternative asset classes in the future) will be needed if MPF investment performance is to match the returns shown in other jurisdictions.

e. We suggest that the choice of active or passive investment strategies to be left to professional investment managers and MPF service providers.

f. This involves more insight into customer expectations and an assessment of trade-offs between performances and fees. Further analysis should be left with the technical workgroup.

g. We support to have a terminal fund/risk profile for members beyond age 65. In general, there would be about 15-20 years of retirement living after age 65. Thus the post retirement investment strategy still needs to balance between risk and return and should maintain some equity exposure. Same as point "f" above, the industry would leave the technical workgroup to advise on the range of asset allocation.

h. We also believe a glide path that can be understood by members is critical. Given life expectancy of 15-20 or more years post retirement, consideration needs to be given to investment strategies which provide returns in excess of inflation, a steady level of income stream to members, and reduced volatility in the income stream. We are also mindful that members have the option to fully withdraw funds from their MPF accounts and invest in other investment options if the industry cannot provide attractive and flexible investment options. Again, the terminal risk profile must be discussed within this context and can be further addressed by the technical work group.

i.. We believe a guiding-principle based approach would be preferable to a more prescriptive approach and would be sufficient for the purpose of maintaining consistency. Such guiding principles should be kept as wide as possible in order to allow sufficient flexibility for MPF service providers to structure their investment offerings with suitable investment objectives, investment strategies, underlying investments, etc. We fully expect markets, customers and investment knowledge to change in the future, and we must be able to react quickly to those changes.

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

☐ Yes ☑ No

We are of the view that keeping the total fee impact for the default option at or under 0.75% is NOT a reasonable initial approach. Our conviction rests on the following facts:

a) In reference to the 2012 Consultancy Report commission by the MPFA on a study of the administrative cost in the MPF system, it clearly indicated that, at the time of that Report, the overall weighted average FER was 1.74% in which the average administration cost and investment management fee accounted for 0.75% and 0.59% respectively. It is obvious that fees have declined in the past few years and we believe such reductions will continue and will ultimately be reflected in the FER. It should be noted that the published FER does not reflect bonus units being rebated to members which effectively further reduces the actual fee paid by members.

b) Simultaneous to a gradual decline of fees, providers have also spent resources in offering e-channels for employers and members, as well as engaging and supporting many initiatives required by the MPFA on streamlining administrative processes (i.e., ePass and TRIS), amidst coping with tightened compliance requirements which have added to costs for the system overall. As such, we have not seen cost savings on administration, which is the key driver of a lower FER.

c) Furthermore, we do not see how the current stage of regulatory requirements on MPF operations could accelerate any reduction in administration cost to a drastically lower level. In conclusion, to achieve better cost savings in the long run, the MPFA should take the lead with joint efforts from the industry to promote the use of e-channels, which have not yet been widely accepted and utilized by employers and members.

d) In 2013 the MPFA published a listing of funds with total fee and total expenses ("FER") of 1.3% or less has set an unofficial benchmark for the definition of "low fee". Such has been widely accepted by the market as a synonym for "low fee fund". The proposed fee of the default option is now hinged on a significant negative variance of over 30% compared to the "low fee fund" listing. We are gravely concerned about the drastic fee reduction assumption made within such a short period of time which is also unsubstantiated.

e) To develop a low fee "default option", the consultation paper proposed using an index-based, passive investment strategy. Yet the number of applicable ITCIS's, especially in the bond category, is small to support this strategy. There are only five fixed income ITCIS's, of which none tracks global government bonds. The overall average FER of the currently available ITCISs is as high as 0.45%, with the FER of some single country ITCISs in the 0.6% - 0.7% range. In this respect, using a passive investment strategy will not necessarily result in a low fee fund.

   If we are required to meet more stringent fee caps, we might have to reduce services or find other means to offset the costs of offering a default fund. The fact is that only the investment manager fee would benefit even with a sufficient asset scale. In fact, there will be no reduction on the administration fee since a reduction in administration processing is unlikely (if not increased). To the trustees and administrators, true saving could only come if there is a wide-spread use of electronic platforms. From page 29 of the **Managing the changing landscape of retirement savings – Report on a study of administrative costs in the Hong Kong Mandatory Provident Fund system** by Ernst & Young, the first of the 4 suggested cost savings measures was "*Industry wide initiatives to transition to end-to-end online and electronic payments processing to reduce costs and streamline processing*". According to this Report, the savings is expected to be at approximately 0.2%.

Therefore, we believe it is vital for the MPFA to work with the industry to promote the use of electronic contribution and payment platform as one of the ultimate solutions to help drive costs down.

We further believe fee and expense levels will be reduced as administrative cost savings (including regulatory imposed costs) are realized and fund size further increases to create sufficient scale in the MPF system. At present, the current asset size of the Hong Kong MPF market lacks scale to significantly drive cost down within a short period of time. Considering all factors, we suggest to set the fee and total expense ratio of the default option to no lower than the MPFA's current definition of "low fee fund" (i.e., management fee of 1% or less, and total FER of 1.3% or lower).

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

☐ Yes ☑ No

We are of the view that keeping the total expense impact for the default option at or under 1% over the medium term is NOT a reasonable approach. Please refer to Q6 on our view.

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

☐ Yes ☑ No

We have reservations over the usage of the word 'predominant'. While passive or index based investment strategies might form part of the strategy, we believe the decision on overall investment approach should be left to each individual MPF scheme provider and fund managers. We note in some jurisdictions such as the US where both passive and active investment strategies are offered, and investment flows are fairly split between the two options. Each MPF scheme provider should be able to assess their customers' expectations and desire, and then design core fund options (considering performance and fees) that provide the best value to members.

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

Our general view is that if the liquidity or trading volume of some asset classes is very thin, the lower level of liquidity would increase expenses.

Another point we would like to mention is that for many (if not all) bond ETFs, the existing indices they track could have elements that do not meet the MPFA's investment requirements (e.g. on the credit rating of the bonds or type of bonds). Hence, separate ETFs may need to be created. New ETFs may lack liquidity and size which again would have ramifications on the liquidity concerns and the FER. Furthermore, bond ITCISs generally have difficulties in mimicking all the constituents of the indices that they are tracking, which means members may have to bear relatively high tracking errors for these ITCISs.

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

☑ Yes ☐ No

Echoing reply from Q1, we believe rather than calling the new retirement investment strategy a "core fund", this retirement strategies should be called "default investment fund" or "default option" to avoid any value judgment being imposed onto this product and potentially misleading the members.

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

☐ Yes ☑ No

We understand the rationale behind the general principle for dealing with the implementation and transitional issues proposed by MPFA in the Consultation Paper, but we do not agree with the entirety of the implementation and transitional arrangements. Whilst we agree that all existing MPF scheme members should be made aware of the new default option arrangements, we do not agree that members currently investing into existing default funds would need to switch to the new default options nor should the future contributions be automatically invested into the new default option. We also have the following concerns:-

a. Given the size of the MPF market as well as the amounts invested in the existing default funds, there would be significant transactions (in respect of both subscription and redemption) for particular securities in a single day, and such an arrangement may lead to unexpected price fluctuations which may not be in the best interest of the MPF scheme members.

b. If the current default fund is a guaranteed fund, there is also the concern that these members who are being forced to switch to a new default options may not be able to benefit from the guarantee, which may only be realized upon satisfying certain conditions in the future.

c. There may be situations where existing members are not aware of the notification / new arrangement due to various reasons such as out-of-town, invalid contact details, etc., which could result in these members being forced to invest into the new default option, which might not to be in their best interest.

d. Members may not consent to such a change in their investment portfolio and could make claims for decreases in asset value associated with such a change.

e. Existing members who have multiple accounts within a MPF scheme may have different investment choices. The proposal creates complications in the communication with scheme members.

f. Existing members could submit switching instruction at any time. Thus, they have opportunities to invest into the new default fund if they elect to do so.

g. Some MPF schemes may have a number of "dummy" account members (i.e. employees who are not properly enrolled in the scheme) where the relevant trustees just only have the name or HKID/passport number of these "dummy" account members. As these trustees do not have the actual date of birth for these members, the using of glide path to reduce risks may not be appropriate for them. In case the transitional arrangement as set out in paragraphs 78 and 79 will be implemented (especially for existing dummy account members where members' existing benefits will be switched to the new "default/core" fund), we suggest applying the glide path applicable to the risk profile for age 65.

Due to our concerns above, we recommend the new default option arrangement should only be applied to new MPF scheme members. We do, however, agree that existing MPF scheme members would only switch into the new default option by making a specific investment choice.

In addition, we believe the MPFA could further improve upon the proposed arrangement by taking into account of the following:-

1. The transitional arrangement shall be set out specifically in the amendment legislation and regulations, especially when it involves switching of members' accrued benefits from the existing default fund to the new default option. The amendment legislation or regulations should cover but not be limited to an aligned switching dealing date to the default option, handling of members who cannot be contacted, and how the members are classified as investing in existing default fund.

2. Due to the potential effect of the arrangement, we recommend that the government or the MPFA carry out promotional and educational programs and have extensive coverage to the public on the transitional arrangement prior to the launch of the default options.

3. MPFA must also provide all trustees with specific guidance in relation to the submission of applications for the addition of default options (e.g. including guidance on standard wordings for the objectives, restrictions, risk disclosures, timetable, etc.).

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?

☐ Yes ☑ No

In relation to the existing members which the trustee or administrator of the MPF scheme cannot readily identify as having made an investment choice, we are of the view the invested contributions, or future contributions, should not be switched from the existing default fund to the new default option even if they have failed to make another investment choice. In addition to the concerns mentioned in Q11, the transitional arrangement should be standardized and one standard rule applied to all MPF schemes in order to ensure efficient and effective communication with all members.

Q13. Other items

Regarding the points raised in Darren McShane's letter dated 25 September 2014 to trustees on the following:

a) **The government or some government agency should take a role in operating the core fund and/or in investing the funds of the core fund**
b) **There should only be a single core fund rather than core funds in each and every MPF scheme.**

a) The government or some government agency should take a role in operating the core fund and/or in investing the funds of the core fund

- Before considering whether to take-up an operating role, the Government should

  - have a clear definition on what a core fund is (not only default fund);
  - have a clear message to the public on the proposal of whether they want to introduce a fund with low fee, reasonable good performance, and suitable for majority of non-sophisticated members;
  - be prepared to see demands from the public for returns with guarantee to beat potentially high inflation; and
  - be prepared to sort-out all the administrative logistics.

- If the Government is involved in the whole set up of the core fund, the core fund would achieve better economies of scale. However, there will likely be issues on aspects like the cash flow management, transfer in/out, allotment/redemption, reporting (scheme member communication) and servicing. Hence, the Government is advised to further consult with the industry on the related arrangements.

- Given MPF is a privately run system regulated by the government, it would be more appropriate to maintain status quo in order to maintain operation efficiency and avoid unnecessary disturbance. As a rule of thumb, market forces drive pricing efficiency and a government-mandated core fund would undermine the free market competition. The policy intent of the government for the MPF regime is to have it private managed with government oversight. If the government wishes to be involved in operating or managing the core fund, then this change of policy intent should be widely consulted and debated among relevant stakeholders.

- We believe the default arrangement should adopt an approach that results in reasonably consistent outcome across schemes and we also support the regulators to issue guidelines rather than prescribing standardized the underlying APIFs for the default arrangement. We believe flexibility should be given to individual providers in deciding the investment strategy or product mix to allow for innovation in the industry.

- We believe a government agency will face the same issues as the trustees in terms of designing a product (i.e., glide path, investment strategy, lack of ITICS, etc.) as well as difficulty in achieving the targeted fee levels especially with insufficient AUM.

- Will the Government

- manage the core fund directly?
- be subject to the same investment restrictions and MPFA oversight as trustees?
- assume the fiduciary role for the product?

The Government could use a third party manager(s). However, it is likely that it will be difficult to achieve the fee target by having to pay third parties. In addition, if the Government is involved, the fund performance, both good and bad, will be fully responsible by the Government, and bear the political responsibility. The Government would likely be receiving a lot of complaints/challenges during the time of poor fund performance. We see a potential conflict of interests if the Government manages the core fund while monitors the investment performance of all MPF funds.

- Who will bear the administrative costs? Contributions, distributions, reporting, etc…, must still be done. The industry is willing to compromise to offer low-fee core fund with standardized investment approach. It is not necessary to have government intervention.

- Even if the Government or some Government agencies could provide the services to operate the core fund under trustees' delegation, we sincerely doubt if this could be achieved at a reasonable cost. With the Government taking full responsibilities in doing so, there is the advantage of not needing to perform due diligence on the Government. However, if the provision of operation/investment arrangement for the core fund is outside of the current MPF arrangements, this could create another level of interaction with the Government or some Government agencies for the trustees, and we do not see it as the most efficient arrangement for it will not be in the best interest of members.

b) There should only be a single core fund rather than core funds in each and every MPF scheme

- We disagree that the core funds (at constituent fund level) of different MPF schemes should be invested into the same APIF(s). We believe flexibility (e.g. on the choice of APIFs and certain aspects of the design of the core fund) should be allowed for trustees / investment managers to make the appropriate investment decision on behalf of members.

- There will be a lack of competition if only one set of APIFs or index funds is allowed for all the MPF schemes. Concentration risk on return/performance (i.e., if the fund does not perform) will be very high, potentially leading to the returns of a significant number of members being affected. The consultation paper indicated around 24.1% of members had not made a fund choice. We expected more members will pick this core fund if it is packaged by the MPFA as a "core" investment strategy with low fee/high return.

- A single core fund (at APIF level) would create a lack of market competition to drive pricing efficiency and investment outcome. Furthermore, it would be a non-level playing field as small fund house could not compete with the international firms to provide that single core fund.

- If members do not satisfy with the performance of the single core fund, there will be no other choices.

- There will be a question on who shall select the single core fund for all MPF schemes. If it is chosen by the Government, there will be conflict of interest.

In summary, we would like to highlight the following:

We support a core fund for each MPF scheme under guidelines from the MPFA.

We support for the MPFA to provide general de-risking guidelines for each provider to design the relevant APIFs or CFs.

We believe centralization does not automatically mean lowering of fee. The centralization might help to reduce the investment manager fee. For the administration fee, there is no less work with the introduction of core fund. In fact, some providers would argue because of the increase in the core fund option, there could be more work than before.

We believe investor education could be a serious problem in the future under a centralized approach. If fund performance is poor under centralization, who is to going to explain? Because the fund manager is chosen by the Government / MPFA, the trustees and service providers will not be able to (or in the proper position to) explain fund performance. Even with the selected investment managers' help, this will be a daunting task. Hence, we believe it would not be in the members' best interests to go with a centralization approach.