Providing Better Investment Solutions for MPF Members

Consultation Conclusions

Financial Services and the Treasury Bureau
www.fstb.gov.hk

Mandatory Provident Fund Schemes Authority
www.mpfa.org.hk

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Table of Contents

I. Introduction

1. The Financial Services and the Treasury Bureau of the Government of the Hong Kong Special Administrative Region ("Government") and the Mandatory Provident Funds Schemes Authority ("MPFA") jointly issued the Consultation Paper, "Providing better investment solutions for MPF members" on 24 June 2014. The Consultation Paper proposed strategies and invited comments on issues including the use of a core fund based on standardized default funds; the investment approach of the default fund as a long-term retirement saving product, the level of fees and charges, member accessibility to the core/default fund and related transitional arrangements. Twelve questions were posed in the Consultation Paper to seek views. The consultation period ended on 30 September 2014.

2. The Consultation Paper invited comments on the following questions:

Q1. the direction of introducing a core fund in the manner set out in paragraph 36 (a) to (d) of the Consultation Paper, namely, (a) the core fund will be based on standardized default fund; (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; (c) the core fund should be good value; and (d) the core fund is available to all MPF scheme members to choose;

Q2. whether the default fund should be substantially the same in all MPF schemes;

Q3. whether it is appropriate that the core fund be based on a standardized default fund;

Q4. whether the appropriate investment approach of the core fund is one that automatically reduces risk over time as the member gets closer to age 65;

Q5. preliminary views on the technical issues set out in paragraph 48 of the Consultation Paper, 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;

Q6. whether keeping total fee impact for the core fund at or under 0.75% is a reasonable initial approach;

Q7. whether keeping total expense impact (i.e. fund expense ratio ("FER")) for the core fund at or under 1.0% over the medium term is a reasonable approach;

Q8. whether passive, index-based, investment strategies should be the predominant investment approach in the MPF core fund;

Q9. particular asset classes which would not appropriately be invested on a passive, index-based approach;

Q10. whether the name of the core fund should be standardized across schemes and preference, if any;

Q11. the general principle for dealing with implementation and transitional issues as set out in paragraphs 78 and 79 of the Consultation Paper; and

Q12. the proposal in paragraph 81 of the Consultation Paper as to how to deal with the transition for existing MPF members of default funds.

3. We received a total of 266 written responses, of which 146 were sent online, 26 by mail, 23 by fax and 71 by email, from members of the public, including employees and employers, approved MPF trustees, investment management companies, insurance companies, industry associations, fund rating agencies, consultants, labour unions and employer associations, political parties, organizations from the social service sector, other market participants and stakeholders. The list of the 12 Questions is attached at Annex A. A list of the respondents is attached at Annex B.

4. During the consultation period, we arranged meetings and fora to gather views from a wide range of interested parties and key stakeholders on the proposed reform strategies as set out in the Consultation Paper. Over 2900 people attended these meetings and fora. Comments made, and views expressed, at those meetings have been considered in developing the proposals set out below.

Summary of views and comments

5. Details of comments received and our responses to specific issues are set out under Part II below. In broad terms, the majority of respondents indicated overall support for the proposals as set out in the Consultation Paper. The majority of respondents supported the proposal that the core/default fund should be substantially the same in all MPF schemes and the proposed fee control. They generally agreed that the core fund would help address concerns about fees and investment performance, and alleviate the difficulties that MPF members faced in making investment choices between a large number of constituent funds ("CFs"). Respondents generally accepted that a core fund based on a standardized default strategy across all MPF schemes would create the potential for attaining economies of scale which could drive down costs, improve returns, remove performance discrepancies between the default funds in different MPF schemes, create competition and provide a benchmark for other MPF funds. There were, however, a diversity of views on some issues, particularly as to the details of how such core funds should be invested, how they should be described and how they could best be structured in order to best achieve operational scale and efficiency.

Conclusions and way forward

6. Responses to individual issues and points raised are included within the detailed summary in Part II. In the light of the comments received, the following

specific directions are proposed:

a. The default investment strategy in each MPF scheme should be based on the same investment approach;

b. The default investment strategy should apply to any contributions or accrued benefits in an MPF scheme for which :

   i. a member does not, or has not, indicated a specific choice of CFs, or

   ii. a member specifically chooses to invest in that manner;

c. The default investment strategy should be designed to reduce investment risks as a member approaches age 65;

d. The default investment strategy will likely reduce investment risks by adjusting a member's accrued benefits and contributions in two or more CFs in each scheme. The main CF used for this purpose may be referred to as the "Core" CF in the scheme and may invest into common underlying investment funds;

e. Management fees of the default investment strategy should not exceed 0.75% of assets per annum. We will keep in view room for further reduction of this fee level upon the implementation of the fee control mechanism; and

f. To encourage a standardized approach, trustees should report performance outcomes of CFs used in the default investment strategy in each scheme against an agreed industry benchmark portfolio and facilities will be made available by the MPFA for the public to compare investment performance across schemes and as against the benchmark on a regular basis.

7. The MPFA has started more detailed discussions with the Government and the industry on how to take the proposals forward. The design and structure of the default investment strategy and the resultant core funds will take more time to finalize. However, based on the comments received from the consultation, research from the Organisation of Economic Co-operation and Development ("OECD") commissioned by the MPFA, further benchmarking of practices in Hong Kong and abroad and subsequent discussions with the industry, the general investment / product approach would be as follows:

a. The default investment strategy should be designed to reduce investment risks as a member approaches age 65 by adjusting allocation between or across a small number of CFs (e.g. a "Core Accumulation Fund" and another lower risk CF) in each scheme;

b. The investment strategy for the contributions and accrued benefits of members who are under 50 years of age should be targeted at an exposure of around 60% to higher risk assets (predominantly in global equities) ;

c. The investment strategy for the contributions and accrued benefits of members who are 50 to 65 years of age should be regularly adjusted to steadily reduce exposure to higher risk assets. The target exposure to higher risk assets, at and after age 65, should be 20%;

d. To accommodate inevitable market volatility and to allow some small degree of investment discretion, providers would have a buffer of plus or minus 5% from the percentages indicated above; and

e. While the industry should not be mandated to adopt passive management, the fee cap, the small size of the asset allocation buffers, as well as the application processes, disclosure and benchmarking will likely drive them towards adopting such an approach.

8. The Government targets to introduce any necessary legislative amendments into the Legislative Council within 2015. Subject to completing the necessary legislative process and the preparation work, it is anticipated that the standardized default investment strategy could be introduced by the end of 2016.

9. We appreciate the responses received and would like to thank all who have participated in the discussion and provided their thoughtful comments.

10. This Paper, the individual submissions and the original Consultation Paper can be viewed on the website of the MPFA at www.mpfa.org.hk under "Information Centre".

II. Summary of comments received and the Government's and MPFA's responses

11. A summary of the comments received from the submissions is set out below. Percentage figures relate to the percentage of written responses of those respondents who answered the specific questions referred to (i.e. not including those made at meetings). Such figures should be treated as general indicators only, as in many submissions, the position expressed is a matter of interpretation and in others, the indication of "yes" or "no" is heavily qualified and in some cases self-contradicting.

II.1 General direction (Q1, Q2, Q3)

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

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

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

Comments received

12. The majority of respondents (Q1: 81.4%) supported the general direction of the proposals. The majority of respondents (Q2: 74.2%) supported the proposal that the default fund should be substantially the same in all MPF schemes and (Q3: 71.2%) agreed that the core fund should be based on a standardized default fund. They generally agreed that the core fund concept would help address concerns about fees and investment performance and alleviate the difficulties that members faced in making investment choices between a large number of CFs. Respondents generally preferred a standardized default fund across all MPF schemes as it would create the potential for driving down costs, attaining economies of scale, improving returns, removing performance discrepancies between the default funds in different MPF schemes, creating competition and providing a benchmark for other MPF funds.

13. Non-industry respondents were particularly supportive of the direction of the proposals, as reflected in the views from employers, unions and social service organizations. They believed that the proposals would bring potential benefits such as reduced fees and improved performance from economies of scale, and relieve those scheme members who did not want to make an investment choice from the need to do so.

14. Industry respondents widely supported the broad direction of improving the default investment arrangement for MPF members and some alignment of the investment approach. Many industry associations, including the Hong Kong Investment Funds Association, the Hong Kong Trustees' Association, the Hong Kong Retirement Schemes Association, the Hong Kong Federation of Insurers and individual service providers, however, expressed different views on the detailed arrangements, including the need for introducing a "core" fund or the degree of standardization for the default arrangement. Many organizations had reservations about using the name "core fund" (discussed further below under Q10), which they considered might be misleading or create the impression that the core fund was superior to other CFs in the system. A number of them preferred the name "default arrangement" or its derivation.

15. On the extent and scope of standardization, the MPF industry, some investment managers and non-industry players considered that the scope and extent of standardization should be more clearly defined. A few non-industry respondents were concerned with the cost involved in setting up the core fund. Industry associations suggested that, to foster competition among providers, investment managers and other service providers should be given the flexibility to come up with their own default investment arrangements for individual schemes, so long as any guidelines that were not too restrictive were complied with. A number of industry respondents also called for the standardization to be applied only to a few factors, such as the name, the glide path and the headline fees, with diversity allowed in respect of other factors such as administration processes, investment strategies and outcomes. A few submissions

commented that a high degree of homogeneity among default/core funds in all MPF schemes would give rise to "systemic risk" or "concentration risk" (through its impact on the MPF system if all default members were invested into a single fund) and would stifle innovation. Some investment managers, especially those offering a range of passively managed index funds, however, disagreed with the broader industry direction and indicated their support both for the core fund initiative and for a high degree of standardization.

16. Respondents, both for and against the core fund proposal, stressed the need to enhance investor education to MPF members. A few respondents went further to suggest that the core fund and the concept of standardization would have an adverse effect on, or would stand against, the effort to educate the public on their responsibility for investment and retirement planning.

Response

17. There is general support shown in the responses to the consultation for introducing a standardized default investment strategy that is substantially the same in all MPF schemes. We note concerns and questions about the extent to which the default/core funds should be substantially the same in each scheme. We believe that, for the reasons explained in the Consultation Paper[1], it is important that those who have not made investment choices should not be subject to materially different outcomes in different schemes. The default investment strategy in each scheme should therefore adopt the same investment approach, involving broadly the same exposure to higher risk assets although allowing for some degree of flexibility within which investment managers could deviate from the standard approach (see further discussion under Q5 below). We share the view that product providers should have some flexibility as to how they deliver a common investment approach and this issue is discussed further under II.7 below.

18. It is recognized, however, that even within such levels of standardized approach, investment outcomes will not be absolutely identical across schemes; differences will arise due to many factors including different securities selection, timing, cash-flows and cost/scale impacts. It is therefore important that the investment performance of core funds making up the default investment strategy is benchmarked against an agreed industry standard and each other.

19. In relation to comments that members should be responsible for their own decision-making, we would emphasise that nothing in the proposals is intended to prevent, or discourage, members who want to make an investment choice from doing so. We do, however, consider it critical that the many members who do not want to, or do

[1] See paragraphs 37 to 40 of the Consultation Paper

not have the time or skills necessary to make an investment decision, are best protected by the development of better solutions than those existing at the moment.

II.2 Automatic de-risking and technical issues (Q4, Q5)

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?
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?

Comments received

20. 70.7% of respondents to Q4 agreed that automatic de-risking would be the right approach for the core fund. Those who were not in favour of de-risking believed that members should be responsible for managing their own investments, some had concerns about fund proliferation if target date funds were used (as new funds would have to be launched from time to time), and some preferred investing in either some conservative investments or the Tracker Fund rather than using the mixed assets investment approach proposed. Underlying investments could include global bonds and global equities, managed actively or passively.

21. The majority of respondents agreed that reducing equity exposure when members approached retirement age would be beneficial to them. Several investment managers provided suggestions on how to better manage the process of de-risking, such as adopting a “central glide path” around which individual service providers would have the flexibility to adjust exposure to equities. The returns from investing into the hypothetical central glide path could also serve as a benchmark for core funds of all MPF schemes. Other respondents advocated using a target volatility glide path where the expected volatility at each “step-down” age would be calculated at that point in time to determine the appropriate mix of equity/bond, and maintaining a significant equity exposure after retirement age. Some respondents suggested de-risking should continue after retirement. An asset consultant proposed that “smart beta” strategies could be considered, because typical passive mandates assume market capitalization was good, which was not always the case. Many others considered that these types of issues should just be left to providers to decide.

22. While it was generally agreed that automatic de-risking was an appropriate approach, many industry participants and non-industry groups cautioned against adopting age as the sole factor for the de-risking process. It was suggested that other criteria and individual circumstances, such as risk tolerance, current balance of accrued

benefits, expected future income, etc., should be factored in as well.

23. A few respondents were of the view that de-risking might not serve the best interests of some people and might not be the right approach for the core fund. For example, if a member incurred losses from an equity position immediately before the de-risking process, the member would lose out on the chance to benefit from a market rebound in respect of the equity position that had been sold off.

24. On the technical issues raised for discussion in Q5, there was some consensus on the number of funds required if a target date approach were to be adopted. Most respondents considered that one fund every five years would be sufficient, though some proposed a period as long as ten years.

25. Whilst numerous industry submissions provided a view on this point, there was no agreement on whether to adopt a target date fund approach or a life cycle approach[2]. Advocates of a target date fund approach claimed that such funds were easier to understand and to compare, and changes could be more quickly implemented in a volatile market. On the other hand, some respondents preferred the life cycle approach because of its cost effectiveness, as fund launches and closures would be kept to a minimum. Non-industry and trustee respondents generally did not have a view on the age at which de-risking should commence. Investment managers generally believed that this should be left to service providers to decide within any prescribed limits.

26. On the issue of the number of providers for the core fund and the degree of discretion afforded to individual product providers, respondents to the public consultation, Legislative Council members, and labour unions generally preferred more government involvement, which is discussed further, under II.8 below.

27. Opinions of the academics and the professionals varied somewhat. Some agreed that de-risking could help members avoid the risk of making wrong asset allocation decisions, while others said factors other than age, including market or general economic factors, might need to be considered. A number of academics and practitioners also suggested that a life cycle investment strategy might lack investment flexibility and might not be able to respond to sudden market changes.

Response

28. We note that there is general support for the proposal that the appropriate

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[2] See Box 2 on page 20 of the Consultation Paper for what is meant by “Target Date” and “Life Style/Life Cycle” in this context.

investment approach of the core fund is a balanced approach that automatically reduces risk over time as the member gets closer to age 65.

29. **Automatic risk reduction**: The vast majority of respondents supported the proposal that the core fund should automatically reduce risk over time. We note that this also, increasingly, reflects industry practice both in Hong Kong and key international retirement savings markets such as the United States ("US"), the United Kingdom and Australia. The OECD Research commissioned by the MPFA also supports this approach as it is best suited to protecting members from extremely adverse investment shocks close to retirement.

30. **Age-based vs other factors**: Some respondents suggested that risk reduction should not be based on age alone and referred to emerging practices of reliance on other additional factors such as risk tolerance, balance of accrued benefits, expected future income, etc. Whilst we agree that such factors may be relevant in better tailoring the investment approach to individual needs, we are concerned that it would be difficult to adopt such approach at this initial phase. Incorporating other factors into asset allocation processes for individual members will require much more information collection and system development. We also note that the appropriate investment strategy arising from such factors is still emerging. We do, however, agree that any new default investment strategies should be developed in a way that is capable of incorporating such development in the future.

31. **Balanced approach vs single asset class**: While most respondents supported a balanced approach that used a combination of equity and fixed interest securities, we note that a few comments suggested substantially different (and, in many cases, contradictory) investment approaches such as investment into cash or the HK Tracker Fund. The OECD Research commissioned by the MPFA supports the preliminary thinking that investment in 100% equities, such as the HK Tracker Fund, would not be optimal as it would expose holders to too much outcome uncertainty[3]. Reducing outcome uncertainty must be considered to be a key objective of a well-designed default investment strategy that is principally designed to protect the interests of those members who do not, or do not want to, make an investment decision. The contrasting position of investing only in cash is also considered to be sub-optimal. Whilst such an approach would reduce outcome uncertainty, it would do so at a high cost, in that likely returns would be lower across almost all probability distributions[4].

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[3] The research indicates that whilst an all Hong Kong equity approach might produce higher median outcomes, at the 10th percentile probability distribution, such an approach would produce only 50.2% of what a balanced (50% equity/50% bond) approach would achieve.

[4] For example at 10th percentile distribution, an all cash portfolio would return only 73.7% of what a balanced approach (50% equity/50% bond) would likely achieve and at 50th percentile distribution (median), an all cash portfolio would return only 72.3% of what a balanced approach (50% equity/50% bond) would likely achieve.

32. **Target date vs life cycle**: The divergent views and finely balanced pros and cons regarding whether to adopt a target-date or life cycle approach are noted. Whilst we do not have strong views as to which approach is preferable, we are of the view that all schemes should adopt the same approach, otherwise it will be very difficult to make valid comparison and benchmarking analysis across schemes. On balance, subject to further discussion with the industry on implementation issues, we propose that a life cycle approach should be adopted, using as few CFs as possible. Such an approach can be developed without excessive upfront investment, will be able to be based on existing CFs in some cases, will not require the regular addition of new CFs, will be highly comparable across schemes, will be able to produce reasonably consistent outcomes across schemes and will be capable of refinements to investment approach as investment and allocation strategies develop.

33. Based on the findings from the OECD Research, comments received from the consultation and discussion with industry providers, we propose that the default investment strategy should adopt a balanced, mixed asset, globally diversified investment strategy which will automatically reduce risk as a member approaches age 65. Incorporating suggestions received in the consultation, the central glide path should allow for asset allocations to be managed and varied within a designated band around the central agreed value.

34. A number of detailed aspects of design, the frequency of rebalancing when reducing risk and the mechanisms for so doing will be further developed in consultation with the industry.

II.3 Fee controls (Q6, Q7)

Q6.	Do you agree that keeping total fee impact for the core fund at or under 0.75% is a reasonable initial approach?
Q7.	Do you agree that keeping total expense impact (i.e. a fund expense ratio (FER)) for the core fund at or under 1.0% over the medium term is a reasonable approach?

Comments received

35. More than half of the respondents (Fee: 63.2%, FER: 60.5%) agreed that a fee level of 0.75% and a fund expense ratio (FER) of 1.0% for the core fund would be a reasonable initial approach. Many non-industry respondents considered that the proposed fee and FER levels to be a marked improvement from current levels, would improve returns and exert pressure on service providers to cut fees on other MPF funds. Some advocated even lower fee levels, and were of the view that there was room for further reduction in existing management fees. Some suggested that fees should be based on investment performance, but noted that fees and performance might not be

positively related.

36. Investment managers and trustees were, however, almost unanimous in their opposition to the proposed fee and FER levels, often citing the 2012 Ernst & Young report in which it was stated that the cost of administration alone was 0.75%. They claimed that the proposed reduction was too much and would have the detrimental effects of lowering incentives to improve services and engage in product innovation. The trustees of the industry schemes mentioned that the extra administration associated with those schemes made it even more difficult to meet the proposed cap. Some respondents pointed out that fee levels at around 0.75% was lower than the average fees of MySuper funds in Australia (which have a relative scale advantage compared to MPF funds). Other respondents considered the proposed fee level higher than the average fee level of target date funds in the US.

Response

37. Non-industry respondents generally welcomed the proposed levels, with some of them expecting even lower levels. The industry opposed the proposal in general and considered it difficult to meet the proposed fee and FER levels.

38. We believe that the fee levels proposed are a reasonable starting point, having regard to the costs of operation of the MPF system, overseas experience and the aspirations of many respondents. We are also mindful of the differences between the MPF system and other retirement savings systems (e.g. contribution rate, asset size, maturity etc), and so would be cautious about making comparisons between the fee levels of different systems. Whilst the proposed levels are ambitious, we do not consider them impossible for the industry to meet. We consider that a challenging target is necessary to help address the concerns and aspirations that the wider community has for the MPF system. Such a 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 structure and fund design. In view of the above, we propose to implement the fee control arrangement of keeping total management fee impact for the default arrangement at or under 0.75% of asset value per annum as an initial approach that can be reviewed, and lowered over time as necessary. With the introduction of the fee control, we expect that the FER for the CFs used in the default investment strategy will decrease to at or under 1.0% over the medium term (e.g. three years after implementation). We will monitor the consequential FER levels over the medium term. We are developing the details of how the fee levels should be measured and calculated in consultation with the industry.

II.4 Passive, index-based investment strategies and asset classes that would not be invested on a passive, index-based approach (Q8, Q9)

Q8.	Do you agree that passive, index-based, investment strategies should be the predominant investment approach in the MPF core fund?
Q9.	Are there particular asset classes which you think would not appropriately be invested on a passive, index-based approach?

Comments received

39. The majority of respondents to the Consultation Paper (Q8: 66.8%) were in favour of a passive, index-based approach to investment for the core fund. They cited reasons such as lower fees and costs, higher returns and the possibility index funds achieving reduced volatility and better performance. On the other hand, some were critical of this approach as they were concerned that the strategy might not generate adequate returns for members, that returns from index funds might be affected by the weak performance of a few 'heavy-weight' constituents, and that fund innovation might be discouraged. Others believed that actively managed funds would provide more flexibility for fund managers to adjust their portfolio in response to market factors.

40. Many respondents proposed different types of investments as underlying investments for the core fund in response to Q9, as follows:

a. *Tracker Fund* – A number of respondents suggested this due to its low fee and good performance.

b. *iBond and inflation-linked return* – Some respondents suggested iBonds to be issued by the Government on a monthly basis to match monthly MPF contributions. Others wanted the returns of the core fund to be inflation-linked, though they did not mention what types of products should be invested in to achieve this. Other products and strategies to hedge against inflation e.g. Treasury Inflation-Protected Securities (TIPS) with returns rising and falling with inflation rates were also suggested.

c. *Guaranteed return* – Favoured by some respondents.

d. *Saving deposits* – Some respondents favoured this believing there would be no charges.

e. *Returns linked to government funds* – One respondent suggested that the return of the core fund should be linked to those of government-run funds, such as the Innovation and Technology Fund. There was no suggestion on the products that should be invested in to achieve this return.

f. *Managed in a similar way to foreign retirement funds* – One respondent suggested the passive, index-based fund should adopt a strategy similar to those for the sovereign funds and retirement funds of Norway and Canada. The equity-bond ratio should be kept at 60:40, passively replicating a global index, with rebalancing from time to time to maintain this equity to bond ratio.

41. Some respondents suggested that items such as bonds, treasury bills, index tracking funds, bond index funds, speculative derivatives, currencies and commodities, property and Real Estate Investment Trusts (“REITs”) should not be used as underlying investments. A few respondents mentioned that equity should not be passively invested while one did not want any investments that were not socially responsible, such as casinos, tobacco companies, and companies with poor human and labour rights records.

42. Many industry respondents did not positively identify with a passive, index-based approach as the predominant approach for the core fund. Most trustees believed that while a passive, index-based approach had its place in the core fund, the investment decision on whether to invest actively or passively should be made by investment managers. Many investment managers believed that active management should be used in the core fund as they believed passive management might not outperform active management. Some also pointed out that there might not be enough approved Index-Tracking Collective Investment Schemes to fully meet the needs of the core fund.

43. Investment managers currently providing passive index funds, however, were in favour of a passive, index-based investment approach for the core fund. They maintained that a low-fee passive index fund would help achieve the objectives of fee reduction. They were also confident of achieving the stated fee control levels.

44. A few submissions from groups with specific interests recommended allowing REITs and private equity as underlying investments for the core fund, believing that these investments would enhance diversification and improve returns for the core fund.

Response

45. Whilst there was majority support for using a passive investment approach for the default investment arrangement, some preferred to use, in full or in part, an active approach, or leave the decision to the industry and service providers. Notwithstanding submissions made to the contrary, we are not convinced that passive management will necessarily produce inferior returns. The research referred to in the Consultation Paper[5] found that actively-managed MPF funds had not delivered better returns than passively-managed ones. Nevertheless, having considered the views received, we do not consider it necessary to mandate that the core funds should only use

[5] See paragraph 70 of the Consultation Paper

passive management strategies. Given the fee cap proposed, industry members have advised us that generally it will only be possible to meet this through the use of passive investment management. If some managers are able to provide active investment management within that fee level, and they and the product provider are satisfied that they can achieve better returns from so doing (and can produce evidence of such in relevant applications to the MPFA), then they should not be prevented from seeking to do so. 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 like reverting to passive management.

46. In relation to appropriate underlying investments for the default investment strategy, some comments are already set out above (in paragraph 32) regarding the investment approach of the core fund. The proposed direction is that the default investment approach should adopt a balanced, mixed assets, globally diversified investment strategy which should automatically reduce risk as a member approaches age 65. Whilst not containing any guarantee as to returns, such an approach will minimize the scope for negative outcomes for members. Individual providers should have flexibility as to what underlying investments or pooled funds they can use in meeting the prescribed approach. Some of the asset classes or strategies mentioned in paragraph 40 above may be adopted by some providers; however, we do not consider it necessary to mandate such investment.

II.5 Name of core fund (Q10)

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?

Comments received

47. A majority of respondents (Q10: 80.2%) agreed that the name should be standardized across schemes. This would help facilitate easy communication with members and would ensure transparency and fair marketing practices. Of the five names suggested in the Consultation Paper, most people chose either “MPF Core Fund” (38.5% of those who indicated a preferred name) or “MPF Default Investment Fund” (34.9% of those who indicated a preferred name). Industry submissions were strongly against using the name “Core Fund”. Many industry respondents expressed concern that the name “MPF Core Fund” might create high expectations for the fund or make people believe that it was the best choice, leading them to overlook other fund choices. Some preferred “MPF Default Investment Fund” to emphasize its nature as a fund for members who did not make investment choices. They also made the point that core fund (singular) could not be used as the likely solution will involve multiple CFs.

Response

48. Based on the comments received, we propose that the default investment arrangement for MPF schemes will adopt a standardized name. We note that there was some confusion expressed regarding terminology and names, particularly as regards the terms “core” and “default” fund. As stated in the Consultation Paper, the proposal was that the “core fund will be based on standardized default funds”[6]. Design questions were therefore focused on what an appropriate default investment strategy should be. The term “core fund” was only intended to reflect the importance of the new default investment strategy for the MPF system. The term “core fund” was not intended to suggest that the preferred default investment strategy would be a single fund[7] as it was always considered likely that the preferred investment strategy would involve multiple funds given that a single fund could not adjust risk for different members.

49. Going forward, we propose to use the term “default investment strategy” in describing the investment approach that will be designed for this purpose. Within the default investment strategy in each scheme, the trustee may use two or more CFs (see paragraphs 6 and 7 above) to reduce risk over time. One or more of those CFs may use the term “core” within its fund name (e.g. the “Core Accumulation Fund”) reflecting its key role within the default investment strategy and the broader MPF system.

50. Accordingly, we will proceed with the proposals on the basis that the standardized approach to investment of contributions and accrued benefits for which no choice of CFs has been made will be referred to, for development purposes, as the “default investment strategy”. Further consideration can be given to how this is described to members once the final form and design of the investment approach are finalized. The names of the CFs used under the default investment strategy will adopt common naming conventions as illustrated in the paragraph above. Properly explained, the above approach should not leave scheme members with any misunderstanding as to the nature of any CF described as “core” funds.

II.6 Implementation and transitional arrangements (Q11, Q12)

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

6 Paragraph 36a of the Consultation Paper

7 See footnote 17 of the Consultation Paper

Comments received

51. A majority of respondents (Q11: 74.4%, Q12: 72.5%) agreed with the general principles for implementation and transitional issues (including the method for handling the transitional process if the trustee could not identify which members were invested in the existing fund by default). Some respondents said that these issues should be clearly communicated to members and members should be reminded of the opportunity to switch to the new core fund. Those who disagreed with the proposed approach had a few concerns. Some thought that the automatic transfer of benefits should only apply to contributions of new members, and not to the accrued benefits of existing members, because of the risk involved and the investment gain or loss that would be realized in an automatic transfer. Some suggested the new core fund should apply only to future investments. One was concerned about confusing members and another was concerned about using a huge amount of paper for notices. Another liked to see that a fresh decision could be made by all members so that disputes could be avoided. Numerous industry submissions suggested the need for clear legislative support to deal with trustee powers and liabilities. A few suggested that the MPFA, the Government, or a new provider should handle the implementation and transition.

52. Many industry and non-industry groups who submitted detailed written submissions had reservations about the proposed implementation and transition arrangements, especially those in relation to the treatment of existing accrued benefits. Concerns included the amount of transactions that might be required to be completed in a single day, the potential loss of guarantee if the existing investments were in a guaranteed fund, uncertainty regarding the legal status of a transfer without member consent, and the adverse impact on fund price for members who remained in the existing fund.

Response

53. In view of the comments received during the consultation, we will proceed in the general direction proposed in paragraphs 79 and 81 of the Consultation Paper, as summarized below. Noting concerns about requiring many transfers to be done on a single day, we will allow trustees timing flexibility, within a reasonable period after implementation (e.g. 12-24 months) within which to complete any necessary transitional transfers. We also agree that further thought should be given to whether transitional transfers should occur where the trustee of the relevant scheme believes that the relevant member has not yet satisfied any conditions relating to a guarantee. Subject to further discussion and advice about details and timing, this direction would have the following impacts on different categories of members:

a. all existing members of all schemes will be advised, in advance of implementation, of the new default investment strategy. They will be invited to consider whether they wish to review their existing choice of CFs and notified that if they are an existing default investor they will subsequently receive a further notice advising them of how their existing accrued benefits will be affected;

b. for members who join a scheme after the implementation date, all contributions will be invested in accordance with the new default investment strategy, unless or until, the member makes an alternate choice of CFs;

c. for existing members of a scheme who have never made a choice of CFs, any <u>contributions</u> made after implementation of the new arrangement will be invested in accordance with the new default investment strategy unless or until the member makes an alternate choice of CFs; and

d. for existing members of a scheme who have never made a choice of CFs in relation to existing <u>accrued benefits</u>, these benefits will, after adequate notice and opportunity to make a choice of CFs, be invested into the default investment strategy.

54. We will further discuss with the industry issues about whether, and if so how, some investments into guaranteed funds should be exempted from transitional transfer. We will also discuss whether there are other categories of member or investments that should be treated similarly.

55. In relation to concerns about whether trustees need legal protection for making transitional transfers, we will seek advice as to whether this is necessary. If considered necessary, we will propose relevant legislative provisions to give trustees the necessary powers and legal protection for acting in accordance with such requirements.

Other issues raised during the consultation

II.7 Structural options

Comments received

56. Despite not being a topic set out in the Consultation Paper, respondents also expressed different views on the possible structural design of the default investment strategy. There were views, mostly from non-fund-industry commentators that there should be a single core fund, or only a few core funds. Some also expressed a wish for more government involvement, although they did not comment on the detailed structural arrangement. There were also comments that the pooling of assets could help bring down fees and achieve economies of scale. On the other hand, some respondents who supported the establishment of a default investment strategy in individual schemes, considered that a common core fund adopted by all schemes would not be desirable as it would create concentration risks. Respondents from the industry were generally in favour of being given the flexibility to incorporate any new requirements about the default investment strategy into their own existing schemes or managed by existing managers, thereby reducing transitional complexity and costs. An industry organization believed that the Government should adhere to its role as the regulating

body rather than set investment requirements.

Response

57. The existing MPF system is a scheme-based system under which contributions are paid into a scheme (chosen by an employer or self-employed person) and invested into one or more CFs in that scheme[8]. The issue about default investment is what rules should apply about how to invest contributions received into that scheme when no instructions have been received from the relevant member. Each scheme needs, and does already have, rules dealing with this question. The proposal, as set out in paragraphs 6 and 7 above, is that, for the first time, these rules should be standardized across MPF schemes. The concept of a "single" default fund, or series of funds across all schemes, is a quite different concept, suggesting the need to identify default contributions and transfer them (either by employers or trustees) from the scheme into which they were paid, to the "central" default scheme and CF. Such a process would create substantial transactional activity each month and create much complexity around issues such as reporting, fees and transfers on subsequent choice under existing MPF structures. Existing infrastructure could not support such a process and it would take substantial time and cost to build any such infrastructure. The establishment costs will be higher and will not be conducive to fee reduction.

58. Individual respondents and organizations representing labour interests considered that there was an imminent need to introduce reform to the existing system to drive down management fees, such that the accrued benefits of scheme members could be better protected. Many of them considered that an earlier implementation of the proposals would be necessary. In view of the above, it appears that establishing a default investment strategy based on the existing framework of MPF schemes would be a more cost and time-effective solution.

59. Another way of achieving some level of centralization would be for all CFs used as defaults in each scheme to be required to invest into common underlying investment pools. Such an approach may be more closely aligned with the current MPF system but will require more regulatory control and will take substantially longer to implement. We note the concerns expressed by some about concentration of operational risks under such an approach.

60. In any event, given that efficiency will be driven by the fee cap of 0.75%, we do not see the need to mandate the use of particular underlying investment pools at this stage. Providers will, because of the fee cap, be forced to seek out efficient and low cost investment solutions. Some, perhaps many, will find it necessary to invest through common underlying investment pools (including, for instance, readily available

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[8] See paragraphs 13 and 14 of the Consultation Paper for more details about existing MPF structure.

index funds) and the MPFA will facilitate this process to the extent possible. Other providers, who can show that it is in members' interests to do so, may be able to use purpose-built investment pools if they can do so within the constraints of the fee cap.

61. If, in the medium term, having regard to the impact of implementing the proposals in this paper, stakeholders are still enthusiastic about further centralization, consideration can be given as to whether it is cost-efficient to build the necessary supporting infrastructure. At this stage, we are of the view that development and implementation should proceed forthwith and subsequent enhancements may be introduced if considered necessary over time.

II.8 Role of the Government and its involvement

Comments received

62. A number of respondents from the industry and intermediary representatives and bodies considered that existing trustees, which possessed professional knowledge, should operate and manage the core fund in the privately-managed MPF system. Some of these respondents considered that the costs of setting this up should not be funded by the public coffer. On the other hand, a number of individual respondents and representatives of labour unions and from the social service organizations preferred a core fund, or elements of it, operated or managed by the Government, the Hong Kong Monetary Authority ("HKMA"), or by a public trustee. They believed that this suggestion could help drive down fees and introduce more competition among existing MPF funds, on the assumption that trustees might not have incentive to improve fund performance.

Response

63. The Government has reiterated on many occasions that the MPF system is established as a privately-run, second pillar system in accordance with principles of the World Bank. The design of the MPF System is to require the working population and their employers to make mandatory contributions to assist the former to save for their retirement well in advance, such that public resources can be focused on assisting those in need. The HKMA should not be involved in running or investing any element of the MPF system as it has no experience/expertise in running or administering an individual account savings scheme. The investment management of the Exchange Fund, which was mentioned by some, is quite different from managing retirement savings contributions. The Government also maintains the view that the core fund should be operated by the market, instead of a public trustee operated by the Government, a public organization or a non-profit organization.

III. Way forward

64. The MPFA and the Government, will take forward the directions set out in paragraphs 6 and 7 above, and will continue to discuss with the industry and technical groups on detailed aspects of the design of the default investment strategy and related transitional arrangements. The final form of any legislative amendments to the MPF legislation will be subject to the usual legislative process. The Government aims to introduce an amendment bill into the Legislative Council within 2015 with a view to introducing the new default investment strategy in 2016.

Annex A

Consultation questions

Q1.	Do you support the direction of introducing a core fund in the manner set out in paragraph 36 (a) to (d) above? ☐ Yes ☐ No Comments:
Q2.	Do you agree that the CF that is the default fund should be substantially the same in all MPF schemes? ☐ Yes ☐ No Comments:
Q3.	Do you agree that it is appropriate that the core fund be based on a standardized default fund? ☐ Yes ☐ No Comments:
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 Comments:

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?

Comments:

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

Comments:

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

Comments:

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

☐ Yes ☐ No

Comments:

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

Comments:

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)

Comments:

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 Comments:	
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 Comments:	

Annex B

List of respondents

1. Alfred
2. AllianceBernstein Hong Kong Limited
3. Allianz Global Investors
4. AMP Capital
5. Arris Partners Ltd.
6. Asia Pacific Real Estate Association
7. Audrey Hui
8. Bank Consortium Trust Company Limited and Bank of East Asia (Trustees) Limited
9. Bank of Communications Trustee Limited
10. BCT Group (BCT Financial Ltd / Bank Consortium Trust Co)
11. BOCI-Prudential Trustee Limited
12. Business and Professionals Alliance for Hong Kong
13. Caritas Family Crisis Line and Education Centre
14. Central and Western District Council (Cultural, Leisure & Social Affairs Committee)
15. Chan Kam Chung
16. Chan Kwun
17. Chik Chiu Ming
18. Chin Yue Sang
19. Chinese Academy of Governance (HK) Industrial and Commercial Professionals Alumni Association
20. Chiu Sai Chung Eric
21. Chui Chan Kit
22. Cititrust Limited
23. Citizens for Fair Pensions
24. Computershare Hong Kong Investor Services Limited
25. Consumer Council
26. Democratic Party
27. Dimensional Fund Advisors Pte. Ltd.
28. Employers' Federation of Hong Kong
29. Equal Opportunities Commission
30. Federation of Hong Kong Industries
31. FIL Investment Management (Hong Kong) Limited
32. Fiona
33. First State Investments (Hong Kong) Limited
34. FWD Pension Trust Limited
35. Gain Miles Assurance Consultants Limited
36. GAMAHK
37. Henry Yau, W.K. Yau
38. Ho Yan Wai
39. Hong Kong Catholic Commission For Labour Affairs
40. Hong Kong Confederation of Trade Unions

41. Hong Kong Financial Planner General Union
42. Hong Kong Investment Funds Association
43. Hong Kong Professionals and Senior Executives Association
44. Hong Kong Trustees' Association
45. Hong Kong Women Professionals & Entrepreneurs Association
46. HSBC Provident Fund Trustee (Hong Kong) Limited and HSBC Institutional Trust Services (Asia) Limited
47. ICI Global
48. Icy Cheung
49. Inland Revenue Department
50. Institute of Financial Planners of Hong Kong
51. Invesco Hong Kong Limited
52. Jardine Lloyd Thompson Limited
53. Jason Cheng
54. Jonathan Tang
55. Lam SY
56. Lee Shunwai
57. Life Underwriters Association of Hong Kong Ltd.
58. M Chan
59. Marc
60. Mercer Investments (HK) Limited
61. Michelle Chau
62. Mok Ka-man Harrison
63. Morningstar Investment Management Asia Limited
64. MPF Ratings Limited
65. Mr Au
66. Mr Cheng
67. Mr Ho
68. Mr Kwok
69. Mr Kwok Tat Po
70. MSCI
71. New Century Forum
72. New People's Party
73. Noble Apex Advisors Limited (Submission 1)
74. Noble Apex Advisors Limited (Submission 2)
75. Northern Trust
76. Patrick Leung
77. Peter H.Y. Wong
78. Principal Hong Kong
79. Rizwan khan
80. Sivler Lam
81. State Street Global Advisors Asia Ltd.
82. State Street's Global Services and Markets
83. Stephen Wong
84. Sun Life Asset Management (HK) Limited
85. Sun Life Hong Kong Limited

86. Sun Life Trustee Company Limited
87. SY Ho
88. Tam Tsz Chun
89. Tang Yiu Chung Vincent
90. The Actuarial Society of Hong Kong
91. The Chinese General Chamber of Commerce
92. The Chinese Manufacturers' Association of Hong Kong
93. The Federation of Hong Kong & Kowloon Labour Unions
94. The Hong Kong Association of Banks
95. The Hong Kong Council of Social Service (Submission 1)
96. The Hong Kong Council of Social Service (Submission 2)
97. The Hong Kong Federation of Insurers
98. The Hong Kong Federation of Trade Unions (Kwai Tsing Service Group)
99. The Hong Kong Federation of Trade Unions Rights and Benefits Committee
100. The Hong Kong Retirement Schemes Association
101. The Hong Kong Society of Financial Analysts
102. The Hongkong and Shanghai Banking Corporation Limited
103. The Professional Commons
104. TM
105. Tom Lam
106. Towers Watson Investment Services Hong Kong Limited
107. TTW
108. Vanguard Investments Hong Kong Limited
109. Virgo
110. Yu Chi Leung
111. 小市民
112. 廢除強積金
113. 梁偉生
114. 蔡沛恒
115. 郭賀昀
116. 鍾桂強
117. 黃潔蓮
118. Respondents at Public Affairs Forum of Home Affairs Bureau
119. Anonymous respondents (148)