

**Date:** 10 October 2014 **By Email**

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

**From:** Hong Kong Retirement Schemes Association

**Subject:** HKRSA Submission on the Core Fund Consultation

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### Introduction

The Hong Kong Retirement Schemes Association (HKRSA) was established in 1996 to promote the interests and best practices of retirement schemes in Hong Kong, including provident and pooled retirement funds. The HKRSA has over 120 corporate members and is a not-for-profit, non-political association, which represents retirement schemes and their members, providing a forum for discussion on issues of current and topical interest. In December 2010 the Association released a paper entitled "The Future of the MPF System - Review and Recommendations".

HKRSA decided to form a Core Fund Workgroup to consider and address the issues in the FSTB and MPFA paper entitled "Providing Better Investment Solutions for MPF Members", released in June 2014 (the "Consultation Paper"). We have also considered the material in slides dated 24 June 2014 and 10 July 2014 from the MPFA briefing sessions.

This paper responds to each of the questions in the Form included in the Consultation Paper, as per below.

### Executive Summary

The following is a summary of our views:

- The current MPF system represents government policy on retirement protection in respect of pillar II: a defined contribution lump sum system that is privately managed with supervision and oversight by relevant regulators. Should the policy intent be changed, this should be widely consulted and debated among many stakeholders and not done through a core fund consultation.
- The current proposal appears to take a paternalistic approach – aiming to protect the defaulters who do not choose but how about those who actually make a choice which could very well be the wrong choice for them - shouldn't they be protected as well?
- The need for investor education is of paramount importance – so that the public appreciate that they need to make an active decision in selecting an appropriate fund and preparing for their retirement. The government should conduct a comprehensive communication strategy to educate citizens about retirement savings.

- The term “Core Fund” could be misleading and raise potentially high expectations of the performance of the fund
- Too much focus is placed on fees. Why should there be a mandatory fee cap on the Core Fund when there is no cap on other funds?
- Our preference is for keeping the current practice whereby each scheme sets its own default fund. Use of any passive / active strategy should be left to the discretion of the scheme provider. It is noted that there are currently not many low cost passive funds eligible for MPF, although there are too many funds in total.
- There should not be a standardized investment approach based on age alone. What is more important is the investment risk, return and the individual’s existing financial position. The ultimate objective of a retirement fund is to attain the target replacement income on retirement.
- Unless it is mandatory for all members to transfer the balances in their current default funds to the new Core Fund, the new fund will not have the necessary economy of scale to drive down fees. But if the MPFA forces such a switch, some members might end up suffering an investment loss or a reduced investment gain, so there would be complaints and even more negativity on the MPF system among the public; and who would bear the responsibility? Therefore, we propose that no existing members should be compelled to switch to any new Core Fund.
- It would be more useful for the government to conduct a broader consultation exercise and take a longer term view in articulating the purpose (including the policy intent) of the MPF system and in designing the most appropriate structure needed to deliver the desired outcome - especially in light of the forthcoming policy decisions regarding the future of retirement protection in Hong Kong.

### **General Comments**

Whilst participants in the Workgroup and HKRSA generally represent a cross-section of organizations within the MPF system (from employers to service providers), most of us are also members of the various MPF schemes, and we believe we can share some views on what is generally considered appropriate as well as in the best interest of MPF scheme members on the whole. It should be noted that this submission represents the majority view of the Workgroup, based on the group’s analysis of available information about the market as presented by providers. In addition, our comments draw on the practical experience gained from connecting regularly with members, including providers who conduct information sessions and employers who need to address member’s issues or other concerns.

We note the matter of structural efficiency (paragraph 66 onwards) about whether a Core Fund would be centralized or whether each scheme should have its own core fund that follows the pre-determined investment approach (as established for the Core Fund). If there were to be such a centralized Core Fund, it should be equipped and positioned to include provisions that the Government might be expected to provide backing (as per the CPF in Singapore), and not just rely on the providers in the private sector. However, this proviso

would go against decades of analysis and discussions that opposed the setting up of a central provident fund and resulted in the establishment of the current MPF system instead.

We believe that a piecemeal approach is potentially chaotic. What is more important is taking a longer term view and addressing retirement protection concerns in a comprehensive manner, including reviewing the merits of more effective means to provide income security for the elderly.

Unless it is mandatory for members to transfer accrued benefits in their current default fund (e.g. a conservative fund) to the new Core Fund, this new fund will not have the economy of scale to drive fees down. However, if it is compulsory for members to switch over to the new fund, and if some of them end up with losses or smaller gains than their original fund(s), since they did not actively choose the Core Fund, would there be associated liabilities?

Therefore we suggest that only those who choose to do so should move to the new Core Fund.

### **Questions from the Consultation Paper**

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

The proposal:

- (a) Standardized default fund ( but what is the meaning of “standardized” )
- (b) should balance long-term risks and returns
- (c) good value
- (d) fund be available to all scheme members

Yes       No

We do not believe that there should be a standardized investment approach. Furthermore, what is meant by “standardized” (with regard to fees, risk or other aspects), when the outcome cannot be certain or pre-determined due to the nature of investments including variability in performance?

There is no need for another set of new default funds for every provider. The status quo of continuing to provide the existing default funds is more appropriate since they have served the MPF system without any apparent or perceived problems. Also, the term “Default Fund” is better than “Core Fund”, since “Default Fund” carries less value judgment, and is more commonly used in the pension /retirement industry globally, whereas “Core Fund” may be misleading for the less informed investors (members).

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

Yes       No

Please refer to the answer under Q1.

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

Yes       No

Please refer to the answer under Q2.

What is more important is the investment return and outcome.

Also, paragraph 39 mentions that a standardized approach to defaults will facilitate better benchmarking and comparison of investment performance and fees across MPF schemes. Shouldn't the focus be on "net return over time"?

**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

The investment approach should balance long-term risks and returns applicable to the entire pre- and post-retirement periods. The emphasis should not be on reaching a particular retirement age (in this case 65). This is an inappropriate approach as members typically live for another 20 years or more past age 65. In other words, the "investment approach" should be focused on longevity (not age 65) with appropriate adjustments.

**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?**

We have no comment on the technical issues.

**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

**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 Q6 and Q7 are fee related, the answer below applies to both questions.

There should not be a mandatory fee cap on the Core Fund (and not on other funds either) because the cap will just become the "floor". Also, why 0.75% as a fee cap? As mentioned above, the broader "fee issue" itself should not be the predominant focus.

If a low FER of 1% is the target, passive style ETF or ITCIS or other similar portfolio so constructed would help to achieve that. The important issue here should be AUM, the larger the AUM the lower the fee. To provide just a fee cap without specifying the risk is inappropriate and can be misleading. The range for multi asset funds run between 1.09% and 2.55% with the median typically around 1.77% to 1.90% (source: MPFA website). So to target the FER at or less than 1% may be far too optimistic.

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

Yes       No

If the MPFA sets the Core Fund risk profile in accordance with a member's age by law, this should be clearly made in a public announcement as a warning to the member. In addition to the warning, there needs to be further appropriate member education. The "passive vs active" issue should be a secondary issue as it is both philosophical as well as market dependent. Moreover, passive funds do not necessarily mean better performance than actively managed funds.

The HKRSA does not agree to adopt a Core Fund as a special default fund. From the perspective of a member who does not make a fund choice, it is inappropriate also to set the risk profile for him or her using a long term perspective. Adopting an active or passive investment style says nothing about the risk profile.

If reducing fees is the sole objective, then passive funds may help achieve this.

Providers should be given the discretion to determine active and passive funds as the Core Fund, perhaps under guidelines and conditions determined by the MPFA.

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

Large AUM will bring lower tracking error and lower fee. It is a lot harder to implement for bonds if the AUM is not very large (i.e. generally if <USD50 million for a fund). Even if the fee is not excessively high, the tracking error can be large. Another concern is that many bond ETFs track indices that have elements that do not meet the current MPF regulations (e.g. credit rating). Moreover, the level of sophistication for eligible MPF investments by virtue of the MPFO is currently not high. Considering passive style investment for those seems inappropriate.

***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?***

Yes       No

The term "Core Fund" is confusing. The term "Default Fund" is more appropriate and is typically used by many other countries.

Should the name of the "Core Fund" be eventually adopted, the name should be standardized across schemes.

***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

We do not see the need for these issues to be addressed based on our position that there is no need for a Core Fund.

However, if the MPFA proposes to introduce the Core Fund, then we wish to point out that the majority of the Workgroup do not agree with the general principle as set out in paragraphs 79-81. This is because:

- a. If the new legislation changes the existing "default selection" for future contributions without providing for active selection when transferring into the new Core Fund, this may incur investment losses and/or produce lower returns on future contributions than the current default fund(s), and the member will suffer.
- b. The proposal "may" create confusion and dissatisfaction among members if they are "forced" to change the existing default selection and their future contribution to be invested in the Core Fund.
- c. The proposal "may" create a considerable amount of administrative work to deal with issues as well as members, with a higher risk of errors by both employers and providers.
- d. A new Core Fund should only apply to those who are newly enrolled and do not elect to make a fund choice at the time of enrolment. However, this will have the disadvantage of not operating at critical mass for some time. Nevertheless, starting from a certain date on, the service provider may have to differentiate between those members who invest in the Core Fund as their preferred fund choice and those members who have not made any fund choice so that the Core Fund becomes their fund choice by default.

***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 do not agree that these issues need to be addressed since in our view, there is no need for the transition. In any case, members can already switch funds or change investment mandate anytime.

Please also refer to comments in Q11.



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We hope the MPFA would find the comments above useful for formulating the final recommendations to the Government on the Core Fund Consultation. Please contact us if the HKRSA could be of further assistance to the Authority.

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