Responses to 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

Whilst we agree that there is a strong need for improvement to the current guidelines/arrangements for members who fail, or decline, to provide an allocation for their contributions (i.e. "defaulters"), we disagree that the solution is the introduction of a core fund as specifically described in 36(a) to (d) of the Consultation Paper.

Rationale:

1. All MPF schemes have existing policies for dealing with defaulters. The historical lack of regulatory guidance in this area, plus the range of compliance positions across sponsors, has led to the variation of approaches across the schemes.

2. Launching new Constituent Funds and APIFs to provide for a "core fund" will only decrease scale whilst increasing complexity and cost – contrary to what MPF needs.

3. The term "core fund" is misleading and inaccurate, as the solution for defaulters should not involve a single "fund" nor will such solutions necessarily be "core".

Paragraphs 36(a) to (d) of the Consultation Paper deal with the premises of default arrangements:

- 36(a): "the core fund will be based on standardised default funds"
  - This statement implies a single core fund, which is contradicted with paragraph 48's potential life-cycle approach (varying the member's holdings of different CFs over time). We agree on the need for more standardisation of default arrangements, but do not support the concept of a single core 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"
  - Aside from our abovementioned objection to "core fund" naming, we fully agree with this point. Individuals are fortunately living longer nowadays, meaning a longer retirement and increased importance of retirement savings. Unfortunately, the current negligible interest rate environment combined with the erosive effects of inflation, mean that investments in risk assets (e.g. stocks) will be required to generate the returns required to achieve retirement savings goals – thus requiring an appropriate balance of risk and return delivered by skilled investment professionals.

- 36(c): "the core fund should be good value"
  - Agreed, however for clarity, "good value" should be judged as risk-adjusted after fees returns, not simply low cost/fees (which the Consultation Paper acknowledged). Fees alone are a poor indicator of value as they fail to address the drivers of adequate retirement savings. Indeed, Conservative Funds have the lowest average fees in the MPF system but investment returns that will fail to protect members' retirement savings – a further argument for restructuring Conservative Funds. Other benefits received by members such as service and education also need to be considered in the context of fees.

- 36(d): "the core fund is available to all MPF scheme members to choose"
    - o Agreed, this is necessary for equality and scale reasons, but should remain subject to the investment suitability of each member.

In summary, whilst we agree to the need to improve current arrangements for defaulters, we argue that there are more efficient ways of dealing with this issue than the introduction of a proposed core fund as currently outlined in the Consultation Paper.

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

☐ Yes **☑ No**

A single default Constituent Fund across all schemes is not a suitable approach given the current structure of MPF schemes, existing Constituent Fund options, and different administrator and/or manager capabilities, etc.

We agree on the need for consistency, but that the Scheme Sponsors and their Administrators are the best to determine how to handle defaulters in their respective scheme(s). Should there be any revised default arrangements, we would strongly recommend MPFA to issue guidelines over legislation for speed and flexibility.

Sponsors / Administrators should have flexibility to implement new default arrangements by using:

1) A series of target date CFs
   OR
2) A combination of life-cycle CFs (e.g. Capital Stable, Stable Growth, Balanced, Growth funds)
   OR
3) Another strategy that achieves the same primary objectives of de-risking towards retirement, and consistency of investment outcomes – refer to our response in Q3 below.

We would expect MPFA to provide the framework for schemes to determine their own compliant default arrangements.

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

☐ Yes **☑ No**

We refer to stated objective of the MPFA with regards to default arrangements, i.e. protecting defaulters from extremely negative outcomes when approaching retirement. There are multiple ways of achieving this objective and meeting the default 'fund' criteria, hence a core fund is not necessarily the most appropriate policy response.

Whilst perhaps the most intuitive default option for members is probably a series of 5 year Target Date funds, this option is likely to bring several unintended consequences. Most MPF schemes do not currently offer Target Date options – meaning new CF launches will be required, and will result in issues in dealing with Target Date fund maturation (benefits roll-over), and future CF approvals and regular fund launches.

A combination of life-cycle CFs would primarily leverage existing funds with less need for new fund launches, however is operationally more complex to administer (potentially leading to higher cost if not automated), and more complicated to compare performance across schemes.

The Consultation Paper does not consider other investment strategies that can achieve this overall objective, including:

- Absolute Return funds – aim to produce positive investment returns over cash/inflation typically requiring investment in derivatives and short-selling to hedge equity risks
- Inflation Protected funds – by protecting against specific market conditions (rising inflation) it provides protection for members' savings at retirement, and will typically have lower equity risk for the entire investment horizon

Further, investment theory continues to evolve with regards to retirement investing, and requiring a core fund to be based on a standardised default fund may stifle such research and innovation (or prevent MPF members from benefiting from defined contribution developments in other markets).

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**

Although there are other investment options (e.g. Absolute Return funds) that would not necessarily need to automatically reduce risk over time, we agree with the general need for members approaching retirement to be exposed to lower overall investment risks than younger members.

To help increase comparability of the core funds offered by the different MPF scheme providers (via either target date funds or life-cycle approach allocating between CFs), we would suggest that a guideline be issued regarding the allocation between asset classes. Specifically, an asset class breakdown such as the below would be desired for consistency with asset allocations of benchmark providers (such as Towers Watson):

1) Hong Kong equities
2) Asia ex-Hong Kong equities
3) Japan equities
4) Europe equities
5) North American equities
6) Global Government bonds
7) Global Corporate bonds
8) Global Emerging Market bonds
9) Hong Kong Government bonds (proxy for Hong Kong Dollar cash)

However, during the process of de-risking (e.g. from equities to fixed income), discretion / flexibility needs to be given to managers to adjust allocations such that the core funds are not forced to sell holdings during stressed market conditions in order to comply with the prescribed allocation(s).

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?

Dealing with each of the elements in Paragraph 48 (a) to (g).

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 are generally in agreement with both approaches (with other options suggested under Q3 above), as the basic concept is similar, however we believe the life-cycle approach is a preferable approach for the following reasons:

- The life-cycle approach is more efficient / cost effective. The target date approach requires each MPF scheme provider to launch a series of target date funds as CFs, and will be required to close funds upon maturity dates and launch new funds on regular basis, which could be operationally intensive.

- Under a (multiple) target date CFs approach, the average size of each fund would be smaller, and unable to achieve scale and the efficiency of a larger fund. – which helps drive down costs.

- Some MPF administrators already have a system which is able to allocate member's contribution across different CFs and adjust that allocation overtime. This is one way that an MPF scheme provider can add value in terms of service provided to members. For those who do not currently have the asset allocation model / system available, they could either develop their own model or work with a third party asset manager who can provide the model / asset allocation advice.

In order for the life-cycle approach to be successful, we suggest the MPFA consider the following:

- Each MPF scheme provider needs to ensure they have the basic "building blocks" as CFs, and there is a certain level of consistency / standardisation across different MPF scheme providers. The building blocks need to cover the various asset classes to be provided by the MPFA under the 'default' asset allocation:
  i) Equities: Hong Kong equities, Japan equities, Asia ex-Japan ex-Hong Kong equities, European equities, North American equities;
  ii) Fixed income: global government bonds, global corporate bonds, global emerging markets bonds; and,
  iii) Cash (or equivalent): Hong Kong government bonds (or Hong Kong Dollars or Conservative Fund)

- Given that one of the objectives is to keep the overall fees low, the use of passive / index funds is preferred, and MPF scheme providers are encouraged to have more low cost CFs investing into low cost index funds. In order to do this, there needs to be sufficient and diverse range of low cost index funds in the ITCIS approved list, and to this end, it is imperative for MPFA to relax the existing ITCIS product restrictions to align them to global standards, to encourage more index fund providers to apply, and broaden the list of low cost ITCIS that CFs can invest into:

- For fixed income index funds, under the current requirement, bonds rated BBB- or below are excluded (does not meet the ITCIS criteria), presumably to allow a 'buffer' in the event of a ratings downgrade. This conflicts with global practice, which considers BBB- to also be Investment Grade. The additional compliance cost and sub-scale funds that result from such customisation for MPF is prohibitive (or at least expensive). Therefore, we argue that the MPFA needs to adopt the global market definition of "Investment Grade" (i.e. bonds rated BBB-/Baa3 and above) and hence enable more existing index funds to qualify as ITCIS. The ratings 'buffer' is irrelevant for ITCIS, as investment grade bond indices will remove downgraded bonds upon rebalancing (typically monthly for most fixed income indices) and the ITCIS will follow suit and promptly sell down any non-Investment Grade holdings. Ultimately, even non-investment grade bonds should have a place in long-term investment portfolios such as MPF.

- To be approved as an ITCIS, securities lending is limited to 10% of the fund assets by the MPFA. However, a key feature of index funds (in all other main regions) is their ability to actively engage in securities lending to a higher amount, as long as there is prudent risk management in place as it adds revenue to the fund and ultimately benefits the investors. For example, in Europe, UCITS regulations allow up to 100% lending, but instead focusses on collateral requirements to ensure the counterparty risk is mitigated and the index fund is protected. The significantly lower MPF security lending limits are preventing more index funds from applying for ITCIS status. We urge the MPFA to raise the securities lending limit to 50% of fund assets, as long as the securities lending is fully collateralised to protect members.

- Expand the list of approved stock exchanges and eligible securities that an ITCIS fund can invest in, or ETF listing venues to be eligible as ITCIS. Examples of issues include: the Shenzhen, Shanghai and Indonesian stock exchanges are not approved exchanges, investments in REITs have artificial limits, certain stapled securities are not permitted, ETFs listed on BATS in the U.S. do not qualify as ITCIS, plus others. Such restrictions deviate from existing fund regimes in Hong Kong or Europe, and have the effect of reducing the range of existing ETFs and index funds that are eligible to be ITCIS, and the range of securities that managers can invest in to generate additional returns for members. We strongly exhort the MPFA to standardise investment restrictions and ITCIS suitability with the Hong Kong Securities and Futures Commission (SFC) equivalent rules, or (preferably) harmonise with a near globally recognised regime such as Europe's UCITS.

- Constituent Funds are currently required to have 30% Hong Kong / Hong Kong Dollar exposure. This is an unnecessary restriction from an investment standpoint, as it limits manager flexibility and increases costs in managing MPF funds. Further, it may be dangerously increasing home bias for members, as many of their personal investments (outside of MPF) are already likely to have home bias (i.e. overweight) in Hong Kong and Asia exposures. The 30% restriction should be scrapped to improve performance for members and help members better diversify their portfolios/savings.

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;

As explained above, in our opinion, the life-cycle approach is preferred. However, if target date CFs is the chosen approach, one fund every 5 years is adequate (e.g. 2020, 2025, 2030, 2035, 2040), taking into account the costs in establishing and maintaining the funds. More funds would only increase the operational / admin burden without a significant benefit to members, and reduce the benefits of scale, as each fund would be smaller on average.

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;

The default allocation set by the MPFA (or benchmark providers) should provide broad, diversified exposure to securities globally, rather than be limited to regional (i.e. Asia Pacific) exposures. This reduces concentration risk and home bias, as many members' personal investments are likely to have home bias / overweight on Hong Kong / Asia exposure already (as noted in Q5.c above)

- As outlined in the response to Q5.a above, in order to create such broad / diversified allocation, each MPF scheme provider needs to ensure they have the basic "building blocks" as CFs, APIFs or ITCIS, and there is a certain level of consistency / standardisation across different MPF scheme providers. The ten (10) building blocks that we propose are as follows:
  6x Equities: Hong Kong equities, Japan equities, Asia ex-Japan ex-Hong Kong equities, European equities, North American equities, global emerging markets equities;
  3x Fixed Income: global government bonds, global corporate bonds, and global emerging markets bonds; and,
  1x Cash / Cash equivalents; Hong Kong government bonds

  Note: if the MPFA removes the 30% Hong Kong minimum as proposed in Q5.a, this list could be further simplified

d) which investment building blocks are more appropriately managed in a passive manner;

Globally, there is a wide variety of index funds and ETFs covering stocks, bonds and alternatives, providing broad exposure across countries/regions and sectors, which can be used as investment building blocks for MPF schemes. The key is to have a sufficient list of <u>existing index funds approved as ITCIS</u> that can be used as building blocks, however currently the list of ITCIS is limited in asset class (predominantly equities) and scope (mainly global / developed markets). As outlined in our response to question Q5.a, a number of issues are limiting the breadth of ITCIS applications, especially lower cost ETFs into the MPF System, limiting the use of index building blocks in any future default 'fund' asset allocation.

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;**

As reference, the following table shows analysis of equity allocations of target date funds in the US (source: Morningstar, as of 31 December 2013):

Target retirement year	**2060**	**2055**	**2050**	**2045**	**2040**	**2035**	**2030**	**2025**	**2020**	**2015**
Years away from retirement	**47**	**42**	**37**	**32**	**27**	**22**	**17**	**12**	**7**	**2**
Equity Allocations (% of Fund assets)										
Minimum	90	83	80	80	70	70	53	45	35	25
Maximum	95	100	100	100	96	96	92	86	79	78
Average	93	92	91	90	88	85	78	71	60	52
Median	93	94	91	90	90	87	80	73	63	54

As seen from the table above, equity allocations are reduced as we get closer to retirement age, but the allocations vary between each fund and the range can be wide. The shorter-dated target-date funds have more variation in their equity allocations than longer-dated ones. Funds aimed at those planning to retire in 2015, for instance, have glide-path equity allocations that vary from 25% to 78% and averaging around 50% just before maturity, while the equity allocations for 2045 funds are more tightly clustered, ranging from 80% to 100%.

Ideally the glide path / de-risking mechanism should depend on the individual's risk profile, as those with higher risk tolerance probably prefer having more exposure to equities for longer and do not want de-risking to start too early. However, given the MPF 'default' will not distinguish between individual risk profiles, the more conservative approach (where de-risking starts earlier) could be adopted as the glide path, i.e. the figures shown in the "Minimum" row.

The Manager should still retain flexibility or time window in when to implement the de-risking, depending on market conditions (e.g. not forced to sell equities and buy bonds when equity prices are low and bond prices are high).

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;**

As explained in the answer to Q5.e, this would ideally depend on the risk profile of the individual member, as those with higher risk tolerance would probably want more equities exposure post-retirement, in the aim of producing higher return. However, given that neither target date funds nor life-cycle approach would distinguish between individual risk profile, a conservative approach may be adopted. Using the US target date market as reference, there is still an allocation to equity of around 25% at retirement age, even for the most conservative fund.

It is worth noting that in the US, there are some funds which continue de-risking post retirement (i.e. the glidepath continues after age 65), so the equity allocation is further reduced.

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**

   At a high level, there should be consistency across all schemes. However, as described in the various responses herein, being too rigid may impact the ability to deliver better investment returns, and limit innovation and choice. Hence leaving some elements to the discretion of the schemes/providers is recommended or even necessary, e.g. to enable the manager to deliver better investment 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**

Our view is that the introduction of a cap on management fees is not in the long-term interest of members of MPF schemes (refer to Q7 below for our comments on total fees / FER).

We fully agree that the MPF default option should be designed in a manner that represents good value for money, and we do agree with the assertion that fees should be expected to further reduce, however capping management fees is not the most reasonable or effective means to do this or provide members with "good value".

The MPF System is operated by the private sector. As such, there is a need to balance members' interests with sufficient commercial viability for providers to invest in infrastructure, member servicing, and education.

The structure of MPF is complicated and involves multiple parties, each affected by different cost drivers - including non-standard investment restrictions (refer Q5.a above), administration complexity, reporting requirement, level of client servicing, insufficient automation, additional compliance requirements, and so on. Mandating lower fees is counterintuitive without first addressing these reasons causing costs to be high in the first place (which the Consultation Paper fails to do).

With reference to Ernst & Young's two studies on the MPF system published in May[1] and November 2012[2], (collectively the "E&Y Papers"), we note that:

1) the investment management fees of MPF funds were lower than expected given the relatively small size of the MPF system;
2) the six (6) cost drivers identified mostly result from scalability and operating inefficiencies:
   i) A higher percentage of manual and paper-based administration processing - each additional transaction adds costs;
   ii) A larger percentage of small employers and self-employed persons - increasing the volume of the employer transactions for administrators;
   iii) A flexible and full service system offering wider member services - increasing process complexity and workload for administrators;

[1] *The evolving MPF system: an objective assessment*
http://www.hkifa.org.hk/upload/Documents/2012News/The_evolving_MPF_system_-summary.pdf

[2] *Managing the changing landscape of retirement savings: Report on a study of administrative costs in the Hong Kong Mandatory Provident Fund system*
http://www.mpfa.org.hk/eng/information_centre/publications/research_reports/files/MPF%20Consultancy%20Study%20Report%28Eng%29.pdf

iv) Smaller scale of assets under management - limits the benefits of economies of scale;
v) Limited industry wide process or infrastructure - limit the ability to spread infrastructure costs across the system;
vi) Insufficient pricing competition - reducing the pressure for providers to minimise costs

Fees have been reducing over time, and furthermore, the FER measure does not take into account bonus shares or other discounts that reduce the net fee impact to members. Whilst the MPF stakeholders have been working to implement some of the cost saving measures as suggested in the E&Y Papers (e.g. Employee Choice Arrangement, online and electronic payments, etc), there are still quite a number of measures that have to be implemented before the total potential savings mentioned in the E&Y Papers can be realised.

We believe that in order to achieve such low fees contemplated in the Consultation Paper, the MPFA would need to implement or push for a broad package of reforms including: (i) unifying the ITCIS criteria and MPF investment guidelines with the SFC Code on Unit Trusts, (ii) simplifying CF / APIF / ITCIS product approvals, (iii) raising contributions and eliminating contribution caps, (iv) providing greater tax incentives to voluntarily build scale faster, (v) reducing compliance burden, (vi) eliminating all remaining manual processes, (vii) reducing reporting requirements, and other recommendations as outlined by Ernst & Young in their suggested 5 strategic responses (which they estimate would reduce costs by 0.35% of AUM in addition to the potentially up to 0.30% 'saving' from recognising discounts and bonus shares in the FER).

In not addressing underlying cost drivers, the Consultation Paper seems to imply that switching to "passive" building blocks will enable the FER to be reduced from the current average 1.69% to 1.00% – a drop of 0.69% – whereas Ernst & Young estimated the entire investment/fund management component makes up only around 1/3rd of the FER (~0.55% currently, with some funds as low as 0.15%) hence whilst switching to "passive" will typically help, it simply cannot achieve the desired saving alone. The MPFA is requested to share further insights on how they believe the proposed total FER of 1.00% could be achieved – e.g. split by fee component.

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**

As per the response to Q6 above, our view is that the introduction of a cap on the FER is not in the long-term interest of members of MPF schemes, preferring instead to take underlying root causes of cost, and better reflecting the true cost to members in the FER (e.g. taking into account bonus shares as a cost offset in the FER figures). Further, it is premature to conclude what a reasonable fee level should be given the uncertainty surrounding the structure of the default option as FER is highly correlated to the investment design as well as the administrative overhead.

However, should the MPFA introduce such caps, our preference would be to focus on the FER and not the Management Fee, as it is FER that impacts the investment return for MPF members.

Further, many ITCIS (especially exchange traded funds) are priced as "all-in" fees, which would disadvantage many of these index funds if there was to be a cap on management fees for default 'funds'. Having a cap only on FER but not management fees would avoid this issue.

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

☑ **Yes** ☐ **No**

Index-based investment strategies <u>are</u> suitable for the proposed default 'fund' based on the information provided in the Consultation Paper and/or separately by the MPFA. Importantly, we wish to highlight the importance of the quality of indices to be tracked by the default 'fund'. The indices used should be representative of the underlying investment universe and based on objective and rule-based methodologies. The indices should align with international standards to minimise complexity, maximise scale, and manage costs, e.g. classification of bonds into investment grade (credit rating of BBB- or above) and non-investment grade bonds. This will help index providers and investment managers be more efficient to manufacture and track the indices.

Should the proposed investment changes listed under Q5.a above be implemented, as an investment manager we believe we would be in a position of offer index-based investment strategies covering <u>all</u> relevant asset classes required by core funds (refer to Q4 above).

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

While index based approach is common for equities and fixed income securities, it can also be used for other asset classes – hence there are few, if any, asset classes that would not be appropriately invested on an index-based approach. Our view is that CFs in MPF schemes should not be restricted from investing in index funds that invest in certain 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**

We agree that the naming should be standardised for convenience. Our preference is "Default Option" (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). It avoids issues with the use of "Core" (may imply central recommendation by MPFA or scheme sponsor) and "Fund" (as it may be implemented using a life-cycle approach instead).

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

☑ **Yes** ☐ **No**

We broadly agree with the approach to deal with transitional issues as set out in paragraphs 78 and 79.

Paragraph 79 mentions that:
"... (The existing MPF scheme members who have not previously made a choice of CF) will be notified of the new arrangements in advance and given a fresh opportunity to make a choice of fund if they wish to, failing which, they will be invested into the new core fund."

We would suggest that a time limit (e.g. 1 month) be given to the existing members to respond to the notification, and after the time limit, their accrued benefits and future contributions will be invested into the new default option. The notification should also highlight that that members can change their allocation of contributions by informing their new investment choices to their MPF Scheme at any time.

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**

We broadly agree that all members who currently wholly invest contributions into existing default CF(s) are given a fresh opportunity to make a choice of fund, as described in paragraph 81. Please also refer to our comments in Q11 above.