The Mandatory Provident Fund (MPF) System is a mandatory, privately managed, defined contribution retirement savings system. As such it meets the recommendations of the World Bank on how to design the second pillar of a multi-pillar retirement protection model.

2. A well-designed MPF System, in which well-considered investment choices are made by, or on behalf of, scheme members, is important for enhancing the contribution that the second pillar can make to overall retirement savings outcomes for scheme members and thus enhance the financial sustainability of Hong Kong’s retirement protection system as a whole.

3. The MPF System will mark its 15th anniversary this December. The Mandatory Provident Fund Schemes Authority (MPFA), being not just a supervisor and regulator, but also a leading advocate of the MPF System and protector of scheme members’ interests, has been enhancing the MPF System for more than a decade.

4. The road to achieving a better MPF System is not without challenges. Its development has always been keenly debated in the community. Concerns raised include the level of fees and charges and the complexity of decision-making for scheme members.
MPF investment choices and decision-making

5. In most modern second pillar defined contribution systems, individual scheme members who bear the investment risks, are given the right to make investment choices. In the MPF System this is done by allowing members to make choices between investment options (called “constituent funds”) within each scheme. Making a fund choice in an MPF scheme, which involves making decisions about pricing, asset allocation and risk/return tradeoffs may be a difficult task for many scheme members. According to a 2013 survey done by the MPFA, one in every four scheme members said they had never made a fund choice for their MPF investment. Whilst this may overstate the actual level of default investment, it does illustrate that many members are quite disengaged from this important decision-making process.

6. Currently, how contributions are invested for those who do not make a fund choice is left to individual scheme rules. As a consequence, the default investment strategy varies substantially across different schemes, and the risks taken on, unknowingly, by defaulting members varies substantially.

7. The MPFA believes that the default investment strategies should be standardized and regulated to ensure that those scheme members who do not want to, do not know how to, or do not have time to make a choice of funds are provided with a consistent, good value, approach that is designed in a manner that best meets the objectives of retirement savings.

General directions

8. The Government and the MPFA conducted a public consultation last year on the proposal to enhance the regulation of the default arrangements for MPF schemes by introducing a standardized, low-fee, default investment strategy for all members.

9. Views from members of the public, as well as the MPF industry, generally supported the direction of the consultation proposals.
10. The Government and the MPFA have therefore proposed the following broad direction for the default investment strategy (DIS):

   (a) The DIS in each MPF scheme should follow the same investment approach.

   (b) It would apply to the MPF contributions and benefits of a member:
       i. who does not indicate, or has not indicated a specific fund choice; or
       ii. who specifically chooses to invest in the DIS.

   (c) The DIS:
       i. will be designed to automatically reduce investment risk as a member approaches the age of 65;
       ii. will reduce risk by adjusting members’ MPF contributions and accrued benefits across two or more funds in each scheme;
       iii. will charge management fees of no more than 0.75% of assets under management per annum (noting that the 0.75% may be reduced over time);

   (d) The asset allocation and investment performance of funds used in the DIS in each scheme will be benchmarked against an agreed portfolio in order to increase transparency and consistency across schemes.

Reducing investment risk with age

11. An obvious challenge in designing a consistent approach to investment of defaults is achieving consensus on what should be the investment approach. The potential returns and associated risks of different approaches need to be balanced. This should not be considered just in the context of traditionally understood investment risk, as a range of timing and human capital risks also impact on outcomes for retirees. Nevertheless some commonly understood relationships between risk and return also apply in this context; too much risk will result in some members suffering from adverse outcome shocks, too little risk will adversely affect adequacy across the whole MPF population. The developed consensus in this area is that investment risk should be reduced according to the age of the member.
12. Based on research into the approaches taken in other jurisdictions, views from our own industry and modeling by the Organisation for Economic Co-operation and Development (OECD) commissioned by the MPFA, we consider that the preferred approach is one that takes on a reasonable level of risk throughout (around 50% equity exposure), but starts at a higher risk exposure and then automatically reduces risk from about the age of 50. The proposed details are as follows:

<table>
<thead>
<tr>
<th>Scheme Member’s Age</th>
<th>Investment Strategy</th>
<th>Investment Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Higher Risk Assets (Predominantly in Global Equities)</td>
</tr>
<tr>
<td>Under 50</td>
<td>Relatively aggressive</td>
<td>60%</td>
</tr>
<tr>
<td>50 to 65</td>
<td>Gradual risk reduction</td>
<td>Regular, progressive, de-risking from 60% higher risk assets down to 20% higher risk assets.</td>
</tr>
<tr>
<td>65 and above</td>
<td>Relatively conservative</td>
<td>20%</td>
</tr>
</tbody>
</table>

MPF scheme trustees will automatically adjust the allocation of individual members holding in a way that keeps the member on the asset allocation glide-path set out above.

**Fee level of 0.75% or below a reasonable target**

13. The proposal that the fees for the default investment strategy should be kept below 0.75% inevitably raised many views – both that it was too high and that it was too low. The Government and the MPFA believe that the proposed fee level of 0.75% is a reasonable starting point, having regard to existing fee levels, the costs of the operation of the MPF System, overseas experience and the aspirations of many respondents.

14. The proposed level is ambitious, but both the Government and the MPFA consider it an achievable level for the MPF industry to meet. A challenging target is necessary to help address the concerns and aspirations of the wider community for the
MPF System. This target will also help focus providers’ attention on producing a highly efficient and simple default fund structure, and will reduce the need for excessive regulation on matters such as the structure and fund design.

15. With the introduction of the fee control, the Fund Expense Ratio for the constituent funds used in the DIS is expected to decrease to 1.0% or below in the medium term (e.g. three years after implementation).

**Passive investment approach not mandatory**

16. As demonstrated in the findings of the public consultation, whilst there was majority support for using a passive investment approach for the DIS, some preferred the use, in full or in part, of an active approach, or leave the decision to the industry and service providers.

17. Some industry members have expressed the view that, in any event, it will only be possible for most providers to meet the proposed fee cap level through the use of passive investment management. There are also views that, if providers are able to provide active investment management at that fee level, and are satisfied that they can achieve better returns by so doing, then they should not be prevented from seeking to do so.

18. The Government and the MPFA, therefore, do not consider it necessary to mandate that the DIS should only use passive management strategies.

19. It is important, however, that any resultant under-performance is transparent, vigilantly reviewed by scheme trustees, and subject to any necessary remedial action by trustees, such as reverting to passive management.

**Timetable**

20. The Government plans to submit the enabling legislative amendments to the Legislative Council by the end of 2015. Subject to the progress of the legislative
process and the preparatory work, the DIS is expected to be introduced by the end of 2016. In the meantime, the MPFA will continue to work with the industry on developing its details.

21. Standardizing the default arrangements of all MPF schemes and imposing a fee control on those funds via legislative amendments is an important policy reform that may fundamentally affect the way that MPF members think about investment decision-making.

22. Not only will the introduction of the DIS remove the investment decision-making burden for many scheme members, but the proposed fee cap may have its impact felt across all MPF funds, affecting fee levels of all funds and bolstering market competition by creating an opportunity for new, cost-efficient entrants.