香港信託人公會
Hong Kong Trustees' Association

Date: 10 October 2014 **By Email**

To: Investment Regulation Department, MPFA
Attn: Providing Better Investment Solutions for MPF Members

From: Hong Kong Trustees' Association

Subject: HKTA Submission on the Core Fund Consultation

The Hong Kong Trustee Association ("HKTA") representing MPF trustees, administrators and sponsors has reviewed the consultation paper jointly issued by the FSTB and the MPFA, and would like to present the following comments for the MPFA's consideration.

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

☐ Yes ☐ No ☑ It depends

Generally, the HKTA supports the direction of adopting a more uniform approach to setting the default fund. Given that the current MPF companies use different default funds for their schemes, there might be a need to align these funds. However, we believe the FSTB and the MPFA must first determine what type of a default option is the most appropriate for a retirement plan, and to clarify the intentions of such default option. If simply intended to address the small minority of members who choose not to make an investment decision, then the default option can be rather simple and straightforward. If the intention is to create a default option to address a broader concern, then the intention needs to be clearer and better communicated to the general public.

Rather than calling the fund with a new retirement investment strategy a "Core Fund", HKTA believes it should be more appropriately called "default investment fund" or "default option" to avoid any value judgment being placed onto this product and potentially mislead some members.

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

☐ Yes ☑ No

Again, this depends on the intention. If truly a default option, it could be similar in different MPF schemes in terms of the investment strategy/approach. General guidelines on a de-risking investment strategy (or glide-path approach) should be adequate for the design of a default fund. However, the investment outcome (such as returns) could not be substantially the same.

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

☐ Yes ☑ No

We refer to the OECD recommendation and overall objective of the MPFA with regards to the default option (i.e., protecting default members from extremely negative outcomes for those approaching retirement), namely a default option which is preferably an age-dependent, life cycle/target date fund that reduces risk over time. Given that there are multiple ways of achieving this objective and meeting the default option criteria, it will depend on the intention of the default option and the degree of "standardization" to be proposed.

If the default option is going to be based on a decentralized approach, only the name, the glide path and the headline fees should be standardized. Other factors such as administration processes, investment strategies and outcomes would be more difficult to "standardize" and standardizing them can potentially introduce added confusion to members.

Similar to Q2, an in-principle general approach plus guidelines for the default option would suffice.

Q4. Do you agree that the appropriate investment approach of the core fund (default option) 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

HKTA agrees that most retirement planning strategies should strive to reduce risk over time as members get closer to their retirement age. Given the limitation that the most relevant personal data in the records of MPF service providers is the age of members, a fund which reduces risk over time as members get closer to age 65 would be a practicable investment approach. However, this investment approach does not take into account other relevant factors such as an individual's total financial resources, personal circumstances, risk appetite, planned retirement date or income needs.

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?

a. A straightforward default option geared for a small minority of members not electing an investment option could adopt an approach for a more consistent design across multiple aspects.

b. With respect to a broader default fund concept, at the moment, we see two most probable investment solutions – life cycle products or target date products. The use of the life cycle products would reduce the needs to create new CFs and yet still allowing for flexible asset allocation strategies. Moreover, economies of scale could be achieved much easier as most building blocks already exist. For target date products, asset allocation strategies are implemented at the APIF level and will involve less subscription or redemption orders at the CF fund level, thereby having relatively less impact on members. However, life cycle funds are more prone to force-redemption during unfavorable market conditions. The choice of which investment solution to use involves more insight into customer expectations and an assessment of possible trade-offs between performance and fee. Further analyses should be carried out by the technical workgroup.

   With regards to possible system enhancements, because some of the trustees have already built the infrastructure to support either approach, additional costs will be incurred to enhance the administration system and/or to create new fund(s) if the new default option to be adopted is too prescriptive and lacks flexibility.

c. The industry supports having 5-10 year increments in a glide path with sufficient flexibility on the range of asset allocation at each point of the glide path.

d. In general, we agree that the investment strategy should provide professional investment managers with the flexibility to diversify among asset classes globally. Initially, the strategy could focus principally on traditional equities, bonds and money market instruments. The investment building blocks at the underlying fund level could follow the current legislative restrictions and it is not necessary to specify further guidelines or restrictions for the default fund. With such proposed flexibility, MPF service providers could choose to make use of their existing underlying APIFs to achieve better economies of scale. However, over time, additional investment flexibility (and possibly the inclusion of alternative asset classes in the future) will be needed if MPF investment performance is to match the returns shown in other jurisdictions.

e. We suggest that the choice of active or passive investment strategies be left to professional investment managers and MPF service providers.

f. The industry believes that a glide path which can be understood by members is critical. Given life expectancy of 15-20 or more years post retirement, consideration needs to be given to investment strategies which provide returns in excess of inflation, a steady level of income stream to members, and reduced volatility in the income stream. We are also mindful that members have the option to fully withdraw funds from their MPF accounts and invest in other investment options if the industry cannot provide attractive and flexible investment options. Again, the terminal risk profile must be discussed within this context and can be further addressed by the technical work group.

g. We believe a guiding-principle based approach would be preferable over a more prescriptive approach and sufficient for the purpose of maintaining consistency. Such guiding principles should be kept as wide as possible in order to allow sufficient flexibility for MPF service providers to structure their investment offerings with suitable investment objectives, investment strategies and underlying investments, etc. We fully expect markets, customers and investment knowledge to change in the future, and we must be able to react quickly to those changes.

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

☐ Yes ☑ No

HKTA is of the view that keeping the total fee impact for the default option at or under 0.75% is not a reasonable initial approach. Our conviction rests on the following facts:

a. In the 2012 Consultancy Report commissioned by the MPFA on a study of the administrative cost in the MPF system, it is clearly indicated that, at the time of that Report, the overall weighted average FER was 1.74% in which the average administration cost and investment management fee accounted for 0.75% and 0.59% respectively. Fees have declined in the past few years and the trustees believe that such reductions will continue and will ultimately be reflected in the FER. It should be noted that the published FERs do not reflect bonus units being rebated to members which effectively further reduces the actual fees paid by members.

b. Simultaneous to a gradual decline in fees, providers have also spent resources in offering e-channels for employers and members, as well as engaging and supporting many initiatives required by the MPFA on streamlining administrative processes (i.e., ePass and TRIS), amidst the needs to cope with tightened regulatory requirements. All these have added to the costs for the system overall and there has been no cost savings on administration (the key driver of a lower FER).

c. Furthermore, we cannot see how the current trend of constantly tightening regulatory requirements on MPF operations could give rise to any reduction in administration cost to a drastically lower level. In conclusion, to achieve better cost savings in the long run, the MPFA should take the lead in working with the industry to promote the use of e-channels, which have not yet been widely accepted and utilized by employers and members.

d. In 2013 the MPFA published a list of funds with fund expense ratio ("FER") of 1.30% or less. Many regard that as setting an unofficial benchmark for the definition of "low fee" and the funds in the list are considered by the market as "low fee funds". The proposed fee of the default option is now hinged on a significant negative variance of over 30% compared to those "low fee funds". The industry is gravely concerned about the drastic fee reduction assumption made within such a short period of time.

e. To develop a low fee “default option”, the consultation paper proposed using an index-based, passive investment strategy. Yet the number of applicable ITCISs, especially in the bond category, is too small to support this strategy. There are only five fixed income ITCISs, of which none tracks global government bonds. The overall average FER of the currently available ITCISs is as high as 0.45%, with the FER of some single country ITCISs in the 0.60% - 0.70% range. In this respect, using a passive investment strategy will not necessarily result in a "low fee" fund.

If providers are required to meet more stringent fee caps, they might have to reduce services or find other means to offset the costs of offering a default fund. As a matter of fact, there would not be any savings of the administration cost since a reduction in administration processing is unlikely (if not increased). To trustees and administrators, true saving could only come if there is a wide-spread use of electronic platforms. From page 29 of the **Managing the changing landscape of retirement savings – Report on a study of administrative costs in the Hong Kong Mandatory Provident Fund system** by Ernst & Young, the first of the 4 suggested cost savings measures was "*Industry wide initiatives to transition to end-to-end online and electronic payments processing to reduce costs and streamline processing*". According to this Report, the savings is expected to bring a FER reduction of approximately 0.20%.

Therefore, the HKTA believes that it is vital for the MPFA to work with the industry to promote the use of electronic contribution and payment platform as a major measure to help drive costs down. The industry also believes fee and expense levels will decline as administrative cost savings (including regulatory imposed costs) are realized and fund size further increases to create sufficient scale in the MPF system. At present, the current asset size of the Hong Kong MPF market lacks scale to significantly drive cost down within a short period of time. Taking all factors into consideration, we suggest setting fees and FER of the default option to no lower than the MPFA's current criteria for "low fee fund" (i.e., management fee at 1% or lower, and total FER at or less than 1.30%).

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

☐ Yes ☑ No

HKTA is of the view that keeping the total expense impact for the default option at or under 1% over the medium term is not a reasonable approach. Please refer to Q6 on our views.

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

☐ Yes ☑ No

We have reservations over the usage of the word 'predominant'. While passive or index based investment strategies might form part of the strategy, we believe the decision on overall investment approach should be left to each individual MPF scheme provider and fund managers. We note in some jurisdictions such as the US where both passive and active investment strategies are offered, investment flows are fairly split between the two options. Each scheme provider should be able to assess their customers' expectations and desire, and design default fund options (considering performance and fees) that provide the best value to members.

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

Our general view is that if the liquidity or trading volume of some asset classes is very thin, the lower level of liquidity would increase expenses.

Another point we would like to mention is that for many (if not all) bond ETFs, the existing indices they track could have elements that do not meet the MPFA's investment requirements (e.g. on the credit rating of the bonds or type of bonds). Hence, separate ETFs may need to be created. New ETFs may lack liquidity and size which again would have ramifications on the liquidity concerns and the FER. Furthermore, bond ITCISs generally have difficulties in mimicking all the constituents of the indices that they are tracking, which means members may have to bear relatively high tracking errors for these ITCISs.

Q10. Do you agree that the name of the core fund (default option) should be standardized across schemes? If so, do you have any preference amongst the possibilities set out in paragraph 77?

☑ Yes ☐ No

Echoing reply from Q1, the HKTA believes that rather than calling the new retirement investment strategy a "core fund", this retirement strategies should be called "default investment fund" or "default option" to avoid any value judgment being imposed on this product and potentially misleading some members.

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

The HKTA understands the rationale behind the general principle for dealing with the implementation and transitional issues proposed by MPFA in the Consultation Paper, but we do not agree with the proposed implementation and transitional arrangements. Whilst the HKTA agrees that all existing MPF scheme members should be made aware of the new default option arrangements, unless the members give an active consent, we do not agree that those members currently investing into existing default funds would need to switch to the new default options nor should the future contributions be automatically invested into the new default option. We also have the following concerns:

a. Given the size of the MPF market as well as the amounts invested in the existing default funds, there would be significant transactions (in respect of both subscription and redemption) for particular securities in a single day, and such an arrangement may lead to unexpected price fluctuations which may not be in the best interest of the MPF scheme members.

b. If the current default fund is a guaranteed fund, there is also the concern that the relevant members who are being forced to switch to a new default options may not be able to benefit from the guarantee as such benefits may only be realized upon satisfying certain conditions.

c. There may be situations where existing members are not aware of the notification / new arrangement due to various reasons (such as being out-of-town, invalid contact details, etc...), which could result in these members being forced to invest in the new default option, which might not to be in their best interest.

d. Members may not consent to such a change in their investment portfolio and could make claims for any drop in asset value associated with this change.

e. Existing members who have multiple accounts within a MPF scheme may have different investment choices. The proposal creates complications in the communication with scheme members.

f. Existing members could submit switching instruction at any time. They can therefore exercise this choice to invest in the new default fund, rather being compelled to do so.

g. Some MPF schemes may have a number of "dummy" account members (i.e. employees who are not properly enrolled in the scheme) where the relevant trustees only have the name or HKID/passport number of these "dummy" account members. As the date of birth for these members is not available, appropriate application of the glide path to de-risking would be difficult. In case the transitional arrangement as set out in paragraphs 78 and 79 is implemented (especially for existing dummy account members where members' existing benefits would be switched to the new "core/default" fund), we would suggest applying the glide path applicable to the risk profile for age 65 for these members.

h. The transitional arrangement shall be set out specifically in the amendment legislation and regulations, especially when it involves switching of members' accrued benefits from the existing default fund to the new default option. The amendment legislation or regulations should cover but not be limited to an aligned switching dealing date to the default option and handling of members who cannot be contacted.

i. Due to the potential effect of the arrangement, we recommend that the government or the MPFA to conduct promotional and educational programs and ensure that there is extensive coverage to the public on the transitional arrangement prior to the launch of the new core/default option.

j. MPFA must also provide all trustees with specific guidance in relation to the submission of applications for the addition of default options (e.g. including guidance on standard wordings for the objectives, restrictions, risk disclosures, timetable, etc.).

In view of the above, we recommend that the new default option arrangement should only be applied to new MPF scheme members. We do, however, agree that existing MPF scheme members would only be switched into the new default option by making a specific investment choice.

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

In cases where the existing members cannot be readily identified in the system as having invested in the current default fund by choice or by default, we are of the view the invested contributions, or future contributions, should not be switched from the existing default fund to the new default option even if they have failed to make another investment choice. In addition to the concerns mentioned in Q11, the transitional arrangement should be standardized and one standard rule should apply to all MPF schemes in order to ensure efficient and effective communication with all members.

Q13. Other items

Regarding the points raised in Darren McShane's letter dated 25 September 2014 to trustees on the following:

- **The government or some government agency should take a role in operating the core fund and/or in investing the funds of the core fund**
- **There should only be a single core fund rather than core funds in each and every MPF scheme.**

All the MPF trustees have the same view as follows:

The government or some government agency should take a role in operating the core fund and/or in investing the funds of the core fund.

a. Before considering whether to take-up an operating role, the Government should

- have a clear definition on what is a Core Fund (not only default fund);
- have a clear message to the public on the proposal of whether they want to introduce a fund with low fee, reasonable good performance, and suitable for majority of non-sophisticated members, or some other messages;
- be prepared to meet the public's expectation/requirement for returns with a guarantee to beat potentially high inflation, and
- be prepared to sort-out all the administrative logistics.

b. If the Government is involved in the whole set up of the core fund, the core fund would achieve better economies of scale. However, there will likely be issues on aspects like cash flow management, transfer in/out, allotment/redemption, reporting (scheme member communication) and servicing. Hence, the Government is advised to further consult with the industry on the related arrangements.

c. Given MPF is a privately run system regulated by the government, it would be more appropriate to maintain status quo in order to maintain operational efficiency and avoid unnecessary disturbance. As a rule of thumb, market forces drive pricing efficiency and a government-mandated Core Fund would undermine free market competition. The policy intent of the government for the MPF regime is to have it privately managed with government oversight. If the government wishes to be involved in operating or managing the "core fund", then this change of policy intent should be widely consulted and debated among relevant stakeholders beforehand.

d. We believe that a government agency will face the same issues as the trustees in terms of designing a product (i.e., glide path, investment strategy, lack of ITCIS, etc.) as well as difficulty in achieving the targeted fee levels, especially with insufficient AUM.

e. There are other issues - will the Government
   - manage the fund directly?
   - be subject to the same investment restrictions and MPFA oversight as trustees?
   - assume the fiduciary role for the product?

   In addition, if the Government is involved, they will be accountable for the fund performance, both good and bad, and a lot of complaints/challenges would arise if performance was poor. We see a potential conflict of interests if the Government manages the Core Fund while monitors the investment performance of all MPF funds.

f. Who will bear the administrative costs? Contributions, distributions, reporting, etc..., still need to be done. The Government must work with the industry on these issues.

There should only be a single core fund rather than core funds in each and every MPF scheme.

a. We disagree that the core funds of different MPF schemes should be invested into the same APIFs. We believe flexibility (e.g. on the choice of APIFs and certain aspects of the design of the core fund) should be allowed for investment managers to make the appropriate investment decision on behalf of members.

b. There will be a lack of competition if only one set of APIFs or index funds is allowed for all the MPF schemes. Concentration risk on return/performance (i.e., if the fund does not perform) will be very high, potentially leading to the returns of a significant number of members being affected.

c. A single Core Fund would create a lack of market competition to drive pricing efficiency and investment outcome. Furthermore, it would be a non-level playing field as small fund house could not compete with the international firms to provide that single Core Fund.

d. If members are not satisfied with the performance of the single Core Fund, there will be no other choices.

e. There will be a question of who shall select the single Core Fund for all MPF schemes. If chosen by the Government, the issue of "conflict of interest" would arise.

In summary, the HKTA would like to highlight the following:

a. We support a Core Fund for each MPF scheme under guidelines from the MPFA.

b. We are supportive of the MPFA on issuing general de-risking guidelines for each provider to design the relevant APIFs or CFs.

c. We believe centralization does not automatically mean lowering of fee as there is no less work with the introduction of Core Fund. In fact, some would argue that with the addition of a new Core Fund, there could be more work than before.

d. We believe investor education could be a serious problem in the future under a centralized approach. If fund performance is poor under centralization, who is to explain? Because the managers are chosen by the MPFA, the providers will not be able to (or not in the position to) explain fund performance. And if there is a big portion of money investing in the Core Fund, the MPFA will have to assume the responsibility to do the explanation. Even with the selected investment managers' help, this will be a daunting task. Hence, the MPFA needs to seriously consider and address the issues before deciding to go with a centralization approach or not.

The MPF trustees/administrators/sponsors are fully committed to the provision of retirement income protection under the MPF system and will therefore support the Government and the MPFA on this important initiative. So if there be anything the HKTA could do to assist the MPFA, please do not hesitate to contact me.

For and on behalf of
Hong Kong Trustees' Association

Ka Shi Lau
Chairman and
Pensions & Funds Sub-Committee Chairman