Mandatory Provident Fund Schemes Authority

Submission to the Public Consultation of the Commission on Poverty on Retirement Protection

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EXECUTIVE SUMMARY

1. This submission sets out the views of the Mandatory Provident Fund Schemes Authority ("MPFA") on the consultation document of the Commission on Poverty ("CoP") entitled "Retirement Protection Forging Ahead" (the "Consultation Document") in respect of the discussions relating to the Mandatory Provident Fund ("MPF") System. Part A provides our views on the role of the MPF System in the overall retirement protection framework of Hong Kong and Part B contains our responses to other key issues discussed in the Consultation Document impacting upon the MPF System.

Part A: The Role of the MPF System

2. The MPFA strongly supports the approach that retirement income protection for the community at large must be based on multiple funding sources. Reliance on a single or few pillars increases long-term risks that benefits cannot be delivered because of changes in political, social, fiscal or economic circumstances impacting on any given pillar.

3. Under the multi-pillar approach,[1] the global trend is for increasing reliance on Pillar 2 (i.e. a mandatory, employment-based, privately managed, fully funded contribution system). Fifteen years ago, Hong Kong was among the forerunners of implementing a mandatory Pillar 2 system – the MPF System.

4. Participation being mandatory in nature, the MPF System helps ensure that each working individual would be setting aside some retirement savings during his/her working life. To enhance efficiency, MPF schemes are managed by private entities and operated through a market mechanism. MPF is an individual savings account arrangement, and scheme members are eligible to withdraw only savings accumulated in their own accounts. The MPF System is therefore a fair system as the contributions and accumulated benefits of a member vest wholly in that member and cannot be redistributed to meet the claims of other members. The MPF System is fully funded, meaning that it possesses adequate assets to cover all current and future payment obligations and is, as such, financially sustainable.

5. Over the past 15 years, the MPF System has been performing its function of helping the employed population to save for retirement. Before the MPF System was implemented,

[1] For details on the multi-pillar approach, please refer to pp. 8-9 of the submission.

only about one-third of Hong Kong's employed population (about 1.1 million) were covered by any sort of occupational retirement protection schemes. As at 31 December 2015, 85% of Hong Kong's employed population (about 3.2 million) were covered by the MPF System or some other forms of retirement schemes.

6. As of December 2015, the total asset size of the MPF System reached $591 billion. The sum includes $479 billion in MPF contributions (net of amounts withdrawn) and $112 billion in investment returns (net of fees and charges). People who otherwise might have accumulated little or nothing for retirement now have a sum put aside to support them later in life.

7. Pillar 2 systems are vehicles for the long-term accumulation of retirement savings, and it takes time for the savings to build up. The MPF System will continue to grow. We project that the net asset value of the MPF System could reach $1,000 billion within the next 5 to 7 years and will continue to grow for another 20 to 30 years thereafter.[2] From an individual member's perspective, the average working life is around 40 years. Therefore, it takes this long for a retirement savings system like the MPF to mature in that only after around 40 years can scheme members first see the magnitude of benefits that such a system can produce over a full working life.

8. As a Pillar 2 system, the MPF System is designed to provide only basic retirement protection, and only for the employed population of Hong Kong. As such, it has some unavoidable scope limitations – it applies only to the employed population and it is not intended to be the sole source of retirement savings even for that group. For many individuals who are participants in the system, MPF benefits need to be complemented by income from other pillars in order to address all the individuals' retirement needs.

9. The MPF System is an integral part of Hong Kong's retirement protection and should not be seen as something that can or should be replaced by other pillars. As pointed out in the Consultation Document, the stronger the MPF System becomes, the less reliant our working population will be on the publicly-funded pillar after their retirement. Different pillars need to work together to provide for total retirement savings adequacy for the population. No single pillar can be an effective solution on its own.

[2] The projection has taken account of the net asset values of the MPF System, the annual contributions into and benefits withdrawn from the MPF System, and a number of socioeconomic factors such as labour force participation rate and unemployment rate.

Part B: Specific Issues Relating to the MPF System

10. With reference to relevant discussions contained in the Consultation Document, this submission also provides our views on various issues relating to the MPF System.

Contribution Rates

11. The Consultation Document discusses various arguments for and against an increase in MPF contribution rate. The level of benefits ultimately provided by the System will be driven by a number of factors including, importantly, the level of the MPF mandatory contribution rate and the maximum level of relevant income. Increasing contribution levels will add to the benefits that the MPF System is able to provide to scheme members upon retirement; however, the need for, or quantum of, any such adjustment would need to be considered in the context of the objective of the System. Since its inception, the MPF System has been designed to provide basic retirement protection for the broad working population of Hong Kong. The purpose of setting a relatively low contribution rate and a maximum level of relevant income in a Pillar 2 system is to allow employees and self-employed persons the flexibility to meet their retirement savings needs by means other than mandatory contributions to the System. If the consultation outcomes suggest that there is an acceptance by stakeholders that the MPF System should provide more benefits than current settings would provide, then the MPFA would support an increase in contributions. The level of any increase in contribution rate would need to be assessed based on overall retirement savings adequacy and the Government's policy on how much retirement protection is intended to be delivered by means of the MPF System vis-à-vis other pillars.

Investment Performance

12. Under the MPF System, fund choices made by scheme members have an important impact on their saving outcomes as well as being the primary driver of the overall investment return of the MPF System as a whole. As a result of scheme members' collective choices, the MPF System has a relatively high exposure to equity markets (66% of total MPF assets as at December 2015). This high equity exposure increases the volatility of returns in the system and leads to significant negative impacts when equity markets suffer downturns.

13. It is therefore important for scheme members to have a proper understanding of the investment risks in relation to MPF. Financial education and proper disclosure of

information are the key tools used by the MPFA to help scheme members make informed investment choices and manage their retirement investment effectively. In addition, the proposed default investment strategy ("DIS") is also designed to cater for the need of scheme members who do not have the time or inclination to take active care of their retirement investment.

Reduction of Fees

14. The MPFA has consistently maintained the position that lower fees are in scheme members' interests and this should be a natural target of the MPFA, the industry and all stakeholders.

15. To this end, the MPFA introduced a range of initiatives to bring fees down, primarily through promoting competition of the MPF industry and streamlining and simplifying MPF administrative processes to cut down administrative costs. These initiatives have yielded some results. From December 2007 to April 2016, the average Fund Expense Ratio of MPF funds dropped by 25% from 2.10% to 1.57%.

16. The MPFA agrees, however, that the rate of fee reductions needs to be faster and deeper. As the MPF System continues to grow, further scale economies are expected to create room for fees to be further reduced. The MPFA has continued to explore and introduce various initiatives to create more room for fee reductions, including the DIS and the feasibility study on putting in place electronic facilities to enhance scheme administration work.

Severance Payment ("SP")/Long Service Payment ("LSP") Offsetting Arrangement

17. SP/LSP offsetting arrangement continues to be a widely debated issue. From the perspective of the financial impact on scheme members' retirement benefits, the SP/LSP offsetting arrangement gives rise to benefits leakage from the MPF System, weakening its retirement protection function. The MPFA is of the view that the issue of SP/LSP offsetting needs to be addressed, including potential removal of the arrangement. Since the SP/LSP offsetting arrangement is a Government policy related to labour relations, the MPFA supports the efforts of the Government in seeking to find a solution that deals with this contentious issue.

Major Initiatives for Refining the MPF System in the Pipeline

18. In order to strengthen the contribution of the MPF System to the pool of resources for old age protection, the operation of the System has been continually refined and reformed.

DIS

19. To help those scheme members with difficulties in making fund choices, an amendment bill was passed by the Legislative Council in late May 2016 to mandate a standardized DIS across all MPF schemes. Preparation work for implementation is underway for launch of the DIS as soon as possible.

20. The DIS is designed to provide all scheme members with a simplified investment option that is consistent with the overall objectives of retirement savings. We believe as our scheme members get older, the automatic de-risking approach of the DIS along with a fee control feature will benefit them, especially for those who find it difficult to make investment choices or simply do not have the time or do not want to do so.

Standardization, Streamlining and Automation of Scheme Administration ("SSA")

21. The MPFA has performed a review and developed a preliminary conceptual model of the electronic infrastructure and processes to standardize, streamline and automate MPF scheme administration in the long run.

22. By means of electronic facilities, the objectives of this initiative (tentatively called "eMPF") are to lower the operating costs of MPF providers, allow employers and scheme members to deal with various MPF matters more conveniently and efficiently, and provide scheme members with more flexibility and better-quality services and tools. The eMPF could therefore promote the speed of delivery of services, transparency of information to scheme members and security of information maintained by MPF providers.

Full Portability

23. The Employee Choice Arrangement ("ECA") was implemented in November 2012. The Government and the MPFA had reiterated that expanding ECA is the settled direction, and the MPFA was asked to conduct a study on the implementation of "full portability" with a view to further increasing employees' autonomy in selecting their

MPF schemes. In this regard, the MPFA is currently exploring the development of the eMPF in a manner that can facilitate “full portability”.

Publicity Efforts to Enhance the Community’s Understanding and Acceptance of the MPF System

24. The MPF System, as a social programme, requires community support for its sustainable development. Ever since the inception of the MPF System, extensive public education and publicity campaigns have been organised to help raise both public awareness and acceptance of the MPF, educate the general public about its benefits for their long-term future, and enhance scheme members’ investment knowledge. The MPFA will continue its efforts to enhance and deepen the understanding and acceptance of the public of the MPF System.

<u>Other Proposals of the Consultation Document</u>

Voluntary Savings

25. The MPFA takes note of the proposal of the Consultation Document for provision of tax concessions by the Government to incentivize people to increase voluntary retirement savings for themselves and their family members. Although the MPFA agrees that tax concessions or other fiscal incentives for MPF voluntary contributions made by employers, scheme members and their family members may produce a positive effect on increasing MPF voluntary contributions, further strengthening the retirement protection function of the MPF System, the effectiveness of tax concessions in the context of a simple and low tax regime like Hong Kong should be taken into account.

Public Annuity Scheme

26. Regarding the proposal of setting up a public annuity plan, the MPFA agrees that due consideration should be given to the structure of the payout phase of retirement savings. It is noted that different jurisdictions adopt different approaches based around a combination of three general solutions: lump sums, phased withdrawals/payment streams and risk transfer approaches such as annuities. All three approaches are available in Hong Kong, although none are mandated. The MPFA agrees that the range of payout options for MPF benefits, whether a particular approach should be mandated and whether there could or should be Government involvement in those options, are issues that should be further researched and developed over the coming years.

INTRODUCTION

1. The Commission on Poverty ("CoP") launched a six-month public consultation on retirement protection on 22 December 2015. This submission sets out the views of the Mandatory Provident Fund Schemes Authority ("MPFA") on the consultation document entitled "Retirement Protection Forging Ahead" (the "Consultation Document") in respect of the discussions relating to the Mandatory Provident Fund ("MPF") System.

2. This submission comprises two parts. Part A provides our views on the role of the MPF System in the overall retirement protection framework of Hong Kong. Part B contains our responses to other key issues discussed in the Consultation Document in respect of the MPF System.

PART A: THE ROLE OF THE MPF SYSTEM

Multi-pillar Retirement Protection Framework

3. The MPFA strongly supports the approach that retirement income protection for the community at large must be based on multiple funding sources rather than over-reliance on any single source. The MPFA notes, and supports, the statement made at paragraph 3.6 of the Consultation Document that "Hong Kong should continue to adopt the multi-pillar model in providing diversified sources to deliver retirement savings and income, to be complemented by a range of public services."

4. The issue of retirement income protection is complicated and multi-faceted, relating both to the responsibilities of individuals and to those of society at large. Many jurisdictions around the world are grappling with this complex issue. The global consensus on the framework under which this should be approached is the diversified, multi-pillar model as advocated by the World Bank. The model is explained in paragraphs 3.1 to 3.3 of the Consultation Document. The World Bank's multi-pillar framework comprises five pillars, from Pillar 0 to Pillar 4. Hong Kong's retirement protection system as classified under this multi-pillar framework is as follows:

Hong Kong's Retirement Protection System under World Bank's Multi-pillar Model

Pillar	World Bank	Retirement Protection System in Hong Kong
0	Non-contributory, publicly financed and managed system	Comprehensive Social Security Assistance, Old Age Allowance, Old Age Living Allowance, Guangdong Scheme, Disability Allowance
1	Mandatory, contributory and publicly managed system	Nil
2	Mandatory, privately managed, fully funded contribution system	MPF schemes, occupational retirement schemes, Civil Service Pension schemes and Grant Schools & Subsidized Schools Provident Funds
3	Voluntary savings	Voluntary MPF contributions, personal savings/investment, life insurance and annuities
4	Informal support, other formal social programmes, and other individual assets	Family support, public health care, elderly care services, public housing, self-owned properties, reverse mortgage, elderly health care vouchers and public transport fare concession

5. Under the multi-pillar framework of the World Bank, the MPF System is a Pillar 2 system: a mandatory, employment-based, privately managed, fully funded and defined contribution system.

6. The World Bank's multi-pillar model is based on the premise that a multi-pillar model is best able to provide retirement income protection because any single pillar alone is unable to address the total retirement needs of the whole population for the reason that it may not cover the entire population or it may be unsustainable in the long-term. Reliance on a single or few pillars increases long-term risks that benefits cannot be delivered because of changes in political, social, fiscal or economic circumstances impacting on any given pillar. Even if a particular source of future benefits looks safe and sustainable today, because delivery timeframes are so long, stretching 40, 60 or even 80 years into the future, it is not possible to predict with any certainty what circumstances will apply when the benefits are needed.

7. By its nature, each retirement protection pillar has its own objectives and target groups and may be funded in a different manner. The multi-pillar approach could therefore better address the needs of different target groups of the population and remain more resilient against different risks faced by a retirement protection system over the long-term. Since certain pillars are better suited to achieve a particular objective than others, it is essential that multiple pillars work together to supplement or complement each other. In this regard, the World Bank's multi-pillar model, which stresses the importance of diversification of sources for delivering retirement protection, provides a

sensible policy framework for addressing the issue of retirement protection in Hong Kong.

8. Whilst there may be global consensus on the basic principles of a multi-pillar approach, the MPFA agrees with the observations in paragraph 3.3 of the Consultation Document that the five pillars proposed by the World Bank is not a template that can, or ought to be adopted by every jurisdiction. Local circumstances need to be considered in each case. Whilst not every pillar is essential in every jurisdiction, the global trend is for increasing reliance on Pillar 2 (i.e. a mandatory, employment-based, privately managed, fully funded contribution system). As noted in Annex 2 of the Consultation Document, an ever increasing number of jurisdictions have been adopting Pillar 2 arrangements as a part of their retirement protection framework. The numbers illustrated in Diagram 1 of that Annex would be expanded substantially if non-mandatory employment-based, privately managed, fully funded contribution systems were included in the analysis. Fifteen years ago, Hong Kong was among the forerunners of implementing a mandatory Pillar 2 system – the MPF System. The MPF System should continue to play a role as a key pillar that works with the other pillars in providing retirement protection in Hong Kong.

<u>The MPF System as a Key Pillar of Hong Kong's Overall Retirement Protection System</u>

9. The MPFA agrees with the comments made in the Consultation Document that the MPF System "has been playing an important role in the entire retirement protection system."[3] The Consultation Document also points out that "The MPF System has been implemented for 15 years only. When the System matures, its function to provide retirement protection can hardly be taken up by other pillars."[4]

10. As a Pillar 2 system, the key function of the MPF System is to help the employed population to save for retirement. For this purpose, the MPF System was carefully designed to supplement other pillars, with features different from those other pillars.

Mandatory and Employment-based System

11. The MPF System is a mandatory and employment-based system, which helps ensure that each working individual would be setting aside some retirement savings during his/her working life. It also helps to ensure that each generation will take responsibility for at least part of its own retirement savings needs.

[3] Paragraph 5.2 of the Consultation Document
[4] Paragraph 5.3 of the Consultation Document

Management by Private Entities

12. MPF schemes are managed by private entities that are subject to detailed regulation and also to market forces. Private management reduces risks associated with changes to political and fiscal circumstances that can affect Government-provided pillars over time. It can also lever off competition among private entities which tends to increase efficiency and innovation which works to the benefit of scheme members.

Defined-contribution, Individual Account System

13. MPF is an individual savings account arrangement. Under the MPF System, any mandatory contributions paid for or in respect of a scheme member are fully and immediately vested in that scheme member once they are paid into an MPF scheme. Any investment return derived from the investment of the mandatory contributions is also fully and immediately vested in the scheme member. The amount of accrued benefits accumulated in the scheme member's account depends on the amount contributed to the scheme and the investment return thereon. Upon retirement, scheme members are eligible to withdraw only savings accumulated in their own accounts. In this regard, the MPF System is a fair system as the contributions and accumulated benefits of a member vest wholly in that member and cannot be redistributed to meet the claims of other members.

Individual Savings as the Source of Financing

14. The MPF System is a fully-funded system with its assets originating from contributions made by and on behalf of scheme members. It does not rely on contributions from the Government. Scheme members can be assured that the accrued benefits in their own accounts will be available for withdrawal upon retirement irrespective of the financial conditions of the Government at that time. The MPF System is, accordingly, financially sustainable.

15. Whilst financial sustainability is a feature of the MPF System, this is typically an area of concern for those pillars financed by Government revenue. In this context, the availability of the MPF System reduces the risk of over-reliance on the pillars financed by Government revenue and consequently reduces financial pressure on those pillars.

Retirement Savings Generated by the MPF System

16. Notwithstanding some negativity in the community towards it, the MPF System has been performing its function of helping the employed population to save for retirement. Before the MPF System was implemented, it is estimated that only about one-third of Hong Kong's employed population (about 1.1 million) were covered by any sort of occupational retirement protection schemes. As at 31 December 2015, 85% of Hong Kong's employed population (about 3.2 million) were covered by the MPF System or some other forms of retirement schemes.[5]

17. As of December 2015, the total asset size of the MPF System reached $591 billion. The sum includes $479 billion in MPF contributions (net of amounts withdrawn) and $112 billion in investment returns (net of fees and charges). People who otherwise might have accumulated little or nothing for retirement now have a sum put aside to support them later in life.

18. Pillar 2 systems are vehicles for the long-term accumulation of retirement savings, and it takes time for the savings to build up. The total MPF assets broke the first $100 billion mark in July 2004. In December 2015, the total MPF assets were close to $600 billion. The MPF System will continue to grow. We project that, based on moderate return assumptions, the net asset value of the MPF System could reach $1,000 billion within the next 5 to 7 years and will continue to grow for another 20 to 30 years thereafter.[6]

19. From the perspective of a scheme member, the retirement savings generated by his/her MPF account would grow over time, along with the amount of contributions made into the account and the investment return thereon. The average working life is around 40 years. Therefore, it takes this long for a retirement savings system like the MPF to mature in that only after around 40 years can scheme members first see the magnitude of benefits that such a system can produce over a full working life. Before the system matures, those reaching withdrawal age will not have had the advantage of a full working life accumulation cycle.

[5] Most of the remaining employed population were not legally required to join any local retirement scheme, such as workers with overseas retirement schemes, employees aged below 18 or 65 and above, and domestic helpers.

[6] The projection has taken account of the net asset values of the MPF System, the annual contributions into and benefits withdrawn from the MPF System, and a number of socioeconomic factors such as labour force participation rate and unemployment rate.

Complementary to Other Retirement Protection Pillars

20. The core issue of this consultation, as stated in paragraph 6.1 of the Consultation Document, is whether the principle of "regardless of rich or poor" or "those with financial needs" should be adopted to enhance the existing retirement protection system. The MPFA is of the view that it is a matter for the Government to consider having regard to relevant factors including the outcome of this consultation.

21. As a Pillar 2 system, the MPF System is designed to provide only basic retirement protection, and only for the employed population of Hong Kong. Therefore, it has some unavoidable scope limitations – it applies only to the employed population and it is not intended to be the sole source of retirement savings even for that group. Because different people have different working careers in terms of when they start working, how much they earn, whether they have career gaps, etc., the outcomes of a contributory system like MPF can vary significantly from member to member. For some scheme members, even if they have participated in the MPF System for a full career of 40 years, MPF benefits may still need to be complemented by benefits from other pillars in order to address all individuals retirement needs. In this respect, the MPFA agrees with the comments made in the Consultation Document that "Given the current contribution rate, the MPF can only provide basic retirement protection for the working population making an average income, and should be complemented by sources of income under other pillars (such as voluntary savings or family support). In fact, the MPF System is designed to be one of the sources of income after retirement."[7]

22. The MPFA also agrees with the comments in the Consultation Document that the stronger the MPF System becomes, the less reliant our working population will be on the publicly-funded social security pillar after their retirement.[8] The MPFA accepts the observations of the CoP that the MPF System should be strengthened to better perform its retirement protection function. The MPFA would also strongly agree with the serious reservations of some CoP members about suggestions from some parties about using part of MPF contributions as the income source for other options.[9] The MPFA would consider diversion of MPF contributions or benefits as being contrary to the basic premise of Pillar 2 systems as set out in paragraphs 13 and 14 above.

23. In view of the role being performed by the MPF as a Pillar 2 system, the MPFA is of the view that the MPF System should not be seen as something that can or should be

[7] Paragraph 5.9 of the Consultation Document
[8] Paragraph 5.27 of the Consultation Document
[9] Paragraph 5.27 of the Consultation Document

replaced by other pillars; nor should funding of Pillars 0 or 1 be confused with private MPF contributions. The MPF System, as one of the pillars, is complementary to other sources of retirement savings, such as Government social security programmes and individual savings arrangements. These different pillars need to work together to provide for total retirement savings adequacy for the population. No single pillar can be an effective solution on its own.

24. However, irrespective of whether the principle of "regardless of rich or poor" or "those with financial needs" is adopted, the relationship between any Government pillar enhancement and other savings, including those accruing under the MPF System warrants careful consideration. If the enhanced Government pillar is means-tested, we consider that it would be better to avoid a means test that adopts a single figure for the cut-off to determine eligibility to receive benefits under the enhanced Government pillar.[10] A means test relying on a single threshold figure may create resentment towards the MPF System by certain members of the public given general antipathy to mandated savings (assuming that benefits accrued under the MPF System will be included in their assets for means-testing) and the value that they may place on Government provision. It may also create perverse incentives for people to exhaust MPF and other personal savings more quickly than necessary in order for the person to obtain earlier access to the means-tested benefits. In other jurisdictions with developed Pillar 2 system, such as Australia and Chile, a tapered or phased approach to means-testing has been adopted which rewards, rather than being seen to penalize, private savings. Such an approach will help incentivize the accumulation of private savings (including MPF) and the prudent use of those savings in retirement.

PART B: SPECIFIC ISSUES RELATING TO THE MPF SYSTEM

25. With reference to relevant discussions contained in the Consultation Document, Part B of this submission provides our views on various issues relating to the MPF System.

<u>Contribution Rates</u>

26. The Consultation Document discusses various arguments for and against an increase in MPF contribution rate.[11] The level of benefits ultimately provided by the MPF System will be driven by a number of factors including, importantly, the level of the MPF

[10] Noting that the simulation in Chapter 6 of the Consultation Document uses a benefit cut-off asset test of \$80,000 for a single person and \$125,000 for a couple.

[11] Paragraph 5.9 of the Consultation Document

mandatory contribution rate and the maximum level of relevant income. Increasing contribution levels will add to the benefits that the MPF System is able to provide to scheme members upon retirement; however, the need for, or quantum of, any such adjustment would need to be considered in the context of the objective of the System. Since its inception, the MPF System has been designed to provide basic retirement protection for the broad working population of Hong Kong. The purpose of setting a relatively low contribution rate and a maximum level of relevant income in a Pillar 2 system is to allow employees and self-employed persons the flexibility to meet their retirement savings needs by means other than mandatory contributions to the System.

27. While a higher rate of mandatory contributions would undoubtedly strengthen the retirement protection function of the MPF System, any possible increase in the contribution rate would need to be assessed based on overall retirement savings adequacy and the Government's policy on how much retirement protection is intended to be delivered by means of the MPF System. Overall impacts would be dependent on the changes to, and impacts on, other pillars including whatever Pillar 0 or Pillar 1 enhancements the Government ultimately adopts, and how an increase in MPF contributions might affect savings levels under Pillar 3 and Pillar 4. It is inevitable that, given public perceptions about forced savings, some scheme members will have reservations about an increase in mandatory contributions which would mean a temporary reduction in part of their income available for consumption and other savings/investment. Nevertheless, the MPFA would naturally support an increase in contributions if the CoP's consultation suggests acceptance by stakeholders of such a change. It may help facilitate future changes in this direction if targets and trigger points for making changes could be identified in advance although we would accept that it will be difficult to do so until an overall retirement savings adequacy is established and any changes to Pillar 0 or 1 arrangements are bedded down. Once these are clearer, a more informed decision can be made about how big an increase in MPF contributions would be required in order for it to adequately supplement the new Pillars 0 and/or 1.

Investment Performance

28. The Consultation Document has discussed the investment performance of the MPF System.[12] It is noteworthy that, under the MPF System, scheme members can choose among the MPF funds in the scheme in which they are enrolled. Fund choices made by scheme members have an important impact on their saving outcomes as well as being the primary driver of the overall investment return of the MPF System as a whole. In

[12] Paragraphs 5.6 and 5.7 of the Consultation Document

other words, the overall investment return of the MPF System is a result of the aggregate performance of the investment decisions made by scheme members and the return of those investment markets that scheme members have chosen to invest into.

29. As a result of scheme members' collective choices, the MPF System has a relatively high[13] exposure to equity markets (66% of total MPF assets as at December 2015) and the Hong Kong equities market in particular (38% of total MPF assets as at December 2015). This high equity exposure increases the volatility of returns in the System and does lead to significant negative impacts when equity markets suffer downturns.

30. Like other defined contribution Pillar 2 systems, MPF assets are invested in financial instruments, such that scheme members are exposed to varying degree of investment risks. Different means may be employed to deal with the investment risks of Pillar 2 systems. Proper design of the default fund, for instance using life-cycle strategies, is recommended by international organizations, such as the Organisation for Economic Co-operation and Development ("OECD").[14]

31. The MPFA believes that it is therefore important for scheme members to have a proper understanding of the investment risks in relation to MPF. Against this background, financial education and proper disclosure of information are the key tools used by the MPFA to help scheme members make informed investment choices and manage their retirement investment effectively. In addition, the proposed default investment strategy ("DIS") (see paragraphs 52-53 below) is also designed to cater for the need of scheme members who do not have the time or inclination to take active care of their retirement investment.

<u>Reduction of Fees</u>

32. The Consultation Document has reported the downward trend of the fees and expenses of MPF funds.[15] In this respect, the average Fund Expense Ratio ("FER") of MPF funds dropped by 25%, from 2.1% in December 2007 to a record low of 1.57% at the end of April 2016. As at December 2015, 184 funds, or 40% of all MPF funds (459), were low-fee funds, the FER of which did not exceed 1.3% or the management fees of which were not higher than 1%.

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[13] The average exposure to equities of pension funds in OECD countries was 23.8% in 2014. (*OECD Global Pension Statistics*). Retrieved from http://www.oecd.org/daf/fin/private-pensions/ . [Accessed March 2016]

[14] OECD (2012). *The OECD roadmap for the good design of defined contribution pension plans.* Retrieved from http://www.oecd.org/finance/private-pensions/50582753.pdf [Accessed March 2016]

[15] Paragraph 5.11 of the Consultation Document

33. The MPFA agrees with the observations in the Consultation Document that "the MPFA has to continue its efforts in reducing fees as there is still a gap between the existing fee levels and the general expectation of scheme members. Reducing fees must remain one of the priorities in the future."[16]

34. Whilst agreeing that fee reduction must remain a priority, it is important for stakeholders to have realistic expectations about what is achievable and reasonable in this respect. There is much debate about whether the fees and expenses of MPF funds are reasonable and fair to scheme members.

35. The MPF System, similar to many Pillar 2 systems in other jurisdictions, is a mandatory, yet privately managed, system. Being privately managed, the operators necessarily have to charge fees that are no less than their costs incurred for business operations. Over the years, stakeholders have expressed a desire for high service levels and tight regulation. In such an environment, identifying areas for cost controls is challenging and initiatives have to be assessed in terms of what service levels scheme members want, as well as the cost implications. Given the complexity and uniqueness of the management and administration of the MPF System, it is a challenging task to identify a benchmark for a reasonable fee level, particularly given that data limitations and scope differences make it extremely difficult to make meaningful comparisons with fee data from other retirement savings schemes in different jurisdictions. Structural differences also need to be considered when looking at other systems. In most public pension systems and even in some Pillar 2 systems, a government agency bears the cost of some part of the system for which it may not charge any explicit administration fees. In reality however, the cost is borne by taxpayers as the operation of the agency is often financed by government revenue.

36. Regardless of whether fees are objectively high or not, the MPFA has consistently maintained the position that lower fees are in scheme members' interests and this should be a natural target of the MPFA, the industry and all stakeholders.

37. To this end, over the years, the MPFA has initiated different measures to drive down MPF fees and expenses by facilitating better, more informed market forces, by reducing costs where possible and by regulating elements of fee charging practices. Market enhancement has included enhancing fee disclosure and transparency, implementing the Employee Choice Arrangement ("ECA") to allow employees to exercise some market choice and regulating certain types of fee practices. The MPFA has also been looking

[16] Paragraph 5.12 of the Consultation Document

into ways to reduce the costs of the MPF System, thus increasing the scope for fee reduction. Taking account of the Cost Study completed in 2012 ("2012 Cost Study")[17], the MPFA has pressed ahead with the implementation of short-term measures within the existing legislative framework, including getting trustees to offer low-fee funds, working with trustees to merge less efficient schemes and funds, streamlining and simplifying administrative processes to reduce operating costs, and encouraging scheme members to consolidate personal accounts.

38. The MPFA agrees, however, that the rate of fee reductions needs to be faster and deeper. As the MPF System continues to grow, further scale economies are expected to create room for fees to be further reduced. The MPFA has continued to explore and introduce various initiatives to create more room for fee reductions. A case in point is the DIS the management fee level of which is to be capped at 0.75% of assets. Compared to existing mixed asset funds which have management fees around 1.5%, this will mean that roughly an extra 0.75% of investment returns will flow into member accrued benefits each year.

39. In 2015, the MPFA also commissioned a consultant to conduct a feasibility study on putting in place electronic facilities to enhance scheme administration work. If feasible, such facilities should be able to greatly improve user experience, allowing employers and employees to manage their MPF contributions and investments more easily and will help reduce scheme administration costs with a view to allowing room for lower fees.

Severance Payment ("SP")/Long Service Payment ("LSP") Offsetting Arrangement

40. The Consultation Document has provided a succinct summary of the history of SP/LSP offsetting arrangement and the views of labour organizations and employer groups on it.[18] While the SP/LSP offsetting arrangement is a Government policy related to labour relations, for the reasons discussed below, the MPFA would support efforts by the Government to find a solution that deals with this contentious issue. In order to facilitate informed discussion about this important topic we have set out below some summary points about the impact of the SP/LSP offsetting arrangement on the MPF System.

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17 Ernst &Young. (2012). *Managing the changing landscape of retirement savings: Report on a study of administrative costs in the Hong Kong Mandatory Provident Fund system.* Retrieved from: http://www.mpfa.org.hk/eng/information_centre/publications/research_reports/files/MPF%20Consultancy%20Study%20Report(Eng).pdf [Accessed March 2016]

18 Paragraphs 5.18–5.23 of the Consultation Document

Financial Impact on Retirement Benefits

41. In 2015, a total of 47 300 SP/LSP offsetting claims were processed by trustees, with 67% being SP claims and 33% LSP claims. The total amount of SP/LSP offsetting claims was $3,354 million. The majority of SP/LSP offsetting claims with known industries comes from wholesale/retail/import and export trade, catering, manufacturing, construction, and community/social/personal services.

42. A total of 14 400 employers (i.e. 5.2% of the total enrolled employers) made use of the offsetting mechanism in 2015. The average amount of SP/LSP offsetting per employer involved in SP/LSP offsetting claims was about $233,000. A total of 45 300 employees (i.e. 1.8% of the total enrolled employees) were involved in SP/LSP offsetting in 2015. The average offsetting amount per employee was $74,100.

43. From the retirement savings perspective, the SP/LSP offsetting arrangement involves withdrawal of accrued benefits derived from employer contributions ("ER accrued benefits") to be used for offsetting, which is tantamount to allowing early withdrawal of accrued benefits. This early withdrawal, or leakage, is contrary to the purpose of the MPF System in preserving benefits in the System for the workforce for retirement use.

44. From July 2001 to December 2015, a total of about $28 billion was withdrawn from the MPF system for SP/LSP offsetting. In 2015, SP/LSP offsetting amount accounted for 22.0% of the total amount of benefits withdrawn from the MPF System. Expressed another way, this amount is equivalent to 5.6% of the total amount of mandatory and voluntary contributions received in 2015. For scheme members involved in SP/LSP offsetting claims in 2015, the amount of SP/LSP offsetting claims, regardless of the type of claim, accounted for 51% of the scheme members' account balance or 93% of the employer's portion of account balance on average. This suggests that, whilst the system-wide leakage caused by offsetting is material but perhaps not critical, the impact on individual members can be very damaging to the long-term accrual of benefits within the System. This is particularly the case for employees who earn less than the minimum level of relevant income (currently $7,100 per month). These scheme members make no contributions themselves and if ER accrued benefits are offset against SP/LSP, they will have only a very small portion of accrued benefits left for retirement savings. As noted above, for scheme members involved in SP/LSP offsetting claims in 2015, the amount of SP/LSP offsetting claims accounted for 93% of the employer's portion of account balance on average, meaning that a scheme member who makes no contributions is left with only 7% of his accrued benefits in that employment on average.

45. Based on the above, the MPFA agrees with the CoP's view that the "offsetting arrangement will undoubtedly give rise to benefits leakage from the MPF System, weakening its retirement protection function."[19]

Operational and Administrative Impact on the MPF System

46. The Consultation Document mentions that the offsetting arrangement "may impede the implementation of 'full portability', a measure which will help enhance market competition and further reduce fees levels."[20] Given that, under "full portability", employees would be free to transfer their ER accrued benefits to other schemes which may have funds with higher risk than those available under the schemes chosen by the employers, some employers are concerned that in case the investment in such higher risk funds suffers losses, they will have to pay more of the SP/LSP out of their own pockets. Therefore, some employers may not be willing to support "full portability" as they want to retain control over the investment of their contributions for SP/LSP offsetting.

47. Other than the reluctance of some employers on allowing employees to have investment control over ER accrued benefits, if employees can move ER accrued benefits to any scheme of their own choice, then employers will have to be able to identify the amount and whereabouts of these benefits in case of payment of SP/LSP in order to complete the offsetting process. To date this has been a practical constraint on the possibility of allowing full portability.

48. The MPFA would also note that the processing of offsetting through MPF schemes is a manual process which does add materially to the costs of scheme administration, hence limiting the scope for future fee reductions.

49. Noting all of the above, the MPFA agrees that, when looked at from the retirement savings perspective, offsetting of SP/LSP causes leakage of benefits weakening the retirement saving function of the system, has been a practical constraint on expanding portability and adds to the cost of the MPF System. Having noted that, the MPFA also accepts that the SP/LSP offsetting is a contentious issue that crosses into other policy areas such as labour relations where other policy considerations apply. As such, the MPFA supports the efforts of the CoP and the Government in seeking to find consensus on how the existing offsetting arrangement can be properly addressed, including potential removal of the arrangement.

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19 Paragraph 5.24 of the Consultation Document
20 Paragraph 5.23 of the Consultation Document

Major Initiatives for Refining the MPF System

50. In order to strengthen the contribution of the MPF System to the pool of resources for retirement protection, the operation of the System has been continually refined and reformed. As noted in the Consultation Document,[21] the MPFA will continue to work on a number of strategies to strengthen the MPF System including:
   (a) Launching the DIS as soon as possible;
   (b) Continuing to perform the necessary ground work for putting in place electronic facilities to enhance the standardization, streamlining and automation of scheme administration (tentatively called "eMPF");
   (c) Implementing full portability in the long run; and
   (d) Stepping up publicity efforts to broaden the employees' understanding and acceptance of the MPF System.

51. The major objectives of these initiatives are to:
   (a) simplify choice, aim for more consistent performance, reduce risk, and control fees;
   (b) streamline, simplify and automate scheme administration, cut down costs and provide scheme members with more flexibility, better quality e-services and tools;
   (c) give employees greater autonomy in managing their MPF; and
   (d) encourage scheme members to actively look after their MPF investment, and educate scheme members on how to make informed investment decisions.

The DIS

52. An amendment bill was passed by the Legislative Council in late May 2016 to enhance the regulation of default arrangements in MPF schemes by mandating a standardized DIS across all MPF schemes. The primary objective of the DIS is to provide default scheme members with a highly standardized and fee-controlled investment strategy which is consistent with the objective of long term retirement savings. Details of the DIS are as follows:
   - The DIS will apply to contributions to or accrued benefits of an MPF scheme for which (i) a scheme member does not indicate or has not indicated a choice of MPF funds, or (ii) a scheme member specifically chooses to invest according to the DIS;
   - The DIS in each MPF scheme would be made up of two constituent funds: namely the Core Accumulation Fund and the Age 65 Plus Fund. The Core Accumulation Fund will adopt a more aggressive investment strategy and invest more in higher risk investments (e.g. global equities), while the Age 65 Plus Fund will adopt a

[21] Paragraph 5.28 of the Consultation Document

more conservative investment strategy and mainly invest in lower risk investments (e.g. global bonds);

- The DIS adopts a de-risking investment principle. From the age of 50 onwards, the accrued benefits of a scheme member in the Core Accumulation Fund will be gradually switched to the Age 65 Plus Fund every year and will be completely invested in the Age 65 Plus Fund by the time the scheme member is 65;
- Assets will be invested in local and overseas markets; and
- Management fees of the DIS should not exceed 0.75% of assets per annum while recurrent out-of-pocket expenses should not exceed 0.20% of assets per annum.

53. The DIS will contribute towards more stable performance and reduce risk, consistent with the objective of retirement savings. Preparation work for implementation is underway for launch of the DIS as soon as possible

Standardization, Streamlining and Automation of Scheme Administration

54. The MPF System involves numerous administration processes, such as processing of contributions received, reporting of and following up with default contributions, processing of fund transfer and withdrawal requests, etc. The efficiency of scheme administration has a great bearing on the administration costs of the MPF System. In the report of the 2012 Cost Study, the consultant identified several cost drivers relating to the administration of MPF schemes and recommended strategic responses for improving efficiency and simplicity. In the light of the 2012 Cost Study, some short-term measures, including getting trustees to offer low-fee funds, working with trustees to merge less efficient schemes and funds, facilitating further automation and streamlining of administrative processes, and encouraging scheme members to consolidate personal accounts have been adopted.

55. The MPFA is now considering further fundamental measures to streamline and standardize the administration of MPF schemes. In this regard, the MPFA has conducted a review and developed a preliminary conceptual model of the eMPF infrastructure and processes to standardize, streamline and automate MPF scheme administration in the long run. The objectives of the eMPF are to lower the operating costs of MPF providers, allow employers and scheme members to deal with various MPF matters more conveniently and efficiently, and provide scheme members with more flexibility, better quality e-services and tools. The eMPF could therefore promote the speed of delivery of services, transparency of information to scheme members and security of information maintained by MPF providers.

Full Portability

56. The ECA was implemented in November 2012. The Government and the MPFA had reinforced that expanding ECA is the settled direction, and the MPFA was asked to conduct a study on the implementation of “full portability” with a view to further increasing employees’ autonomy in selecting their MPF schemes.

57. While the community consider ways to rationalize the relationship between SP/LSP and MPF benefits, the MPFA is currently exploring the development of the eMPF in a manner that can facilitate “full portability”. As mentioned in paragraph 55, the MPFA has developed a preliminary conceptual model of the eMPF infrastructure and processes to standardize, streamline and automate MPF scheme administration in the long run. The eMPF infrastructure and processes once put in place could be utilized to facilitate “full portability”.

Publicity Efforts to Enhance the Community’s Understanding and Acceptance of the MPF System

58. The MPFA fully realizes that the MPF System, as a social programme, requires community support for its sustainable development. Ever since the inception of the MPF System, extensive public education and publicity campaigns have been organised to help raise both public awareness and acceptance of the MPF and educate the general public about its benefits for their long-term future.

59. The MPFA has taken various initiatives to enhance scheme members’ investment knowledge, reinforce public understanding of the MPF System and raise public awareness of the importance of early planning and investment for retirement. Over the years, publicity campaigns with specific themes relating to MPF investment have been rolled out on different platforms, including television, radio, print and in recent years online as well, targeting the general public.

60. Apart from the ongoing publicity campaigns to enhance public understanding of the MPF System and MPF investment, the MPFA also organized large-scale territory-wide campaigns to publicize enhancements to the System, such as the launch of the ECA, adjustments to the minimum and maximum levels of relevant income and introduction of stiffer penalties for non-compliant employers.

61. The MPFA also maintains a regular dialogue with stakeholders including labour unions, employer associations, academics, media, non-governmental organizations, professional

bodies, think tanks, political parties, Legislative Council and District Council members as well as the MPF industry and other regulators on MPF-related issues, and works closely with them to refine the MPF System. In pursuing proposed changes to the MPF System, extensive engagement in the form of meetings, briefings and seminars has been conducted for relevant stakeholders to gauge their concerns and opinions. Members of the public are also widely involved through various channels to help them understand the proposals and gather their views so as to better align the proposals with public needs.

62. Based on operational experience and suggestions of stakeholders, the MPFA will continue its efforts to enhance and deepen the understanding and acceptance of the public of the MPF System.

Other Measures

63. In the Consultation Document, the CoP proposes the following two measures:[22]
   (a) Properly addressing the SP/LSP offsetting issue; and
   (b) Exploring the feasibility of raising the contribution rate at an opportune time.

64. MPFA's views on the issue of SP/LSP offsetting are set out above in paragraphs 40-49, and the MPFA's views on the issue of raising the mandatory MPF contribution rate are set out in paragraphs 26-27 above.

Voluntary Savings

65. The Consultation Document also proposes that "the Government can provide tax concessions to incentivize people to increase voluntary retirement savings for themselves and their family members. Possible measures include providing tax concessions for voluntary contributions under MPF schemes, or voluntary MPF contributions by employed persons for their non-working spouses".[23]

66. The MPFA agrees that tax concessions or other fiscal incentives for MPF voluntary contributions made by employers, scheme members and their family members may produce a positive effect on increasing MPF voluntary contributions, further strengthening the retirement protection function of the MPF System. In some countries, tax incentives are provided to voluntary contributions made to its mandatory Pillar 2

[22] Paragraph 5.29 of the Consultation Document
[23] Paragraph 5.34 of the Consultation Document

systems or Pillar 3 voluntary systems. However, the efficacy of tax incentives is affected by many factors, such as the structure of the tax system, the levels of taxation and equity issues around incentivizing one particular form of savings vehicle. In higher tax jurisdictions, tax incentives can be particularly influential in affecting savings patterns. The effectiveness of tax concessions in the context of a simple and low tax regime like Hong Kong should be taken into account and other incentives such as matching contributions could be considered.

67. As such, the MPFA is of the view that the issue would need to be considered from the broader perspective of what type of incentives (e.g. deductions or co-contributions) provided to which parties (employers, employees, self employed persons) can most effectively encourage further long-term retirement savings for those most in need (e.g. whether incentives can or should be generally available or directed to a particular wealth cohort).

Public Annuity Scheme

68. The Consultation Document mentions that the CoP generally supports the concept of annuity[24] and considers that the community should explore the feasibility of a public annuity plan.[25]

69. The MPFA agrees that, in common with other modern Pillar 2 accumulation schemes, due consideration should be given to the structure of the payout phase of the MPF System. By necessity, in establishing new arrangements, first priority is given to optimizing the accumulation phase, but ultimately how scheme members access benefits on withdrawal is a critically important issue. The MPFA, in conjunction with the International Organization of Pension Supervisors, has participated in research work identifying the payout structures adopted in different jurisdictions. It is noted that different jurisdictions adopt different approaches based around a combination of three general solutions: lump sums, phased withdrawals/payment streams and risk transfer approaches such as annuities. Following amendments to the MPF legislation which became effective in February 2016, both lump sums and phased withdrawals are permissible within the MPF System. Private annuities are also accessible outside the MPF System. All three approaches are therefore available in Hong Kong, although none are mandated.

[24] Paragraph 6.31 of the Consultation Document
[25] Paragraph 6.33 of the Consultation Document

70. Whilst payment streams and/or annuities are generally seen as preferred solution for providing income in retirement, it should be noted that even the best designed annuities or payment stream cannot convert an inadequate amount of savings into an adequate income stream. Noting that the average amount of accrued benefits per scheme member was estimated to be about $143,000 as at December 2015 (since scheme members have at most been accumulating benefits for 15 years under the System), annuitizing MPF savings or moving to payment streams may be more meaningful when the MPF System becomes more mature and scheme members have accumulated a larger sum of accrued benefits.

71. The MPFA does however agree that the range of payout options and whether a particular approach should be mandated, are issues that should be further researched and developed over the coming years. These issues include the type of payout structure, whether any one option or a combination of options should be mandated and whether there could or should be Government involvement in those options.

The Mandatory Provident Fund Schemes Authority
8 June 2016