

Consumer Council

Submission on Providing Better Investment Solutions for MPF Members “Core Fund”

1. The Consumer Council (the Council) would like to submit views to the Financial Services and the Treasury Bureau and the Mandatory Provident Fund Schemes Authority (MPFA) regarding the consultation paper “Providing Better Investment Solutions for MPF Members” on introducing a core fund to enhance the regulation of default fund arrangements of Mandatory Provident Fund (MPF) schemes.
2. In principle, the Council welcomes and supports the introduction of a standardized, low-fee core fund as a new arrangement in the MPF system to facilitate comparisons among funds by MPF scheme members and induce price competition and thereby lower the fees in the long term.
3. The following sets out the Council’s views to keys areas that have direct implications to the interests of consumers/scheme members, for consideration of MPFA.

CORE FUND

4. The current default arrangement, as stated in the consultation paper, which the contributions of scheme members who do not make an investment choice are now invested in the default funds of trustees is not ideal due to a wide variation in risks and returns of these funds.
5. Having recognized this issue, the Council believes that MPF, as an important pillar of retirement savings, should offer adequate protection to scheme members, whilst a choice with standardized risk and return should be provided across MPF schemes, especially for those scheme members who have not indicated any investment choices. A standardized, low-fee core fund would better refrain scheme members from selecting uninformed choice of products with variations in investment mix and cost.
6. Furthermore, as most MPF scheme members have limited financial knowledge, the Council considers that the proposed core fund would help to simplify

complex investment decisions, which in turn may encourage higher participation rates. It is worth noting that scheme members may perceive the core fund as the endorsed choice from the Government and therefore would have a high potential in attracting scheme members and accelerate the growth in fund size.

7. For these reasons, the Council is of the view that setting an appropriate core fund is essential important to address the needs of scheme members and that a high degree of protection is required as the core fund would be effectively set for the population as a whole. The Council believes that the design of the core fund should be aimed at delivering a more stable and low risk retirement protection to all scheme members.

OPERATION OPTIONS

8. On the options of how the core fund may be introduced, there are two operation options mentioned in the MPFA's presentation materials. The options are: each MPF scheme provides its own core fund with the set requirements, or all MPF schemes use a common core fund.

9. Notwithstanding the above two options, the Council considers that there could be a number of ways as to how the core fund could be managed, such as to be provided by a single or multiple provider(s). A hybrid approach will be having a few providers to provide a common core fund with specifications stipulated by the MPFA. Other option raised in the market is to designate a public entity to operate the core fund.

10. There are pros and cons to each option. For instances, if scheme providers are allowed to establish their own core funds in their schemes, financial sustainability and low management costs may not be attained due to limited scale efficiency. In the case of a sole provider, scheme members may suffer from over-concentrated risk which could result in unexpected loss if its operation is in disruption or to the extreme, closure of business. In contrary, with a few providers, the continuity of core fund is ascertained even there is a closure of one provider as other providers exist in the market. Nevertheless, the operation of core fund would undoubtedly involve complex decision processes with multiple scheme providers and that the more complex the system is, the higher the cost will be. On the other hand, the experiences from the UK and Sweden demonstrated that a public trustee would help

lower the management costs of default fund.¹

11. The Council believes that all these options relate not only the trade but also have cost implications to scheme members as illustrated above. Competition concern should also be considered if single provider or a few providers would be selected to provide a common core fund.

12. Given the lack of information on the operation options given in the consultation paper, the Council is of the view that more details should be provided for further deliberation by the public before finalizing on which operation model should be chosen.

13. The Council urges that the Government and the MPFA, together with the trade, to put forward the selection criteria of provider(s) in future consultation process, while the Council considers the following principles, from consumer perspective, would be crucial in this subject:

(1) Ability to lower the cost: The core fund as a benchmark product to facilitate price competition, the future provider(s) should pledge to maintain the cost level be comparable to and well under other products in the MPF market.

(2) Ability to lower the risk and maintain stable return to scheme members: At present, the risk levels of default funds vary widely across schemes. For the benefits of scheme members, the Council is of the view that the future provider(s) should be capable of maintaining a stable return and to minimize the risk as far as practicable.

14. After all, which operation model to proceed with is a matter of Government policy but consideration should be given to the public concerns about cost impact to scheme members and the rising public demand for a higher degree of protection of retirement savings.

INVESTMENT STRATEGY

15. In line with the objective of the core fund to provide a long-term

¹ The current management costs of default fund of UK National Employment Saving Trusts (NEST) and Sweden Seventh National Pension Fund (AP7) are 0.30% and 0.12-0.19% respectively.

retirement saving solution designed for MPF scheme members who do not or do not want to make an investment choice, the investment approach of the core fund needs to be carefully considered.

16. As stated in the consultation paper, there is no consensus on when is the best time to adjust the risk exposure level of core fund. Since retirement age varies amongst scheme members, an inappropriate timing to adjust risk exposure level of core fund would affect the returns.

17. The Council considers adopting an investment approach that automatically reduces risk over time, as proposed in the consultation paper, may be appropriate to manage the core fund. Life-cycle or target date funds are suitable defaults as they should be appropriate for scheme members not only at the time of joining the scheme, but also throughout their careers and even during retirement.

18. Having said that the issue with these funds is that the label can be applied to a wide range of investment products, with different 'glide paths' (e.g. some ending up with a low level of equities, some still relatively high) resulting in very different investment and risk profiles. Furthermore, life-cycle funds are not without risks such as duration mismatch (when assets are sold at unsuitable timing).

19. Consideration should be given to adopt a 'dynamic' strategy that evolves beyond simple age to consider other factors when switching between assets – notably the level of the balance in the fund. A degree of flexibility could be introduced in terms of the timing and amount of assets switched so that, for example, large amounts of one asset are not sold into or just after a sharply declining market. Also if the target level of the fund has been achieved, funds can be switching into lower risk assets to ensure that balance is 'locked in'.

COST

20. Costs and fees are particularly important for MPF funds, as they reduce returns, the size of the accumulated balance and therefore the amount of retirement income which can be generated. According to a survey conducted by the Council in July 2007, an annual management charge of 1% of funds under management can reduce accumulated assets by as much as 20% (over a 40 year period), thus the impact can be substantial. This is an issue which scheme members may not aware of and therefore need protection from proper policy setting and design of the core

fund.

21. In view of that, the Council supports a cap of management fee for the core fund to minimize the cost impact on the returns of MPF but there will be concerns as to how the fee cap (an upper limit) is set and whether it is reasonable and competitive. In reference to overseas experiences, which the management fee levels of default funds are generally far below the proposed level of 0.75% by the MPFA, also with the fact that products with management fee lower than this cap are already in the market, the Council is of the view that the proposed level is very conservative. A more aggressive level should be adopted to facilitate price competition and bring more returns to scheme members. Thus, the Council urges the MPFA to further adjust the cap to a lower level to protect the interests of scheme members.

22. In medium term, the Council believes that keeping total expense impact (i.e. FER) at or under 1.0% would not be adequate. Having recognized that over 12% of MPF products with FER lower than 1.0% are found in the market, with the reduction in management fee over time, this level should be decreased as far as possible.

23. Nonetheless, the Council is also of the view that measures should be applied to ensure pricing efficiency. For instance, a review mechanism on the fee impact should be established. Such mechanism shall be conducted periodically and the factors to be considered for setting the limit shall be made known and transparent to the public.

NAMING OF CORE FUND

24. The Council supports the standardization of the core fund for the sake of easy identification and believes that the name of the new core fund should be broadly recognized. The name of the core fund should be distinct from that of other investment products in the market, making it identifiable and unique amongst the existing and future products.

25. A portion of default funds, already existed in the MPF market, are named with words such as "Simple", "Basic", "Guaranteed" and "Balanced", which may give rise to misinterpretation by consumers if the proposed core fund is of similar terms. To avoid misleading scheme members, the Council advises any products with analogous names in the market are to be revised accordingly.

26. Nevertheless, the Council suggests the MPFA to formulate appropriate guidelines or regulations on the naming of future MPF products to ensure scheme members or the general public, no matter what their backgrounds are, can differentiate the core fund from other investment products or MPF products in a simple manner.

TRANSITIONAL ARRANGEMENTS

27. It is understood that the core fund size must be able to sustain its operation and the management costs incurred should be minimized as far as possible. By transferring existing scheme members' default funds into the new core fund as the initial capital, the core fund would be able to initial its investment strategies and to achieve reasonable returns.

28. However, the proposed arrangement for the existing MPF scheme members will involve an automatic transfer of their accrued benefits to the new core fund unless they make a choice to invest into some other MPF funds. As this would be a major change to many scheme members, the Council considers it not acceptable to make such an opt-out arrangement as this could incur potential loss (arising from the "high buy low sell" phenomenon) to these scheme members.

29. For better protection of these scheme members, the Council suggests that the existing members shall be informed of the potential impact on their accrued benefits and contributions if they choose to make any changes and be remained in the same type of fund unless the scheme members have indicated change of their investment choice.

30. The Council is also of the view that a sufficient transitional period should be provided for all scheme members to exercise their rights to choose. This transitional period shall be adequate for selections and all existing scheme members of default funds shall be noticed about that. The change of investment choice should be thoroughly publicized so that all parties in the market are well informed.

FURTHER CONSULTATION

31. The Council appreciates the core fund proposals being put forward by the MPFA and agrees that *"ensuring that all MPF scheme members have access to a low fee, standardized core fund that is designed in a manner consistent with the objective*

of retirement savings needs”, as stated in the consultation paper, should be ascertained.

32. In light of the subject would affect the retirement prospects of over 3.8 million of labour force, the Council strongly recommends that a second public consultation on the proposed operation models and subsequent implementation of core fund when details are in place is vital and necessary.

CONCLUSION

33. Hong Kong, along with advanced economies around the world is currently grappling with the dilemma of implementing a retirement protection model that would be financially sustainable for both the Government and the public.

34. MPF, as one of the five pillars of the multi-pillar retirement protection model recommended by the World Bank, should not be a standalone policy to be reviewed. The Council recognizes the worth of introducing Core Fund which is a good starting point for safeguarding benefits of MPF scheme members. The Council, however, is of the view that a holistic examination and assessment on the retirement protection policies and strategies would be essential for the utmost benefits of the community. The Council believes that enhancing coverage, adequacy in protection, affordability and sustainability are imminent issues to be addressed in light of the growing ageing population in Hong Kong.

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