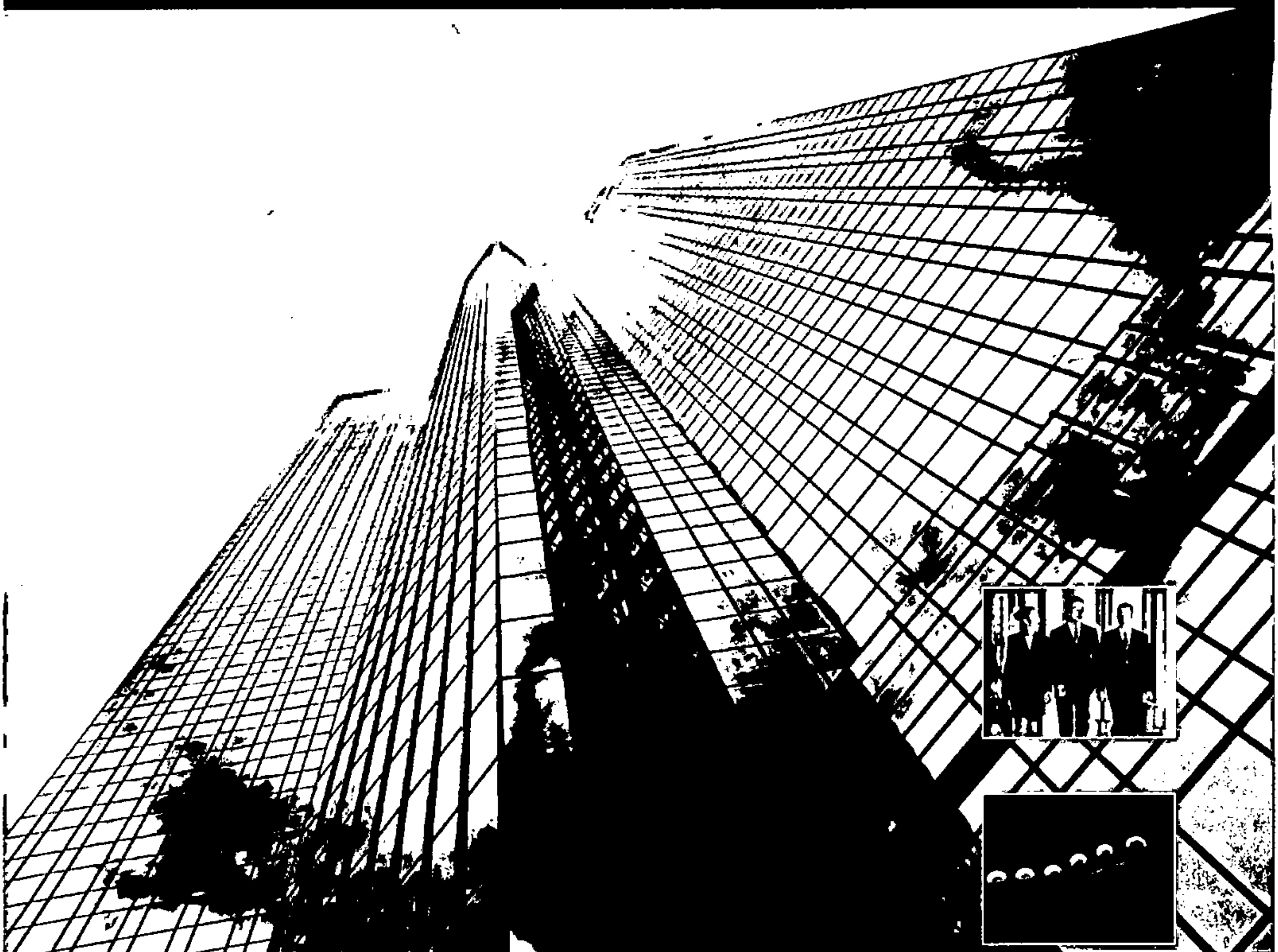
Research on

Pension Structures in Major Defined Benefit Markets & Comparison with MPF Scheme
&
Response to Consultation

JLT



A Jardine Matheson Associate Company

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Introduction

The purpose of this paper is to find possible improvements for Hong Kong MPF charging structure by comparison with major international defined benefit (DC) pension markets, as well as analysis on the effect of different charges on overall return.

The first part of this paper focuses on introduction of three major DC market, namely Superannuation in Australia, 401(k) in United States, and pensions in UK. By comparison between the three markets with Hong Kong MPF market, the paper further discusses on charging structure of pension schemes and tries to find out possible ways to reduce the costs and expenses. And in the final part of this paper, the impact of different charges on pension return to investors will be analysed and compared.

The JLT response to consultation is included in the final chapter. JLT are very keen to enter into dialogue with the MPFA over any proposed change as we feel that we have much to add given the worldwide pensions expertise of the group.

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1 Major DC International Markets

1.1 Australia

The superannuation guarantee was introduced in 1992. It consists of a mandatory employer contribution to a private pension plan. The pension plans may be operated by employers, industry associations and financial service companies or even by individuals themselves. The mandatory contribution rate has been 9% of employee earnings since the 2002/2003 tax year. Starting in 2013/2014, the superannuation guarantee has started to gradually increase to 12% by 2019/2020 (prior to the recent federal election, the government – when in opposition – announced that it will keep the rate unchanged at 9.25% until June 2016 and then gradually increase the rate to 12% by 2021-22). The Australian system also includes taxation concessions to encourage additional private retirement savings.

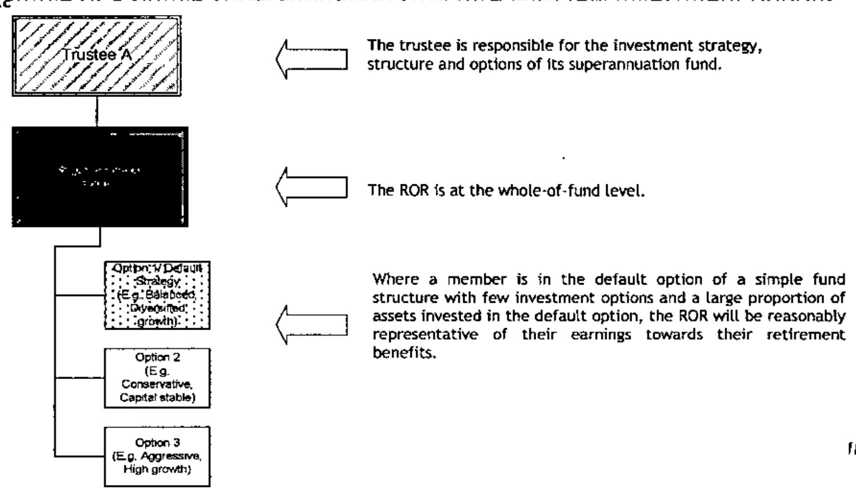
Employers need not contribute for workers earning less than AUD 450 a month (equivalent to AUD 5 400 a year), but they can choose to contribute for these workers (note that this minimum has not been increased in the past). There is also a limit to the earnings covered by the superannuation guarantee: employers need not contribute for employees' pay above this threshold. For each quarter of the financial year 2012-13 this amount was AUD 45 750. This limit is worth almost 2½ times of average wages and is indexed to a measure of average earnings.

The withdrawal stage of the superannuation guarantee complicates the calculations. Although there are some defined-benefit occupational plans, most employees are members of defined-contribution schemes. Members can withdraw the accumulated capital as a lump sum or as an income stream. Currently, most benefits are taken as a lump sum, at least in part. For comparison with other countries (where defined-benefit plans predominate), the capital from the superannuation guarantee is assumed to be converted to a price-indexed annuity. The annuity calculation is based on mortality data for Australia.

Structure of Superannuation fund

Superannuation trustees choose a structure for their fund ranging from a simple structure (e.g. few investment options) to more complex structures (e.g. many products with hundreds of investment options with varying investment objectives and risk profiles). The obligations of a superannuation trustee are the same regardless of the structure. Diagram 1 and Diagram 2 show examples of two different types of superannuation fund structures. Diagram 1 shows a superannuation fund with a trustee that offers three different investment options. Diagram 2 shows a superannuation fund with a trustee that offers a number of different products and many investment options.

Diagram 1: Example of a simple superannuation structure with few investment options

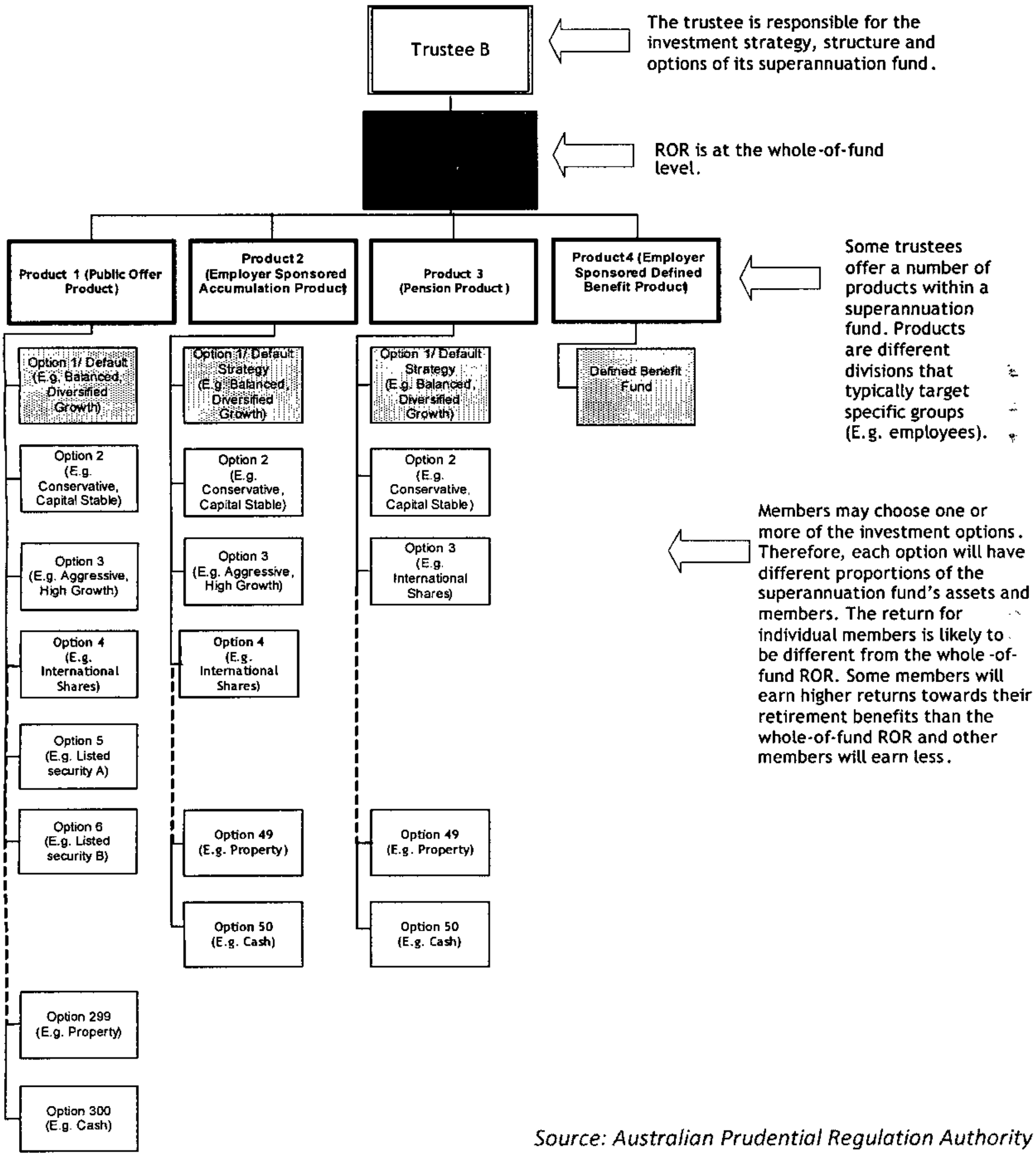


l Regulation Authority (2013)

Where a superannuation fund offers choice of investment options, a trustee will typically include a default strategy or option. When a member does not make a choice of one or more investment options, they are invested in the default strategy (unless the governing rules of the superannuation fund specify that each member must choose an investment strategy).

Diagram 2: Example of a complex trustee structure with many investment products and options

The diagram below shows a superannuation fund with a trustee that offers a number of different products and many investment options.



Source: Australian Prudential Regulation Authority (2013)

As demonstrated in Diagram 2, a superannuation fund may comprise:

- An employer sponsored product or fund that is only open to employees of a particular employer or group of employers;
- A defined benefit product (that may also be employer sponsored);
- A public offer fund or product which offers membership to the public; and/or
- A pension or retirement product or fund which offers products for members who have retired.

Five Most Popular Superannuation Fund Types

1. **Retail Funds**. Retail Funds, with 15.4 million members in 2012, are for-profit Funds and are open to anyone. These Funds are run by financial institutions and insurance companies. Investment choice is offered in 73 percent of Retail Funds, which hold 98 percent of all Retail Fund assets.
2. **Industry Funds**. Industry funds, with 11.7 million members in 2012, are not-for-profit Funds that are generally open to all. However, some may restrict membership to individuals working in a specific industry. They are run solely for the benefit of their members and include trustee boards with representation from employers and employees. Profits are returned to members' accounts. The great majority is accumulation funds (individual savings funds, not defined benefit pension plans), with investment choice offered in 93 percent of Industry Funds, which hold 99 percent of Industry Fund assets. Investment options are generally limited compared to options in Retail Funds.
3. **Public Sector Funds**. Public Sector Funds, with 3.4 million members in 2012, are not-for-profit funds and generally open to Commonwealth, state and territory government employees. Many of these Funds started as defined benefit plans but a majority is now accumulation funds. Investment choice is offered in 74 percent of Public Sector Funds, which hold 99 percent of Public Sector Fund assets.
4. **Self-Managed Superannuation Funds (SMSF)**. SMSF funds, with 0.9 million members in 2012, are known as "do-it-yourself" Funds because individuals manage their own accounts. A SMSF can have between 1 to 4 members and each member is a trustee. Anyone can set up a SMSF. Unlike other Funds, the Australian Prudential Regulation Authority (APRA) does not regulate these Funds. The Australian Tax Office (ATO) is the regulator. These Funds offer access to a broader range of investments than other funds, including direct property investments.
5. **Corporate Funds**. Corporate Funds, with 0.6 million members in 2012, are generally accumulation funds restricted to employees of a specific company, though some allow family members to join and/or allow participants to keep their savings in the Fund after termination from the company. They are not-for-profit funds run by a board of trustees with equal representation of employees and the employer-sponsor. The trustees can manage the investment options directly or have the investment options managed by an Industry or Retail Fund. Investment choice is offered in 47 percent of Corporate Funds, which hold 93 percent of Corporate Fund assets.

Diagram 3: Comparison of Member and Accumulated Assets of five major Superannuation funds mentioned above

Superannuation fund type	Members (in thousands)			Assets (in $Aud billions)		
	2004	2012	% Growth	2004	2012	% Growth
Retail	13,764	15,408	12 %	$207.4	$371.4	79%
Industry	8,946	11,664	30	$94.0	$267.3	184
Public sector	2,707	3,371	25	$112.1	$222.7	99
SMSF	524	914	74	$127.5	$439.0	244
Corporate	774	551	-29	$50.5	$56.1	11

Source: Australian Prudential Regulation Authority (2013)

Latest development of Superannuation

Industry submissions to the Super System Review estimated that savings up to $1 billion annually are achievable from the SuperStream reforms.

SuperStream is a comprehensive package of reforms designed to enhance the 'back office' of superannuation and includes measures to:

- Implement the new data and e-commerce standards for superannuation transactions;
- Allow the use of tax file numbers (TFNs) as the primary locator of member accounts;
- Facilitate account consolidation and improve treatment of contributions made without sufficient member details; and
- Establish an advisory governance body to advice on the implementation and maintenance of the standards.

The Government's Securing Super reforms will also:

- Provide better information about the amount and timing of superannuation payments to employees; and
- Provide notification from funds to members on whether contributions have or have not been received.

The reforms introduced through SuperStream and Securing Super will improve the productivity of the superannuation system:

- The adoption of data standards will result in more automated and timely processing of transactions, improved efficiency, and an easier system for employers to use, fewer lost accounts and more timely flow of money to members' accounts.
- Reducing the number of multiple member accounts will reduce administration fees and insurance premiums on multiple accounts paid per member and maximise retirement benefits.
- Through the Government's Securing Super initiatives, employees will be able to better monitor their contributions.

Fees & Charge Structure

Basically, super funds charge five major fees on superannuation:

1. **Membership Fee**: Super funds charge a membership fee – usually weekly fee and varies from $1 to $5 per week.
2. **Administration Fee**: also known as Management fees. This fee is charged by super funds for looking after or managing super accounts. Mostly these have a tiered fee structure. The higher the super balance, the lower % of fee applies although the total dollar cost will be more as the balance grows.
3. **Management Expense Ratio (MER)/Investment Cost**: MER is the fee charged by Fund Manager for managing investment. This fee is based on the choice of investment, usually charged as a percentage of super balance.
4. **Performance Fee**: This is the fee charged by fund managers for being able to exceed the target performance for the year. Most of the funds will provide an estimate for the coming year rather than the exact fee. This is because fund performance is not known until the end of the year and the performance fee is based on whether or not the fund manager outperforms the market. Some of the funds include this in their MER while others show it separately in their PDS.

5. **Contribution Fee**: Usually charged while making contributions to the super account, with this fee payable to financial adviser for recommendations. Usually this fee is negotiable with adviser and it varies from zero to 5%. This means that for every $100 paid into the super account, it may be credited with only $95.

1.2 US 401(k)

A 401(k) Plan is a defined contribution plan that is a cash or deferred arrangement. Employees can elect to defer receiving a portion of their salary which is instead contributed on their behalf, before taxes, to the 401(k) plan. Sometimes the employer may match these contributions. There are special rules governing the operation of a 401(k) plan. For example, there is a dollar limit on the amount an employee may elect to defer each year. An employer must advise employees of any limits that may apply. Employees who participate in 401(k) plans assume responsibility for their retirement income by contributing part of their salary and, in many instances, by directing their own investments.

Diagram 4: Services Provided to 401(k) Plans

Administrative Services

- Recordkeeping
- Payroll and Investment Transaction Processing
- Plan Creation / Conversion / Termination
- Trustee and Custodial Services

Regulatory and Compliance Services

- Plan Document Services
- Consulting
- Accounting and Audit Services
- Legal Advice
- Nondiscrimination Testing
- Processing of Domestic Relations Orders

Participant-Focused Services

- Participant Communication
- Websites, Call Centers, Voice Response Systems
- Participant Education and Advice
- Loan and Withdrawal Processing

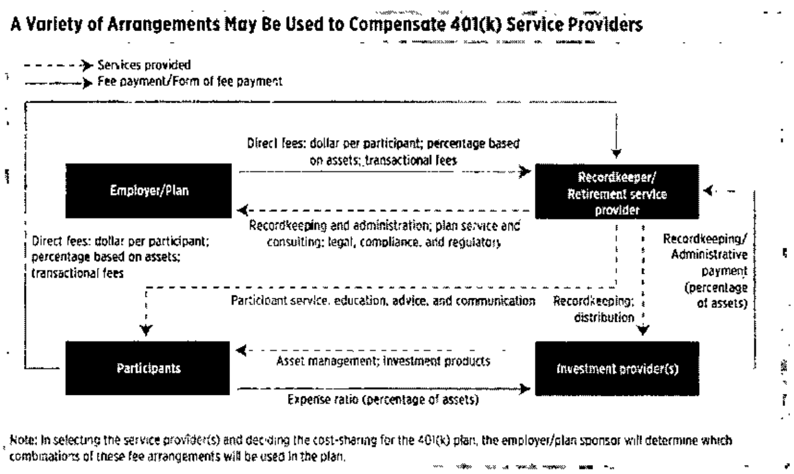
Investment-Related Services

- Professionally Managed Diversified Pooled Investment Options
- Brokerage Window
- Employer Stock Fund
- Insurance and Annuity Services

Source: Variety of Services in 401(k) Plans _ Investment Company Institute (ICI)

Fees & Charge Structure

Diagram 5: Expense Structure from Service of in 401(k) Providers



Source: The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2013_ Investment Company Institute

Diagram 5 shows possible fee and service arrangements in 401(k) plans. The boxes on the left highlight employers, plans, and participants, which use services in 401(k) plans.

The boxes on the right highlight recordkeepers, other retirement service providers, and investment providers that deliver investment products, investment management services, or both.

The dashed arrows illustrate the services provided. For example, the investment provider offers investment products and asset management to participants, while the recordkeeper provides services to the plan and the participants. The solid arrows illustrate the payment of fees for products and services. Participants—or the plan or employer—may pay directly for recordkeeping services Participants may pay indirectly for recordkeeping services through fund expenses reflected in investment expense ratios (solid arrow from participants to investment providers) if the investment provider covers some recordkeeping/administrative expenses by paying the recordkeeper (solid arrow at the far right) for recordkeeping services (dashed arrow between recordkeeper and investment provider).

It is regulation that the plan sponsor pay the costs associated with the initial design of the plan, as well as any design changes. Beyond these design services, employers can share the costs of the plan services with their employees. However, many employers choose to cover some or all plan-related costs that legally could be shouldered by the plan participants. Any costs not paid by the employer, which may include administrative, investment, legal, and compliance costs, effectively are paid by plan participants.

A Means to Compare: The "All-In" 401(k) Plan Fee

As Diagram 5 shows, 401(k) plan fees can be assessed per plan, per participant, or per dollar invested (asset-based fees). In addition, the fees may be paid by the plan sponsor (the employer), the plan participants (employees), or the plan itself. To compare fees across plans, this array of fee arrangements must be converted into an "all-in" fee—a single number for each plan constructed as a percentage of plan assets. An all-in fee is necessary to determine the key factors that influence plan fees.

Because fees are affected by many factors, a range of fees is found across 401(k) plans. One observation is that plan size was a key driver of the all-in fee. Plans with more participants and larger average account balances tended to have lower all-in fees than plans with fewer participants and smaller average account balances. This effect likely resulted in part from fixed costs required to start up and run the plan, much of which are driven by legal and regulatory requirements.

It appears that economies of scale are gained as a plan grows because these fixed costs can be spread across more participants, a larger asset base, or both. In addition, plans with lower allocations to equity investments tended to have lower fees than plans with higher equity allocations, reflecting the fact that fixed-income investments generally have lower expense ratios than equity investments.

Looking at Fees and Expenses of Mutual Funds Held in 401(k) Accounts

Virtually all participant-directed 401(k) plans offer a variety of pooled investment options (such as a selection of mutual funds, collective trusts, and/or separately managed accounts), and some also include guaranteed investment contracts (GICs), company stock, or a brokerage window that gives participants access to direct investment in stocks, bonds, and other securities. All told, 63 percent of the $4.2 trillion in 401(k) plan assets at year-end 2013 was invested in mutual funds. Mutual funds are required by law to disclose their fees and expenses, and some observation is that:

- 401(k) plan participants tend to be invested in lower cost mutual funds

- At year-end 2013, 86 percent of mutual fund assets in 401(k) plans were held in no-load funds, while 14 percent were held in load funds, predominantly in fund share classes that do not charge retirement plan participants a front-end load

A 401(k) plan is one of potentially many benefits offered by an employer. As with any other employee benefit, the employer generally determines how the costs will be shared. A variety of investment options and services are provided through 401(k) plans. Sixty percent of the $3.6 trillion in 401(k) assets at year-end 2012 was invested in mutual funds, primarily in equity funds. Although 401(k) investors as a group tend to hold lower-cost mutual funds, some participants pay more than the average and some pay less. Thus, the average fee does not necessarily reflect the reasonableness of the fees for any particular plan.

Many Factors Affect Expenses and Fees

A variety of factors affect the expenses and fees paid by the participants in any particular 401(k) plan. The investment options' fees can often cover plan services. Participants who work for employers that do not heavily subsidize their plans will tend to incur higher fees. Participants in plans with a small amount of assets will typically pay higher fees as a percentage of assets or per dollar invested than plans with greater assets because of the relatively fixed costs that all plans, large or small, must incur. Similarly, participants in plans that have many small accounts will typically pay higher fees per dollar invested than plans with larger accounts. Plans with more service features will tend to be more costly than more streamlined plans with fewer services for plan participants. In addition, the investment objective of a participant's 401(k) investments also influences fees. For example, international equity funds, which are more complicated to manage than domestic equity funds, tend to have higher fees but also may offer the potential for higher returns and additional diversification.

Diagram 6: Percentage of 401(k) equity mutual fund assets, 2012

Source: Expenses and Fees Paid on Mutual Funds in 401(k) Plans _ Investment Company Institute (ICI)

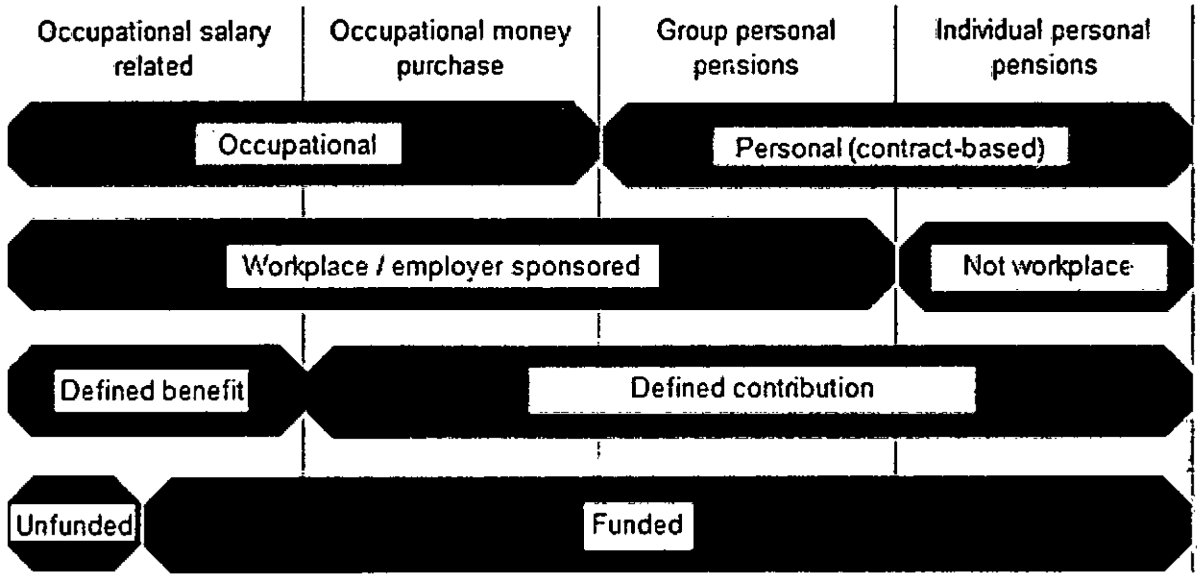
1.3 UK Pension

The future of private (and, possibly, public) sector pension provision in the UK is, for the foreseeable future, defined contribution (DC). The same can also be said of most other countries with a funded pension system.

Even the most die-hard proponent of defined benefits (DB), who may have been clinging to the hope that DB 'risk sharing' was a genuine alternative to traditional final salary pensions, must largely accept this fact. The statistics certainly speak for themselves:

- Only around a quarter of DB schemes are open to new members;
- Within the private sector, about 60 per cent of active members are in, mostly contract-based, DC pension arrangements ;
- Internationally, DC plans now hold 44% of the $26,000bn invested worldwide up from 35% 10 years ago and, in the UK, 40% of assets are now in DC pension plans – up from 3% in 2000; and
- Moreover, DC is set to become all the more prevalent in the UK from October 2012 when employers will have to start auto-enrolling their employees into a pension scheme and contribute for them. (It is generally accepted that the workplace pension reforms are a 'DC issue')

Diagram 7: Private Pension System in UK



Source: Pension Trends Chapter 8: Pension Contributions, 2013 edition _ UK Office of National Statistics

People belonging to defined contribution pension schemes can take up to 25% of their accumulated pension pot as a tax-free lump sum.

Cost structure

There are potentially many ways to categorise and draw relationships between costs and charges. We have used two broad categories when describing the application of the charges and costs:

1. Investment charges – the charges and costs from the perspective of an investment in a pooled investment vehicle (fund).
2. Bundled services charges – the charges and costs from the perspective of the service offered by a bundled insurance provider.

<u>Investment charges</u>

The following costs are common across pooled investment vehicles or funds:

- Annual management charges

The AMC is the fee paid to a fund manager for the provision of the fund manager's investment services and expertise. It represents the manager's income from the fund, from which it pays most directly applicable organisational costs such as salaries, access to research, and so forth, resulting in a residual profit.

– Additional expenses

Additional Expenses are fund specific and relate to some of the (often external) expenses incurred by a fund manager in offering a fund. These costs might include for example registration, custody costs, audit fees, bank charges and interest.

– Total expense ratio (TER)

The TER can be considered as the combination of AMC and additional expenses figures. The TER is defined as the total average cost over a year divided by the average net assets.

Unfortunately, this figure is not as helpful as the name purports, as it does not represent the total cost of investing, and may be calculated (and certainly reported) inconsistently – a common example being the frequency with which it is updated by different reporting organisations – for example, quarterly by some and annually by others.

– Costs of trading

UCITS schemes in the UK must publish TERs and the Financial Conduct Authority (formerly the FSA) specifies the calculation method to be used. This method specifically excludes the following costs:

- Transaction costs
- Interest on borrowing
- Payments incurred because of financial derivative instruments
- Entry and exit costs (for example commission or fees payable to advisors)
- Soft commission

Of these hidden costs, the most significant is generally transaction costs. This might include for example stamp duty, brokerage fees, market impact costs, and performance fees within some fund-of-fund structures.

It is worth categorising two groups of transaction costs. The first is the result of trading required for the fund manager to implement the desired investment strategy. In a passively managed fund, that might be changes within the index being tracked. These costs cannot be avoided.

In an actively managed fund, this will be trading in shares that the fund manager considers under/overvalued. Here the manager should have no interest in transacting unnecessarily, because it will reduce returns. If a manager avoided 'necessary' trading to minimise transaction costs, it could change the nature of the fund – in extremis, an index tracker would find it hard to track its benchmark if it avoided trading. In both cases, dividends will need to be reinvested, which also means trading. At the same time, the manager should be able to carry out transactions they see as being value adding, net of transaction costs.

The second group is the trading which is forced on the fund by virtue of the investment / disinvestment activity of investors – if a member cashes in a large unit holding, it forces the manager to sell shares.

Often, the impact of the second is estimated and passed on to trading investors through a fund bid-offer spread (see Directly applied spread costs/dilution levies). Whilst not reported within the TER, the implicit impact of other transaction costs is reflected in the performance of a fund, and so there should be an alignment of interest such that the manager keeps them under control.

Type of charge	Where does the money go?	How much are they?
Annual management charge (AMC)	The fund manager	c 0.05% – 0.20% for passive funds c 0.40% – 1.5% for active funds
Additional expenses	Fund managers, custodians, banks, fund accountants, auditors and so on	c 0.01% – 0.05% for passive funds c 0.07% – 0.45% for active funds
Total expense ratio	As above	A combination of annual management charge and additional expenses
Cost of trading	Broker, HMRC and so on	It is impossible to be certain, but possibly 0.1% pa

Bundled insurance provider charges and costs

In the first section we outlined the costs associated with pure investment in pooled vehicles. All of those costs, and more besides, apply to bundled insurance provider charges. Provider charges are higher because they provide administration services, such as member record keeping and communication. The costs that investors should be aware of in the provider context are outlined below. The aspects covered in this section are: Platform fees, Additional expenses, and Initial charges; while related pricing factors covered in this section: commission, active member discounts.

- Platform charges

  A pension provider offers administration as an integral part of its offering, and this has to be paid for through a platform charge which usually forms part of the AMC. The AMC shown by providers also typically includes the fund manager's AMC which the provider must 'price in'. As such, a 'provider AMC' can be considered as a 'fund manager AMC' plus a 'provider/platform charge'. The size of this charge is not always disclosed, and contractual terms may be agreed on the basis of either the platform charge or the overall AMC offered. The former is more transparent and ensures that the benefit of increased investment with the fund manager is passed on to the member, rather than the provider.

  Some providers impose an additional element of AMC for the provision of some services such as blended funds or communication services. This is usually included and reported within the headline AMC. AMCs for funds in the same scheme are rarely all at the same level. This reflects the element of the AMC being passed back to the fund manager, which will vary between funds.

- Additional expenses/TERs

  In the vast majority of cases, this figure should simply be a direct reflection of the underlying pooled vehicle additional expenses. There are two exceptions.

  - One is for Stakeholder pensions, where providers are legally bound to maintain a charge cap net of additional expenses and must therefore ensure the cap is not exceeded.
  - The second is that at least one insurer in the market adds in some of its own costs (for example, fund custody) to additional expenses, meaning that investors pay. In our view, this is poor and opaque pricing practice for providers.

- Initial charges

  Initial charges, largely unseen in DC since the introduction of Stakeholders, are staging something of a comeback. Initial charges are now perhaps most closely associated with NEST (to pay back the Government's financing), as it is generally no longer common pricing practice for other providers.

An initial charge is usually separately disclosed, and applies as an instant deduction from each contribution made prior to the contribution being invested. The impact of an initial charge reduces the longer the contribution remains invested – it is difficult to compare this type of charge with an AMC.

– Commission

Commission is a payment made by a provider to a consultant/IFA that is generally directly related to the size of contributions. The payment is not disclosed as a charge, although it is disclosed. The impression is therefore given that the provider is paying the fee, rather than the member. Of course, these (often very high) costs for the provider must be recouped – and the result is a higher AMC than would otherwise have applied had no commission applied. The introduction of the Retail Distribution Review from 31 December 2012 means that commission is no longer permitted for new schemes set up after this date. However, we are aware of many cases where arrangements set up prior to this date have been used for automatic enrolment. Commission also applies when contributions are increased (even as a result of pay increases), meaning that commission-based schemes may continue to generate windfalls for advisers for years to come.

– Active member discounts

Some providers offer terms whereby active employees are offered a lower AMC than 'deferred' members – people no longer working for the employer. This approach effectively means that past employees are cross subsidising current employees. For trust-based schemes, the Pensions Regulator has deemed active member discounts to be 'not acceptable'. However, the practice is more common for GPP and Stakeholder pensions. This is perhaps not surprising, as the provider is selected by the employer, who is naturally more concerned with existing employees.

Type of charge	Where does the money go?	How much are they?
Annual management charges	Provider and fund manager	c 0.3% – 0.6% for passive funds c 0.5% – 1.75% for active funds
Additional expenses	Fund managers, custodians, banks, fund accountants, auditors and so on	c 0.01% – 0.05% for passive funds c 0.07% – 0.45% for active funds
Initial charges	Provider, if the charge applies	NEST's initial charge is 1.8%
Commission	Consultant/IFA	if it applies Up to 0.5% pa where it applies
Active member discount	Active members and the provider	c 0.5% pa where it applies

2 Different Fees & Impact of different charges on pension value and return

2.1 Different Fees

The following costs are common across pooled investment vehicles or funds:

Asset Management Charges

- **Custodian fees** are expenses incurred in relation to custodial services rendered to the pension entity. A custodian is an entity that holds title of the assets on behalf of the pension entity, but where the powers of investment management remain with the trustee.
- **Management fees (non-investment)** are fees paid by the pension entity for management services provided by the pension entity. Consulting fees and trailing commissions are included in this item.
- **Operating expenses** include expenses incurred which are not ordinarily directly associated with the generation of investment income (i.e. expenses that are not directly related to the investment portfolio of the pension entity, but more toward the administration of the pension entity).
- **Property maintenance costs** are all costs relating to an investment in property including (but not limited to) repairs and maintenance, valuation fees and stamp duty.
- **Investment expenses** are all expenses which are associated with the generation of income on the investment portfolio of the pension entity.
- **Interest expense** is any interest expense paid or payable by the pension entity.
- **Tax expense on earnings** represents the tax associated with operating performance. It includes the tax on investment earnings but excludes contributions tax and surcharge.

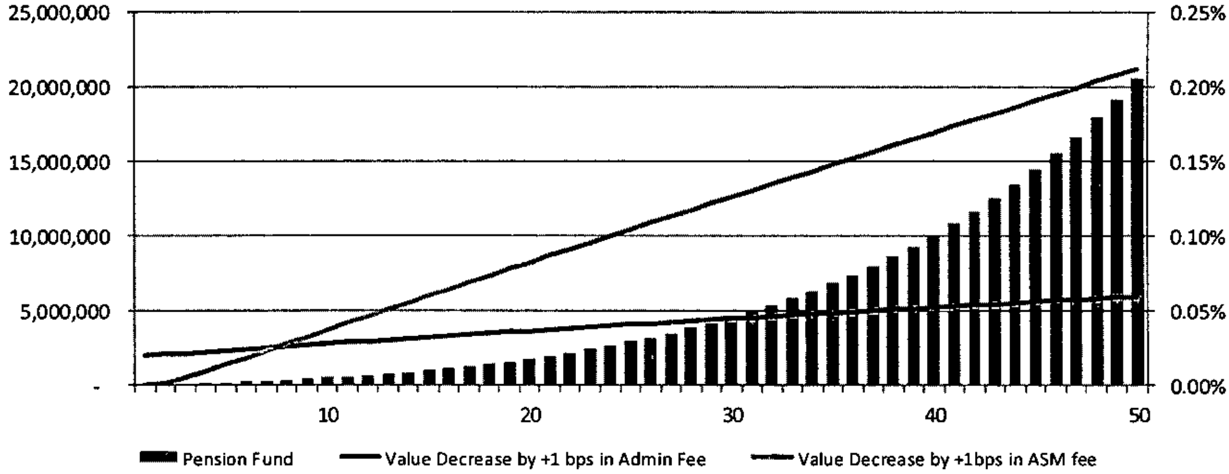
Administrative Charges

- **Administration fees** are fees paid/payable by the pension entity for any administration service provided to the entity. These include internal and outsourced administration services, employee costs and fees paid to the employer sponsor for administration services.
- **Director/trustee fees and expenses** are fees paid/payable by the pension entity to the directors/trustee(s) for carrying out the functions of a trustee/director, including any consulting or administration services provided.
- **Asset consultant fees** are expenses for fees paid/payable to asset consultants engaged by the trustee in relation to the management of the pension entity's investment portfolios. This includes fees paid to independent third parties as well as related entities of the pension entity.
- **Actuary fees** are fees paid/payable by the pension entity for actuarial services/reviews commissioned.
- **Fees and commissions** are income earned by the pension entity in the form of a fee or a commission. These typically include income for scrip lending and underwriting activities.
- **Contributions tax and surcharge** represents tax expenses in relation to taxable contributions made to the pension entity during the period (contributions tax) and contributions surcharge tax.
- **Lump sum benefit payments** are benefit payments paid as a lump sum and includes (but is not limited to) retrenchment, redundancies, resignation and disability benefit payments.
- **Net cost of member benefit insurance** represents members' death and/ or disability insurance premiums expense less rebates received or accrued from insurers in relation to insurance premiums.
- **Pension benefit payments** refer to benefits paid to members in the form of a pension and include complying pensions, allocated pensions and annuity payments.
- **Total fees paid to audit firm** includes any fees and expenses paid/ payable to the external audit firm for external audit and compliance services, internal audit services and other services.

2.2 Impact of Charges on pension fund value and investment return

Below here is an example of pension fund with monthly contribution accumulated for 50 years.

Diagram 8: An example of fund value accumulation and impact of fees on fund value



Source: JLT Internal analysis & Projection

Two fees are compared here – administration fee and asset management fee. Administration fee is proportion to monthly contribution, while asset management fee is proportion to total pension fund value.

For simplicity of calculation, the assumption here is 5% of 1m annual salary (subject to a 5% annual increase), with VAT at 14% and 1% admin fee with 2.5% ASM charge. Expected real growth in fund value is 7% per annum.

Then by adjusting 1 basis point up on administration fee (which means that administration fee is 1.01% of each contribution), the change of pension fund value is as follows (also red line as shown above):

Accumulation duration	20 years	30 years	40 years	50 years
Decrease on fund value	4 bps	4 bps	5 bps	6 bps

Still for the original assumption, by adjusting 1 basis point up on ASM fee (which means that ASM fee is 2.51% of each contribution), the change of pension fund value is as follows (also green line as shown above):

Accumulation duration	20 years	30 years	40 years	50 years
Decrease on fund value	8 bps	13 bps	17 bps	21 bps

As a general conclusion, this could mean a 1% increase in administration fee could result in 6% decrease on values after 50 years of accumulation, and 1% of increase in ASM fee could result in 21% decrease on values after 50 years of accumulation. Taking in count of the large fund value after durations of accumulation, little adjustment in both administration fee and ASM fee would be of considerable negative impact.

To evaluate the impact of both fees on fund value, we also examined the real rate of return from 20 years of accumulation to 50 years of accumulation; results are shown in the following table:

Accumulation duration	20 years	30 years	40 years	50 years
Annual return on investment	5.5%	6.6%	6.9%	7.0%

Surprisingly, with the assumption of 5% annual salary increase and 7% real fund value growth (could be roughly viewed at 12% real growth), the rate of return only turns to 7% upon 50 years of accumulation – showing the large negative impact of both administration and ASM fees.

3 A final look at Hong Kong MPF

In comparison to some well-established foreign retirement protection systems, the Hong Kong Mandatory Provident Fund (MPF) system is still immature after 20 years of development. In terms of the amount of assets, American pension schemes have US$210 Trillion under management, which is 60 times more than the Hong Kong's fund. Pension assets managed by Australia is 30 times more than the fund in Hong Kong. The relatively high administration costs and limited efficiency of the Hong Kong MPF is mainly caused by its small magnitude, extensive investment options, flexible services and provision of multiple contribution accounts.

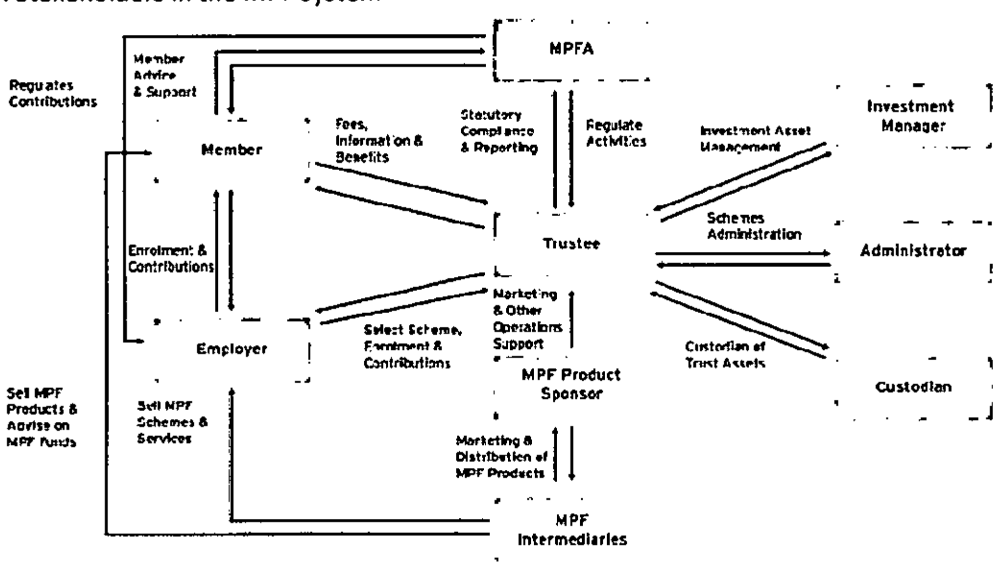
The existence of extensive investment options takes clue from the development process of MPF. The MPF used to have employers select a number of provident fund schemes, with each scheme contains around 10 fund options for the employees to choose from. Since the implementation of 'Employee Choice Arrangement" (ECA) in November 2012, the fund options for each employee increased from 10 to more than 400.

As it can be seen, extensive investment options led to smaller fund sizes, which all have small economy of scale hence high costs. In contrast, some foreign schemes might only provide limited options or no options at all.

One of the reasons for great flexibility of Hong Kong MPF is that each contributor can have unlimited number of contribution accounts. In comparison, Australia has an automatic account consolidation system which could help to reduce the costs of service providers. The accounts will accumulate if the employee does not merge the old account with the new account before he/she starts a new job. In September 2012, there are 4.18 million of these accounts. The problem of having multiple accounts is having higher administration costs, as the trustee still manages the accounts even if the contribution has been terminated. As a result, consolidating personal accounts will not only help the contributors manage their own accounts, but also lower the associated costs.

There are 10 approved MPF trustees in Hong Kong. The majority of these trustees delegate some or all administrative functions to various service providers, who receive a service fee in return (Diagram 9). Members pay trustees a total fee, either as a single amount or as separate fees for investment management and other management services. Trustees also apply different forms of charging mechanisms.

Diagram 9: Stakeholders in the MPF system



Source: Managing the changing landscape of retirement saving _ Report on Nov 2012_from Ernst and Young

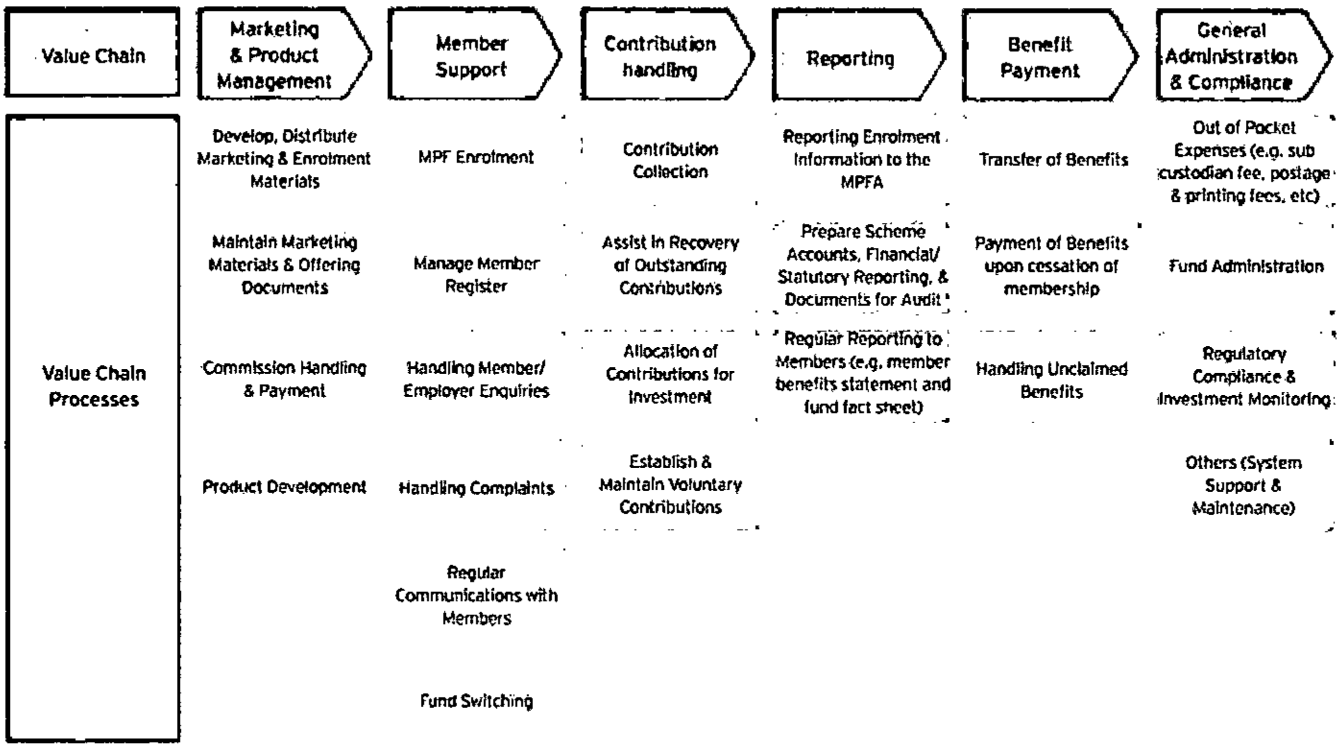
It is expected that over time, the number of MPF members will increase, and this is combined with the introduction of the ECA program, which offers employees a choice of providers, and it is believed that ECA will increase transaction volumes in the MPF system. If the system continues with no process and infrastructure changes, this means there will be more MPF accounts per member that will require servicing, additional transfers between administrators and as a result more manual and paper-based transactions and costs.

The following table summarizes the industry level findings, cost implications, and identified cost drivers for the MPF system:

#	Industry level findings	Cost implications	Identified cost driver	Potential JLT Value Add
1	The scale of the MPF system in terms of accumulated AUM is small compared to international country benchmarks	Limited economies of scale in administration operations	Small scale of the MPF system and administration	✓
2	Large trustees enjoy benefits of economies of scale in operations compared to smaller trustees	Small trustees' administration is more costly		✓
3	Inability of employees to select their MPF provider for current contributions lessens price competition	Reduces trustees' incentive to compete on fees and reduce their costs	Insufficient pricing competition to minimize costs	✓
4	Trustees have no power over MPF product sponsors and therefore have limited influence over MPF products or fees charged. The sponsor, who has influence over fee charges, does not have an official role under the MPF Ordinance, and is not regulated by the MPFA	Trustees have limited influence over fees levied by sponsors		✓
5	Trustees face similar administration issues, but there is minimal industry cooperation on improvement initiatives	Costs are incurred as issues are addressed separately	Lower industry co-operation to resolve industry-wide issues	✓
6	The MPF system is highly flexible, allowing multiple member accounts, offering a wide range of investment options with few restrictions, and providing full member service across multiple channels	Increased administration costs from high service and account proliferation	A highly flexible, full–service MPF system	✓
7	Mandatory participation in the MPF system for small employers and SEPs presents challenges in implementing process automation	Trustees continue paper and manual processing with small employers and SEPs, which is costly to the system	High percentage of small employers and SEPs	✓

As mentioned above, the Hong Kong MPF system has the highest fees and administration costs as a percentage of AUM (Asset under management). Data collected from trustees and administrators indicate that the weighted average administration cost, based on AUM, across the system is 0.75% of AUM, i.e. costs of HK$$2.7 billion, based on the 2011 Hong Kong MPF AUM of HK$$356 billion. The most costly components within the value chain were member support (representing costs of 0.19% of AIU, HK$$0.7 billion) and contribution handling (0.14% of AUM, HK$$0.5 billion). The full breakdown of the costs across the value chain is show in (Diagram 10 and Diagram 11)

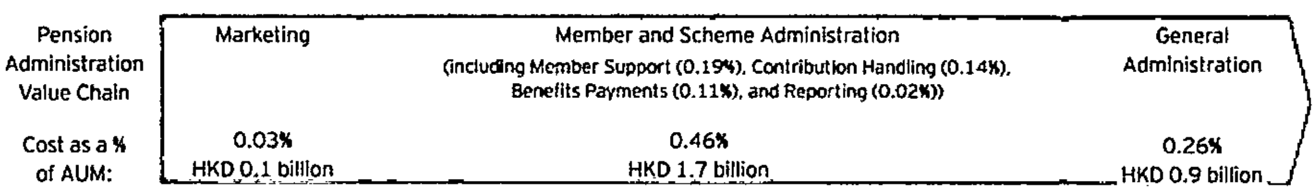
Diagram 10: MPF administration value chain model



Source: Managing the changing landscape of retirement saving _ Report on Nov 2012_from Ernst and Young

Diagram 11: MPF administration cost and expenses breakdown by value chain

Total Administration Cost: 0.75% of AUM



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By virtue of our traditional roles, we have to maintain unparalleled access to three critical resources: intellectual capital, advanced technology, and data – lots and lots of data to offer these value-added products and services – including performance measurement, universe comparison, risk management and compliance monitoring.

The effectiveness and financial sustainability of a pension system depends to a large degree on the efficiency of its administration, which involves its capacity to

- Collect contributions in a timely, non-intrusive, but cost-effective manner.

- Record relevant information over a long period of time based on modern information technology (e.g. contribution base, contributions, withdrawals – including pre-retirement withdrawals, family characteristics, etc.)
- Manage accumulated reserves to the benefit of the contributor (i.e. maximizing risk-adjusted return);
- Communicate with contributor and beneficiary in a client-oriented manner;
- Disburse retirement benefits in a secure and efficient manner;
- Detect, control and sanction misrepresentation and fraud;
- Facilitate portability; and
- Provide a vehicle for dispute resolution.

While some progress has been made, all pension administrations in the region are far from best practice in at least one of these functions. Failure in even one function impinges on the overall credibility of the scheme and results in higher evasion/lower coverage, which eventually reduces the scope and size of old-age income provided.

Although privately operated, the reference systems, like one in Australia, and the UK, have centralized either some or all of the administration functions, include member enrolment, contribution processing, benefits transfer and payments. In addition to benefiting from economies of scale in operations, such centralized platforms also facilitate and enforce standardization of pension data and processing. This allows straight-through processing, increases industry transparency, and promotes competition in fees and services.

The design and implementation of pension systems throughout the world has allowed learning by error. JLT should help HK MPF to adopt various approaches to minimize account proliferation, including automated account consolidation (e.g. Australia) or only allowing members to have one account in the system (e.g. UK's National Employment Savings Trust (NEST)). Implementing such measures reduces account maintenance costs, and provides members with a consolidated view of their pension portfolios to facilitate management of their savings.

Pushing the current market boundaries to simplify the administration process and service proposition, will become a significant revenue generating opportunity, on the back of a fundamental change in HK Pensions policy. JLT Asian should also utilise the integrated service offering and proprietary technology solutions (BenPal and Profund) already available to engage with clients early.

With help from JLT UK, JLT Asia should have the capability to play an influential role on providing &/or supporting this 'centralised' administration function – ideally, an online solutions.

4. Response for Consultation

Form for Responding to Consultation Questions

Q1. Do you support the direction of introducing a core fund in the manner set out in paragraph 36 (a) to (d) above? ☒ Yes ☐ No Comments: A low cost default fund that provides a "balanced risk" approach to investment. Is key to providing good member outcomes for those who do not either wish to or have the required knowledge to choose their own investments.
Q2. Do you agree that the CF that is the default fund should be substantially the same in all MPF schemes? ☒ Yes ☐ No Comments: There should be a consistent approach to the risk rating of all default funds and a maximum charge. The approach taken by individual insurers however could be different and this is to be encouraged to promote market competition.
Q3. Do you agree that it is appropriate that the core fund be based on a standardized default fund? ☒ Yes ☐ No Comments:
Q4. Do you agree that the appropriate investment approach of the core fund is one that automatically reduces risk over time as the member gets closer to age 65? If not, what other option would you propose? ☒ Yes ☐ No Comments: This approach negates the need for investors to choose/change their own funds as they move towards retirement and stops individuals having to "rebalance" funds as time to retirement changes.

Q5. Do you have any preliminary views on the technical issues set out in paragraph 48, in particular whether consistency is required on all aspects of default fund design in all schemes or can some elements be left to the decision of individual product providers? Comments: Consistency in terms of a risk rating and a "Zero customer" investment are required so that any member who defaults into the fund has a balanced / low risk portfolio whose exposure to risk automatically reduces before retirement. How each insurer attracts this goal should be left to them to encourage market competition on charges and performance.
Q6. Do you agree that keeping total fee impact for the core fund at or under 0.75% is a reasonable initial approach? ☒ Yes ☐ No Comments: Given where charges are at the moment with MPF a charge of under 0.75% is a reasonable starting point. However the ambition should be to lower this charge substantially by creating efficiencies of administration and economics of scale.
Q7. Do you agree that keeping total expense impact (i.e. FER) for the core fund at or under 1.0% over the medium term is a reasonable approach? ☒ Yes ☐ No Comments: 1% is a reasonable FER, however the goal must be reduce this charge by creating more market efficiencies and ensuring that value for money is sought in every aspect of the fund management and administration process.
Q8. Do you agree that passive, index based, investment strategies should be the predominant investment approach in the MPF core fund? ☒ Yes ☐ No Comments: Passive index based funds will give the low risk investment strategy and essential low charges required to provide value for money of the majority of investors.

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

Comments:

Hedge funds, Private equity, currencies as all of these suffer from high costs a degree of iliquidity and barriers of entry and exit

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

☒ Yes ☐ No

Your preference:

☐ "MPF Core Fund" (having regard to its use as a core investment approach for retirement savings)

☐ "MPF Basic Investment Fund" (emphasizing its design as a basic investment approach for retirement savings)

☐ "MPF Simple Investment Fund" (emphasizing its design as a simple investment process for retirement savings)

☒ "MPF Default Investment Fund" (reinforcing that its primary design is built around the default investment strategy for those who do not, or do not want to make an investment choice in saving for retirement)

☐ "MPF "A" Investment Fund" (or some other term which removes any implications about the nature of the strategy)

Comments:

It should be made clear that if no choice is made contributions will default into the default investment fund.

Q11. Do you agree with the general principle for dealing with implementation and transitional issues as set out in paragraphs 78 and 79? ☐ Yes ☒ No Comments: Movement of future contributions for those who do not reply should not be done. Movement should only occur if a positive response is received. This will avoid potential future litigation.
Q12. Do you agree with the proposal in paragraph 81 as to how to deal with the transition for existing MPF members of default funds? ☐ Yes ☒ No Comments: The default positive for those who do not response should be to leave investment where they are. The new default rules should apply from a date in the future and not be retrospective.

Information of Respondent

(Please refer to the Personal Information Collection Statement on pages 47 and 48 of this Consultation Paper)

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