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Attention: Consultation on Providing Better Investment Solutions for MPF Members

30 September 2014

**Subject:** Mercer's response to the Consultation Paper

Dear Sir/Madam,

Please find enclosed Mercer's response to the Consultation Paper "Providing Better Investment Solutions for MPF Members" issued in June 2014.

We are pleased to be able to take part in the consultation around a significant change to the MPF Scheme and contribute our views on the local retirement landscape. Mercer is a wholly owned subsidiary of MMC, a global company listed on the NYSE, and advises institutions on issues around supporting and building their human capital. Retirement benefits are a key part of employee's compensation, and we have over 40 years of experience of advising employers on investment solutions for their employee benefits, as well as other aspects of retirement including benefit structure, member communication and processes for efficient implementation of ideas to achieve their goals.

We look forward to the outcome of the review. Please feel free to contact us if you wish to further discuss our responses.

Yours sincerely,

**Deborah Bannon**
Investments Business Leader, North Asia Ex-Japan

# Providing Better Investment Solutions for MPF members

This document contains Mercer's response to the Consultation Paper prepared by the Mandatory Provident Fund Schemes Authority on the longer term reform proposals on the MPF system.

Mercer's fundamental belief for investment of retirement savings is a solution which considers, distinguish and address the different needs of members. When we consider investment design for retirement assets, we categorize members into three broad groups in order to response to the specific needs of each group; those with little engagements in investment decisions, those with some engagements in investment decisions and those with full engagements in investment decisions. The Consultation Paper focuses on the setting of a core fund which will be set as the default fund for MPF schemes, and we recognize that such core fund will more likely be used by those members who are less engaged in investment decisions. We believe that the focus of the investment design for these members should be to deliver an adequate and sustainable income in retirement.

The Consultation Paper calls for three areas of response:

1. 12 questions are set out in the document
2. Comments on the broad proposals
3. Comments on more detailed consequential implementation issues.

### Response to the 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, we support broadly the descriptions here. The MPFA would also have to provide guidelines over the interpretation of "long-term" and "good value". There is some caution to be had around squeezing fees too substantially in the initial stage of the development of these changes to lead to stifling of innovation and willingness of providers to go that bit further to bring better outcomes to members.

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

Somewhat yes, since that would provide the desired commonality that the MPFA seems to expect. While member profile is the main concern when we think of any benefits design, there other elements that are linked to the employer. For example, the corporate culture that they are running and where retirement benefits sit in that group. Further, if the workers tend to be more mobile, i.e., tend to move between jobs frequently compared to the country average (and hence, a possibility that assets may be frequently redeemed out of one provider and transferred to another), there may be a case for the default fund to be a conservative fund, providing maximum portability features .

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

Yes, this would greatly simplify implementation of the Core Fund which to us, would include the negotiations with providers, the communications to members, the back-office administration and front-office processes. By building the Core Fund from the default funds would also help to raise assets faster and therefore helping to achieve the "good value" objective.

However, the Core Fund may also deviate from the default fund over time, as new investment ideas become available in the market, and a change to the default fund and the Core Fund at the same time would be fraught with difficulties.

Criticism of the standardized default fund will naturally flow to the Core fund, and vice versa. So we would caution tying the two together too closely.

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, we would agree that building in an automatic system of de-risking as a member closes in on retirement age (i.e. 65) would be sensible. We would be cautious on the definition of risk, noting that the paper is focused mostly on absolute volatility.

This suggestion is consistent with one of the guiding principles of Mercer when designing a solution for less engaged members of retirement schemes where we considers the changing requirements across a member's whole life, including what happens at, and after, retirement.

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?*

We support sharing the responsibilities of implementation with the industry providers. And MPFA providing the high-level direction. Different providers have different specialties within their firm, and by dictating the investment style, or derisking style of the Core Fund is likely to create more of a winners vs losers situation as not all administration systems are built in the same way, and not all investment funds or unit trusts are formed with the same terms and conditions around entry and exit of investments. It may also be beneficial for providers to come up with their preferred way of operating the default funds and so be responsible for demonstrating "good value"

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

We agree that targeting a certain level of fee initially would be a good idea, although 0.75%pa of AUM could mean investing a large proportion of the core fund in passive equities, to make room for covering other fees that can be difficult to negotiate for all but the largest players in the MPF provider market.

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?*

We agree that it is a good idea to encourage providers to find ways to keep expenses low by providing a target FER level over the medium term for the core fund.

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

Yes, we agree that passive, or index-tracking approaches would be appropriate for a significant proportion of the core fund's asset allocation. Further, we support the observation that intelligent diversification across sector, markets/ geographies and multiple sources of return will be more of a concern instead of relying on active manager to execute that as they see fit. We would however be in favour of more consultation around the type of index that should be used, noting the pitfalls of the common market-cap indices which would have to be weighed against their simplicity and lower cost.

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

Our philosophy is that active management would be effective where a) markets have less volume in trade and in companies b) information is not "efficient" and non-transparent c) execution of trades is complex and expensive.

We believe the following types would require an element of active management. Although the degree could vary from manager to managers:

- Emerging market equities
- Hong Kong equities
- Certain fixed income strategies e.g. Rmb-related bonds
- Real-estate securities

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, we would be strongly in favour so that members and providers alike are clear on the underlying building blocks. It would also make it simpler to make comparisons in the reporting process, whether in number-crunching work or in verbal presentations. For that reason, the name should also be short.

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

Yes, we agree with the approach for dealing with paragraph 78, but we are less supportive of paragraph 79, since it would be far simpler to announce to members that default = Core Fund for all Post-launch date, and is applicable to new joiners of the MPF scheme after the launch date. Indeed, it may be a good idea to incorporate the year of launch into the name of the Core fund. For those of existing MPF scheme members who have not previously made a choice, the issue with changing investment of their accrued benefits is that there may be members who were consciously defaulted into the current default fund of the scheme.

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?*

No, we continue to believe that there should be no movement of assets for members currently in the default funds, as there will be transaction costs, and risk of administration errors in moving assets for a subset of the population – within which, we agree with industry practitioners, it will be difficult to be confident that those members are truly in the targeted segment for the Core fund. We continue to suggest that more is done to generate member interest and improve understanding of their arrangements, also, to ensure that providers make it very simple for them to review their holdings of current accrued benefits, the destination of their future contributions, the other options available and why they may choose them.

If there is an urgency to build up assets in the Core fund, then we propose that only future contributions are diverted to the Core fund, combining this with the member awareness campaign

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