Principal International (Asia) Limited
Unit 1001-3, Central Plaza
18 Harbour Road
Wanchai, Hong Kong
Tel : (852) 2827 1628
Fax : (852) 2827 1511
Website : www.principal.com

September 30, 2014

Investment Regulation Department
Mandatory Provident Fund Schemes Authority
Units 1501A and 1508, Level 15
International Commerce Centre
1 Austin Road West, Kowloon
Hong Kong

Attention: Consultation on Providing Better Investment Solutions for MPF Members

Dear Sirs and Madams:

Principal Hong Kong[1] consists of member companies of The Principal Financial Group® (The Principal®). The Principal is a global leader in investment management including asset management, retirement services, and insurance solutions. We are the second largest asset manager among U.S. life insurers based on assets under management ("AUM"), and a clear leader in terms of the global breadth of our businesses across Hong Kong and China, Asia, Australia, Europe, Latin America and the U.S. Principal had approximately US$518 billion in assets under management as of June 30, 2014 and serves over 19 million customers worldwide.

We appreciate the opportunity to submit our comments and thoughts on the questions in the Consultation on Providing Better Investment Solutions for MPF Members paper (the "Consultation Paper").

The MPF system has come a long way in 14 years and we need to recognize the benefits the system has provided. The system now totals almost HK$550 billion and growing. These balances belong to the members. They cannot be taken away unlike government or employer provided benefits. The system covers approximately three million people. These people are much more knowledgeable about retirement than they were years ago. MPF funds are invested in local capital markets contributing to the appreciation of asset values. Is MPF perfect? No. Can more be done? Absolutely. But, let us not lose sight of the positive impact the MPF system has had on society.

[1] Principal Hong Kong represents a set of wholly-owned Hong Kong based operating companies including Principal Trust Company (Asia) Limited, Principal Insurance Company (Hong Kong) Limited, Principal Asset Management Company (Asia) Limited and Principal Investment & Retirement Services Limited.

We often get caught in the trap of jumping to solutions before clearly defining the problems we are attempting to address. As a result, we fail to address the core issues and create unintended consequences. Some might argue for more government intervention to manage pension funds or administer plans. Others may claim we need a universal pension system. While some of these ideas may have merit, until we better define a vision for "the MPF of the future", it is difficult to understand how any one proposal helps achieve retirement security for members.

Before commenting on the specific questions, we believe there needs to be more discussion around defining the vision for "the MPF of the future". In our opinion, the objectives outlined in the Consultation Paper lack a well-defined concern; rather we detect three independent issues in the Consultation Paper.

1. Default Fund Option

The first goal is to "ensure that the MPF system can adequately protect the interests of those members who do not, or do not want to, make a choice of funds..."

The Core Fund Consultation states that 24.1% of members have never made a fund choice. Based on our own data and anecdotal evidence from discussions with several other trustees, "default" levels appear to be 10% or lower. If so, the data would imply either the overall rate is too high or some scheme providers have "default" levels well in excess of 24%.

We are concerned, that similar to the ECA exercise, this process will result in a significant drain of resources and added costs to the MPF system while only addressing a small percentage of members; those who do not make a choice. Our initial reaction would be for the MPFA to focus on those select providers with high levels of "defaults" as opposed to creating a costly industry solution which unfairly punishes providers who invest effort into reducing "default" levels through member education programs.

We do however see merit to the proposal that investment outcomes for defaulting members could be more consistent across schemes. To meet the MPFA's strong preference for consistency in outcomes of "default funds" at a fair cost, we believe that a solution can be found that uses existing funds. This would be more efficient in addressing the objective of providing standardized funds for those individuals who do not, or do not want to make a choice of funds.

One possible proposal would be to utilize the existing "mixed asset funds" or "balanced funds" based on members' age, similar to the life cycle approach identified in Box 2 of the Consultation Paper. These funds have already been approved by the MPFA and would not incur the startup expenses associated with new funds.

2. Core Fund

A second objective is to "improve the investment choice framework" especially for members who are unable to make decisions about their investment options.

While some comment about the numerous investment choices, we feel there is actually a lack of innovation within MPF fund options. The current 450 fund choices represent the same vanilla options offered across 41 schemes. Additionally, there seems to be an assumption that members are not capable of choosing what is right for them. We fundamentally disagree with such a belief. If 24% of members have never made a fund choice, it implies over 75% of members have actively made fund choices[2]. Providing more appealing investment options would encourage more active engagement by members in the management of their retirement savings.

Rather than creating a very prescriptive fund(s) designed by individuals whose expertise lies outside of investment management, we would propose allowing professional investment managers to continue to develop solutions that are attractive to our customers, the scheme members. These solutions would be driven by the demands of the members. Providers have little incentive to introduce funds not wanted by customers.

3. Good Value

As a trustee we fully agree with providing "good value" while acknowledging the definition of "good value" varies. The third goal of the Consultation Paper seems to be to set a "fee cap" on the core fund as a means to subsequently force down fees on other investment options. We continue to caution that "low fees" can be misleading. For example, many providers have introduced "tracker funds" in order to meet the MPFA's direction of providing "low fee fund options". Yet those tracker funds have fees that are 3-5 times higher than investing in the same tracker funds outside of the MPF scheme, given the associated administration and distribution costs. This is not in members' best interest.

We understand a frequent criticism of Hong Kong's schemes is its cost. As stated in our letter to the Chairman of the Bills Committee on the MPFA Amendment Bill (2014), we propose increased disclosure and transparency of fees. In the U.S., the Employee Retirement Income Security Act ("ERISA") requires fiduciaries to ensure that the services provided to the plan [scheme] are necessary and that contracts or arrangements for services, and the cost of those services, is reasonable.

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[2] According to findings from an independent survey conducted by Nielsen and commissioned by Principal Hong Kong, 44% of respondents seek professional advice and another 40% either ask family/friends or feel they can make decisions themselves when they need investment guidance.

In order for a service contract or arrangement with a retirement plan [scheme] to be reasonable, service providers[3] must disclose information about the services they will provide to the scheme and the compensation they will receive, including indirect compensation from sources other than the scheme (i.e., sales of other services by the trustee's affiliates). This information also requires disclosure of compensation paid to distributors so members can understand the services provided, assess the reasonableness of the compensation (direct and indirect) received by the service providers, and identify any conflicts of interest that may impact performance.

We believe such disclosure on compensation and discounting practices will enable market forces to drive down fees quickly and efficiently without the need to set fee caps. Such disclosure also provides trustees with the comfort that their fiduciary obligations are being fulfilled in the best interest of the beneficiaries (the members).

We wish to continuously express our support for your efforts to provide for better investment solutions for MPF members. We have provided further suggestions and opinions in our responses to the 12 questions of the Consultation paper, which we hope you will consider. We highly recommend further definition of the concerns the MPFA is attempting to address so we can provide an efficient and valued service to members.

We thank you for your serious consideration of our views. We look forward to further discussions of this matter.

Respectfully,

Rex Auyeung
President – Asia
Principal Financial Group

Art Bacci
Head – Hong Kong Group
Principal Financial Group

[3] Service providers would include trustee, custodians, administrators, insurance companies, banks, agents, brokers and other advisors.

Responses 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:

As we see it, the core objective of the MPFA and the Government in issuing the "Providing Better Investment Solutions for MPF Members" (the "Consultation Paper") is best illustrated in paragraph 8:

> *"...there has been an emerging body of research internationally which highlights the importance of having well-designed default funds within retirement systems, in the event that scheme members do not, or do not want to, make a choice of funds.* ***It is therefore important to ensure that the MPF system can adequately protect the interests of those members who do not, or do not want to, make a choice of funds, whilst at the same time allowing adequate opportunities for choice by those members who do want to make their own investment decisions."***

The direction and spirit of the Consultation Paper as seen through the above paragraph can be broken down and summarized as follows:

i. Implementing a standardized default framework to adequately protect members who do not, or do not want to, make an investment choice ("defaulters" or "defaulting members");
ii. To address the complexity of the MPF system by making the default investment framework transparent and relatively simple for members to navigate;
iii. Reduce the costs of the MPF system to provide members with good value investment solutions that meet their retirement needs, and;
iv. To promote innovation in the MPF system so as to provide comprehensive choice for members who choose to make their own investment decisions.

We believe that the subsequent introduction of the term 'core fund' in section I.4 dangerously distracts from the objective of the Consultation Paper. It does so in several ways, but its primary distraction stems from the implication that the objectives of creating a meaningful default arrangement for defaulting members can be achieved in a single 'core fund'. The Consultation Paper itself is clear on this point in section III.2 when referencing likely desirable investment solutions.

We understand that reference to a 'core fund' is made in an attempt to provide a standard terminology for consistency throughout the Consultation Paper and 12 Questions. However, given the complexities of the MPF system and the challenges of meeting retirement savings goals, we believe it is unproductive to oversimplify the diagnosis of a need for a default investment framework into a need for a 'low fee, standardized core fund.' As such, where the Consultation Paper refers to 'core fund', we will interpret this to mean a 'default framework', or 'default investment framework'. The objectives of the Consultation Paper can remain the same, but this allows for a more honest discussion over the likely solution and outcome.

- **36(a):** ***"the core fund will be based on standardised default funds".***

We support the objective of implementing a default investment framework for industry participants to provide defaulting members with a more standardized investment outcome.

We believe that a relatively consistent investment outcome for defaulting members can be met through multiple investment solutions (target dates, life cycle, and others), and therefore should not be based on a 'standardized default fund'.

- **36(b):** ***"as a default fund, the investment approach of the core fund should balance long-term risks and returns in a manner appropriate for retirement savings".***

We believe that all retirement focused investment plans should balance long-term risks and returns. Every MPF member is encouraged to consider their individual risk profile and circumstances when considering investment options, and any default investment framework should seek to replicate this objective, to the extent possible, when providing members with a suitable default option.

- **36(c):** ***"the core fund should be good value"***

We believe that it is in the interest of all MPF stakeholders that the entire MPF system be good value. As indicated in paragraph 50 of the Consultation Paper, "good value" includes reference to the provision of value-added services, achievement of desired investment outcomes, as well as an analysis of fees and costs. Given the challenges facing members in retirement planning, each aspect of good value is important, and we encourage the MPFA and the Government to consider some of our suggestions in response to Questions 2 through 12 below, so as to enhance the MPF system for the benefit of all members.

- **36(d):** ***"the core fund is available to all MPF scheme members to choose"***

Any default investment framework should be made available to all MPF scheme members.

In order to truly meet the objectives expressed in (i) through (iv) above, we would encourage the MPFA and the Government to take this opportunity to enhance the MPF system by addressing some of the system's structural challenges.

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

☐ Yes ☑ **No**

Comments:

With reference to paragraph 37 of the Consultation Paper, we see merit to the argument that there could be more consistency in the investment outcome of defaulting members. The Consultation Paper correctly highlights that a potential consequence of the current system is for two materially similar defaulters to have materially different investment outcomes based on choice of service provider, and in this circumstance we agree that a default framework could improve the MPF system.

However, as noted in paragraph 38 and further addressed in the technical issues of Q5, the default framework may be based on multiple CFs, and not any single CF. Additionally, we believe that the focus of the default framework should be on consistency of investment outcomes, rather than standardizing funds. This is further explored in response to Q3 below.

As an additional point, our experience of defaulters is materially different to the MPF Survey results referenced in the Consultation Paper. Based on our internal tracking, we show fewer than 10% of our members to be defaulters, which is well below the 24.1% figure cited in paragraph 25[1]. Anecdotal conversations with other MPF service providers reveal similar defaulter levels well below the cited MPF Survey. Therefore, the discrepancy between our data and the MPF Survey's self-identified defaulters may be an argument in favour of increased investor education and engagement.

Unless a few MPF providers have a significantly higher number of defaulters, the MPF Survey almost certainly includes members who have made a choice, but who do not recall making a choice and, more importantly, likely do not follow their own MPF retirement account. Encouraging members to more actively participate in their MPF retirement accounts through education and awareness will lead to better retirement outcomes.

[1] 24.1% of member respondents "indicated that they had never made a fund choice".

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

☐ Yes ☑ **No**

Comments:

We do not believe that a single "core fund" can meet the stated objectives in the Consultation Paper. Any default investment framework that seeks to provide defaulting members with a relatively consistent retirement outcome that involves de-risking over time will necessarily involve more than a single 'standardized default fund'.

We therefore believe that the focus of the default framework should be to have clear guidance on providing defaulting members with relatively consistent investment outcomes. We would argue that if it is possible for two or more investment options (e.g. target date funds or a life cycle approach) can deliver materially similar investment outcomes, then both investment strategies should be accommodated within the default investment framework. By focusing on investment outcomes, instead of standardized default funds, the default framework could allow MPF providers the opportunity to take advantage of scale in existing CFs, or to create new CFs where it is seen as beneficial to members.

We would also caution against issuing overly prescriptive guidelines/legislation for the default framework. As technology improves and innovation provides new product alternatives to current investment options, any overly prescribed standardization of "default funds" may restrict future development from delivering superior investment outcomes to members.

As a final note, paragraph 39 states that the MPFA expects a level of standardization that allows for 'better benchmarking and comparison of investment performance' across and within the MPF schemes. We posit that while it is possible to achieve benchmarking and comparisons of investment performance in almost any default framework, this consideration should be secondary to achieving a default framework that works within the context of the MPF system. We encourage competition among MPF providers and believe that investment performance is one factor of comparison; however, too much focus on comparing investment performance is not in the long term interests of MPF members. Retirement savings is about developing a savings plan, achieving long-term retirement goals, and not being distracted by short-term market fluctuations.

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:

We agree that an investment approach that automatically reduces risk over time is appropriate within the context of an investment framework for defaulters.

The ideal investment approach is one that matches an investment strategy with an individual defaulting member's retirement needs. However, since the nature of a defaulting member is that they do not, or do not want to, provide additional information (e.g. financial circumstance, number of dependents, other retirement savings accounts) that would allow for a tailored investment strategy, an investment approach must be developed using readily available information. While not necessarily an ideal outcome for all defaulters, an investment approach that automatically reduces risk over time, using years-to-retirement (as estimated by current age and expected age of retirement) is appropriate within the context of an investment framework for defaulters.

However, as noted above, while automatically reducing risk over time is an appropriate investment approach for a default framework, it does not necessarily provide the ideal retirement investment solution for every individual member. For a comprehensive retirement savings strategy, other factors should be considered, which can be further addressed through investor education programs.

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:

As one of the leading providers of target date funds in the U.S. retirement market, we look forward to participating in discussions on the technical issues surrounding aspects of default fund design. Below are some of our preliminary views on the issues addressed in paragraph 48:

- **48(a):** ***"Whether the preferred approach is a series of target date CFs that adjust risk in each target date CF over time or a life cycle approach that varies the member's holdings of different CFs over time"***

We believe that both target date CFs and the life cycle approach can be used to meet the investment objective of de-risking defaulting members' investment portfolios as they near retirement. Furthermore, we believe that both approaches have advantages and disadvantages, and it would in the interest of members to leave the ultimate decision over which approach to implement up to individual MPF providers. So long as a broadly consistent investment outcome can be achieved, the strategy that is employed can be tailor-made by each MPF provider.

- **48(b):** ***"if a series of target date CFs is the preferred approach, how many funds are needed: is one fund every 5 years adequate or are more or less funds preferred, taking into account the establishment and maintenance costs of new funds"***

Ultimately, considerations on the glide path and terminal risk profile will have an impact on the number of target date funds needed. Following international examples, one fund every 5-10 years is a typical range that will likely apply.

- **48(c):** ***"what types of assets should be the investment building blocks at the underlying fund level: more sophisticated design might require more asset types, however, this will involve greater complexity and costs"***

We believe that the underlying investment building blocks should ultimately be decided by individual MPF providers, who are better positioned to weigh the complexity, costs and potential benefits involved in the development of products.

Currently, the investment restrictions within the MPF system allow little flexibility and provide limited choice of underlying investment blocks when compared to international examples. We would encourage the MPFA to explore how the existing MPF investment restrictions might be revised to more effectively leverage available investment strategies and asset classes for the benefit of MPF members. Within respectable limits there is an argument to be made for the inclusion of additional asset classes, including: alternatives, high yield, real estate, etc. These asset classes can provide members with access to other sources of investment returns and allow for greater diversification of portfolios.

- **48(d):** ***"which investment building blocks are more appropriately managed in a passive manner"***

There is no clear cut answer to the question of passive vs. active, which depends as much on investor preferences as it does on investment expertise. Principal, as one of the leading providers of target date funds in the 401(k) market in the U.S., offers multiple target date solutions, including ranges of target date funds that invest in active strategies, passive strategies, and a combination of passive and active strategies.

Additionally, within the MPF context, certain asset classes which some investors consider suitable for passive management (e.g. investment-grade US fixed income) would not be eligible as building blocks given the MPF investment restrictions (e.g. minimum credit rating of BBB or equivalent and above).

- **48(e): "*what should be the approach for reducing risk over time (i.e. the glide path): should de-risking start 20 or more years away from retirement or should it only happen in the 10 years immediately preceding age 65*"**

There are several considerations involved in creating a glide path, which include the following:

i) the risk profile in the early years of investment;
ii) the age at which de-risking begins;
iii) the de-risking slope, i.e. whether straight line or curved;
iv) the terminal risk profile at the expected age of retirement.

While not a comprehensive list, each of the above factors will directly affect the shape of the glide path. Ultimately, in order to answer the above, there are a number of factors that should also be considered:

a) Life expectancy: people are living longer and more active lives in retirement, leading to an increased need for a post-retirement investment strategy.
b) Available mechanism of withdrawal: the ability to take a lump-sum vs. phased withdrawal may impact the desired risk profile at retirement.
c) Investor behaviour: how do members treat their MPF balance at retirement?
d) Post-retirement investment options: is the MPF system a viable post-retirement investment option?

Ultimately, some of these factors that determine glide path structure may be left up to individual providers.

- **48(f): "*what should be the terminal risk profile of the approach at age 65: should risk be reduced as far as possible, or given that members will still need investment exposure post retirement, should some equity exposure be maintained at and beyond age 65*"**

Among target-date investment options (including the life-cycle approach) there is an ongoing debate over the two distinct models: "to retirement" vs. "through retirement". The "to retirement" model proposes that a target date fund should manage the reduction of risk asset exposure to reach the most conservative allocation *at* the target date, after which the risk profile remains relatively constant. The "through retirement" model, on the other hand, focuses on managing the asset allocation and risk exposure *throughout* the life of an investor (beyond retirement), reaching the most conservative allocation at some point beyond the target date.

Each MPF member has different needs, and neither model can address the needs of all defaulters. Additional considerations on the factors listed above in response to 48(e) are needed to address which approach, if any, is more appropriate for the MPF system.

- **48(g):** ***"whether consistency is required on all of these aspects across all defaults in all schemes or can some elements be left to the decision of individual product providers"***

We believe that within the default investment framework there should be a broad consistency of investment outcomes, however, it will also be important to retain flexibility of choice within the system.

As an example, it is possible to provide guidance over the need to have a de-risking strategy and an approximate target terminal risk profile, while leaving decisions on target date vs. life cycle, glide path slopes, asset allocation and investment strategies up to each individual product provider. This would achieve broadly similar investment outcomes for defaulting members, while maintaining an element of differentiation and competition within the MPF system.

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:

While we acknowledge and support the objective that the entire MPF system (not limited to the core fund) provides "good value", we do not believe that attempting to cap fees through legislation is an effective method of achieving meaningful change. As the MPFA acknowledges in paragraph 50 of the Consultation Paper, "good value" is not solely measured by price and fee levels. It includes the provision of value added services and the delivery of favourable investment outcomes. Discussions with our customers indicate that not everyone is focused on fees, with many members and employers willing to pay higher fees for superior service and better performance. The preferences of these consumers should not be ignored or sidelined.

While we understand that a frequent criticism of the MPF system is fees, we would caution against this oversimplification. When compared with equivalent mutual funds that are available for retail sale in Hong Kong, the stated FER for MPF Constituent Funds are relatively competitive across asset classes.[2] In many cases overall MPF fees are well below retail levels. Furthermore, given the competitive discounting practices among providers, the average published MPF fees are not the fees paid by most members. We believe the actual fees paid by members are, on average, at least 20% lower than the published fees.

Regardless, we do believe that more can be done to bring down the costs of the MPF system which will lead to greater efficiency and lower fees. The November 2012 study of the Hong Kong MPF system[3] (the "Study") addressed a few key drivers of cost, which includes administrative inefficiencies, a low level of transparency in pricing, the small scale and the relative young age of the system, and some of the intrinsic qualities of the HK employer market. The MPFA, with the industry, has begun to address some of the recommendations made in the Study, but more can be done to further address the drivers of cost. Below are a few proposals on areas we believe will lead to the greatest gains in efficiency, and increases in scale and transparency, for the benefit of MPF members:

1. **Address high administrative costs through increased automation.** The Study correctly addresses that the current system includes a high percentage of manual and paper-based administrative processing, which adds to costs. We recommend that the MPFA explore allowing providers greater flexibility in the use of technology and automation. Given that one of the hurdles towards greater technological efficiency is consumer behaviour; our experience in operating in international retirement markets has shown that offering financial incentives has proven successful in pressing consumers to make the switch from paper-based processing to automated methods.

2. **Reduce compliance costs through standardizing investment restrictions.** The current restrictive investment environment of the MPF system unnecessarily adds cost to both investment management and compliance functions. By forcing managers to follow a non-standard investment universe (e.g. higher minimum credit rating than

[2] Based on data from Morningstar as of September 15, 2014, the AUM weighted average Annual Report Net Expense Ratio of Asia ex-Japan Equity, Moderate Allocation Retail Broad (Balanced 50% Equity), and Global Bond Retail are 2.10%, 1.49% and 1.34% respectively. This is roughly comparable to the Consultation Paper's analysis of Equity Fund (1.71%), Mixed Asset Fund (1.84%) and Bond Fund (1.50%).

[3] 'Managing the changing landscape of retirement savings', report on a study of administrative costs in the Hong Kong Mandatory Provident Fund system, Ernst & Young, November 2012.

standard 'investment grade' quality, etc.), additional resources are required to ensure compliance. Additionally, these restrictions prevent investment managers from taking advantage of scale outside the MPF investment universe.

3. **Increase pricing transparency through fee disclosure requirements.** Based on an internal analysis, we believe that at least 25-30% of MPF fees can be attributed to commissions and incentives paid in the distribution of MPF services to employers and members. Further, the MPF sales process creates potential conflicts of interest between members, employers and distributors. For example, do affiliates of MPF providers/trustees offer employers a menu of discounted services (e.g. insurance, banking, financial advice, etc.) that are subsidized by higher MPF fees, which are then ultimately born by employee members?

   We propose that the best method of addressing these concerns is to shine a light on how service providers are compensated, providing members with the information they need to decide on the reasonableness of the fees they are paying. In the U.S., the Employee Retirement Income Security Act ("ERISA") requires fiduciaries to ensure that the services provided to the plan/scheme are necessary and that the contracts and arrangement for services, including costs, are reasonable. This means service providers must disclose information about the services they will provide to the scheme and the compensation they will receive, including indirect compensation from sources other than the scheme (i.e. sales of other services by the trustee's affiliates; insurance, banking products etc.). In providing disclosure of compensation paid to distributors and received by service providers, members can identify any conflicts of interest that may impact performance.

   Retirement plan fees can be complicated to understand. It is important for members to understand the value they are receiving from their scheme. This includes reviewing the overall value of the services provided to assess whether the fees being paid are reasonable.

4. **Increase contribution rates to levels that can provide greater retirement security.** Principal believes that we are in an 'Era of Personal Responsibility' whereby the combination of aging populations, globally competitive employers searching for qualified employees and fiscally constrained governments requires individuals to save adequately for retirement and to be less dependent on other sources of retirement income. A frequent criticism of the MPF system is that it does not provide sufficient savings for retirement security. While it should be noted that the MPF system is designed as a pillar two retirement system and thus was not created to provide complete retirement security, this critique does have merit. Increasing savings rates is the surest way to increase retirement security. This can be achieved through multiple avenues:

   a. Slowly increase contribution rates, e.g. by 1% per year, until contribution levels reach at least 15% of salary;
   b. Increase or remove maximum contribution levels to adequately match retirement savings with earning power;
   c. Provide additional incentives to increase voluntary savings, including but not limited to tax incentives or mandatory employer matches.

   In an era where the international trend is to increase the pension age under Pillar 1 programs and raise contribution levels under Pillar 2 programs, the MPF system should not lag behind. Furthermore, while encouraging higher contribution rates benefits members in providing greater retirement readiness, it also has the benefit of increasing the scale of the MPF system, thereby leading to lower costs.

In conclusion, capping fees at 0.75%, or any level, may on the face of it prove popular (as would lowering taxes, for example), but will not address the underlying drivers of costs within the system. To truly deliver a successful outcome for MPF members, the root causes of these cost drivers should be assessed, with appropriate changes made to the system to enhance productivity and efficiency, ultimately leading to better overall investment outcomes. The Consultation paper states that the fee impact to members will be important to the success of the MPF core fund, however, it should not be forgotten that the true measure of success will be defined by the level of retirement security provided to MPF members, and not solely by any headline fee attached.

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:

As mentioned in our response to Q6 above, we believe that implementing any form of fee cap is not an effective method of controlling the underlying drivers of costs in the MPF system. We urge the MPFA and the Government to focus their time and energy on tackling these problems for the broader benefit of MPF members.

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

☐ Yes ☑ **No**

Comments:

We believe that the choice of active vs. passive investment strategies should be left to individual service providers, investment managers and customer preference.

While we agree that there is an ongoing global debate about the relative advantages of active vs. passive investment strategies, the debate is far from settled. Furthermore, equating passive strategies with lower fees as a sweeping generality is incorrect, and we would argue that the conclusion reached in paragraph 71 (and Table 2) of the Consultation Paper is misleading.

Table 2 looks at Constituent Funds ("CFs"), breaking them out between passive and actively managed strategies and concludes that passive CFs have a lower FER. This is a prime example of selection bias, as the majority of currently available index tracking CFs buy into the same few approved Index Tracking Collective Investment Schemes ("ITCISs"). MPF service providers have likely chosen these ITCIS due to their low cost, and therefore the CFs represented in Table 2 do not reflect of the actual costs associated with the average ITCIS.

A more illustrative guide to measuring the costs of active vs. passive investment strategies in the MPF system is to examine the fees of the available universe of approved ITCISs. Of the more than 120 approved equity-focused ITCISs listed on the MPFA website, only 31 have an FER of 0.30% or below, and all 31 invest in either the U.S. or Hong Kong markets. For non-HK/non-U.S. equity exposure, the cost of ITCISs is higher, ranging from 0.31% up to 1.49%, with the majority costing between 0.50% and 0.75%. Active investment management mandates can often be delivered at, or even significantly below, these costs.

Given that the investment management universe is dynamic, we do not believe that any single investment approach, whether active or passive, should be mandated to be the "predominant" approach. We further reiterate our response to Q5 that the MPFA should consider the inclusion of additional asset classes to allow for greater diversification and better portfolio construction. A competitive market environment and the availability of investment choices, both active and passive, will better determine the appropriate investment approach for any fund in the MPF system.

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

Comments:

We do believe that certain asset classes or markets may be better suited for active vs. passive strategies, depending on individual investment needs and objectives.

Typically, considerations of market liquidity, pricing, information efficiency, and indicators of historical active manager performance against benchmark can determine whether a particular asset class or market is better suited to passive strategies. At Principal we employ the use of passive strategies for markets and asset classes that exhibit little alpha potential from active managers, and where we know there is sufficient liquidity in the ETF or passive strategy so as to be able to transact as needed.

We also believe that individual investor preference also plays a significant role in the choice between active vs. passive management, often beyond any analysis of asset classes.

Q10. Do you agree that the name of the core fund should be standardised 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" (emphasising its design as a basic investment approach for retirement savings)*

☐ *"MPF Simple Investment Fund" (emphasising 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:

We believe that it is in the interest of MPF members to have broad consistency in the presentation and disclosure of the default framework. However, as mentioned in our response to Q1, we do not believe that a single standardized core fund can meet the challenges presented in implementing a default investment framework. As such, standardization of the name may not be possible.

As we have indicated, our belief is that the default framework can be implemented by allowing individual MPF providers the flexibility to choose their own default investment strategy (whether target date, life cycle, or other) within a framework that provides guidance on desired investment outcomes. Within this framework, it is possible to provide all MPF members, defaulting and non-defaulting, with an appropriate disclosure of the default arrangement.

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:

We agree with paragraph 78, that upon implementation of the default framework the accrued benefits and future contributions of MPF scheme members that have previously made a clear choice should not be affected.

However, we disagree with several of the principals laid out in paragraph 79. Is the MPFA suggesting that trustees or administrators have the discretion to make investment switches for MPF members without their prior consent and instruction? Unless this issue is addressed, we do not see how existing defaulters can be switched in the mechanism described in paragraph 79.

Furthermore, switching accrued benefits of all defaulters on a single day would have a material impact on the existing default CF, and the members who have chosen to invest in the default CF. As such, we would strongly urge the MPFA to reconsider any automatic switch of accrued benefits. Instead, we support investor education and awareness programs to help promote new arrangements and the default framework, allowing members to make switches at their discretion.

With respect to how existing MPF members should be made aware of the new default framework, we believe that the MPFA and the Government need to be clear on the purpose and objective of the default framework. It is an unfortunate fact that the MPF system frequently receives negative publicity, which is exasperated by poor knowledge of the MPF system's design and its purpose, as well as inconsistent messaging to the public by the media, government and industry. The objective of any reform must be clearly and coherently communicated to the public.

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:

As an administrator and a trustee we are able to identify all defaulting members and differentiate them from members who have actively chosen to invest 100% into the existing default fund.

For the transition of existing defaulting members, please refer to the concerns laid out in response to Q11 above.

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

Name:	Art Bacci
Organisation:	Principal Hong Kong[4]
Address:	27/F Hopewell Centre, 183 Queen's Road East, Hong Kong

[4] Principal Hong Kong represents a set of wholly-owned Hong Kong based operating companies including Principal Trust Company (Asia) Limited, Principal Insurance Company (Hong Kong) Limited, Principal Asset Management Company (Asia) Limited and Principal Investment & Retirement Services Limited.