

# Providing Better Investment Solutions for MPF Members

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## *Consultation Paper*



Financial Services and the Treasury Bureau  
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# I. The Path to a Better Mandatory Provident Fund System

## I.1 Introduction

1. The Mandatory Provident Fund (“MPF”) system, implemented in December 2000, is a mandatory, privately-managed, defined contribution, employment-based and fully-funded pension system. The system is the second pillar of the multi-pillar retirement protection model as recommended by the World Bank<sup>1</sup>. It is an important part of the total savings pool for retirement needs in Hong Kong. We should, however, keep in mind that **the MPF system, as merely one of the pillars, is complementary to other sources of retirement savings, such as government social security programmes and individual savings arrangements.** These different pillars need to work together to provide for total retirement savings adequacy for the population. No single pillar can be a solution on its own and improvements to the MPF system could not alone completely address retirement savings adequacy nor coverage for non-workers. That said, **a well-designed MPF system where well-considered investment choices are made by, or on behalf of, scheme members is important** in enhancing the contribution that the second pillar will make to overall retirement savings outcomes for individual workers and the financial sustainability of our retirement protection system as a whole.

2. The development and implementation of the MPF system have always been keenly debated in the community. Since its inception, the Government and the Mandatory Provident Fund Schemes Authority (“MPFA”) have constantly worked towards making improvements to the system to better meet the expectations of stakeholders and this remains an ongoing process. In addition to various supervisory and administrative initiatives of the MPFA, the relevant legislation has been amended on 14 occasions since implementation in December 2000<sup>2</sup> and another Amendment Bill (providing for, amongst other things, benefits withdrawal on terminal illness and withdrawal by installments) is currently under preparation for introduction into the Legislative Council

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<sup>1</sup> The multi-pillar retirement protection model is explained further in the Glossary to this Consultation Paper.

<sup>2</sup> Key legislative changes have included facilitating investment into index funds (2002), introducing an adjustment mechanism for relevant income levels (2002), streamlining scheme administration (2002, 2008, 2009, 2012), refining investment restrictions (2006), enhancing disclosure of information (2008), enhancing enforcement against employers (2002, 2008, 2012), introducing the employee choice arrangement (2009), improving regulation of MPF intermediaries (2012), adjusting minimum and maximum relevant income levels (2002, 2011, 2013), and protecting the interest of scheme members upon bankruptcy (2011).

shortly. We fully understand that, as with retirement savings systems in other jurisdictions, a system that is so important to so many members of the community will continue to attract vigorous debate. The Government and the MPFA remain committed to improving the system in a structured manner that has due regard to the fundamental premise of a diversified, multi-pillar retirement protection model.

3. Various issues are the subject of ongoing debate including the level of fees and charges, the complexity of decision-making for members and whether returns generated by funds within the system meet expectations of what should be delivered by a well-designed retirement savings product are of particular concern.

## **1.2 The level of fees and charges**

4. As part of the strategy to address the fee issue, the MPFA commissioned a consultancy study on the cost of operations of MPF schemes in 2012. The Consultancy Report<sup>3</sup> was published in November 2012, and based on it, the MPFA formulated a number of short-term measures to reduce the costs of MPF schemes and consequently the fees charged to those schemes. Progress made on various short- and medium-term measures is summarized in paragraph 53. Since late 2012, providers have reduced the fee levels of some 36% of MPF funds<sup>4</sup>. These reductions represent increased investment returns flowing through to members of those funds.

5. In addition, in 2012, the MPFA recommended to the Government that fundamental changes to improve the MPF system be made and options that can be further explored, including providing low-fee funds in all MPF schemes; considering the possibility of introducing a not-for-profit operator to operate a simple and low-fee MPF scheme (a public trustee); reviewing the feasibility of imposing a cap on fund fees; and providing a type of basic, low-fee, default fund arrangement.

6. In his 2013 Policy Address, the Chief Executive noted concerns

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<sup>3</sup> Report on a study of administrative costs in the Hong Kong Mandatory Provident Fund System, Ernst & Young November 2012.

<sup>4</sup> With fee reductions ranging from 0.5% to 70.2% from their former level.

expressed in the community and highlighted that the Government and the MPFA would work together to adopt a multi-pronged approach to bring down MPF fees and charges. The Financial Secretary further mapped out in his 2013 Budget Speech the improvement measures, including promoting electronic platforms, consolidating employees' accounts, rationalizing the types and numbers of MPF funds in order to reduce the administrative costs, maximizing market forces to reduce fees and charges, as well as, in parallel, developing proposals on MPF fee cap that will be introduced in case of market failure.

### **I.3 MPF investment choice and decision-making**

7. The experiences of pension arrangements in other jurisdictions have been reviewed to ascertain lessons and insights into how best to deal with the complex issue of investment decision-making by members. Research from key international bodies such as the Organisation of Economic Co-operation and Development (“OECD”) and the International Organisation of Pension Supervisors (“IOPS”) provides roadmaps for the way forward and a number of key insights. It should be emphasized that **saving for retirement is a long term process, typically around 40 years, exposing investments to multiple market investment cycles.** This suggests that **members should adopt the right perspective towards inevitable cyclical market fluctuations and place their investment focus on managing the various types of risks and risk/return trade-offs throughout the whole investment period.** Furthermore, larger contributions will tend to be made and accrued benefits at their largest towards the end of the working life, thus increasing risks at that time. This suggests that to achieve a good balance between risks and likely returns over that important period, members should generally be more conservative with their investment approach as they approach retirement age. It can be seen that **saving for retirement is therefore different from strategies that may be appropriate for typical retail investments.** In contrast to shorter term and retail-driven investment strategies and behaviours which might appropriately focus on short-term trends and opportunities, saving for retirement requires a structured approach that focuses on the long term and caters to specific risks closer to retirement.

8. Locally, we know that many MPF scheme members do not take an active role in managing their MPF investment, many are confused about investment choice and many do not feel that they have adequate financial

knowledge to make investment decisions. Balancing the various investment implications can be quite difficult for members who may not be very knowledgeable or experienced in complex issues such as investment and how various risks can be best managed. Even members who may be quite knowledgeable about share trading, for example, might not appreciate the fundamental differences between trading strategies and strategies appropriate for investing retirement savings. In this regard, 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.**

#### **I.4 Proposals – Introducing a core fund**

9. After careful consideration, the Government and the MPFA have come to the view that the most pragmatic and effective next step in reforming the MPF system, is to improve the investment choice framework by **ensuring that all MPF scheme members have access to a standardized, low-fee investment product that is designed in a manner consistent with the overall objective of retirement savings.** We therefore propose a new arrangement, set out in more detail in Part III below, under which all MPF schemes will offer the same type of low-fee investment fund or funds, referred to as the “core fund” below. This core fund will be built around, and based on, analysis related to the appropriate default investment approach for members who do not, or do not want to, make an investment choice. MPF contributions from scheme members who do not make a choice of fund will be invested in the core fund. The core fund will also be available for selection by other scheme members if they consider that its investment strategy and low fees suit their personal needs. In addition, we envisage that the core fund will become a benchmark and a driving force for competition and fee reduction for other funds in the MPF system.

10. **In summary, the core fund is a new arrangement, which will have the following features:**

- a. **the design of the core fund will be based on the standardized**

**default fund developed for those MPF members who have not made any investment decision;**

- b. the investment approach of the core fund should be to balance long-term risks and returns in a manner appropriate for retirement savings. Taking (a) above into account, it is proposed that a life cycle/target date approach that reduces exposure to risky asset in the period before a member reaches the age of 65, may be the preferred investment approach;**
- c. the core fund should be good value, in particular, the fees for the core fund should be 0.75% of assets per annum or under, and in the medium term, the fund expense ratio (“FER”) for the core fund should be kept at or under 1%. The use of passive investment strategies will help make low cost and low fee outcomes more achievable;**
- d. all MPF scheme members are free to choose the core fund, if they consider that the investment strategy and the low fees of the core fund suit their personal needs.**

## **I.5 Objectives of this Consultation Paper**

11. In line with the insights and developments above, this Consultation Paper sets out longer term reform proposals for the MPF system focused on ensuring that all MPF scheme members have access to a low fee, standardized core fund that is designed in a manner consistent with the objective of retirement savings needs. Members of the public are invited to consider the 12 questions set out in this Consultation Paper, and to comment on the broad proposals and some of the more detailed consequential implementation issues.

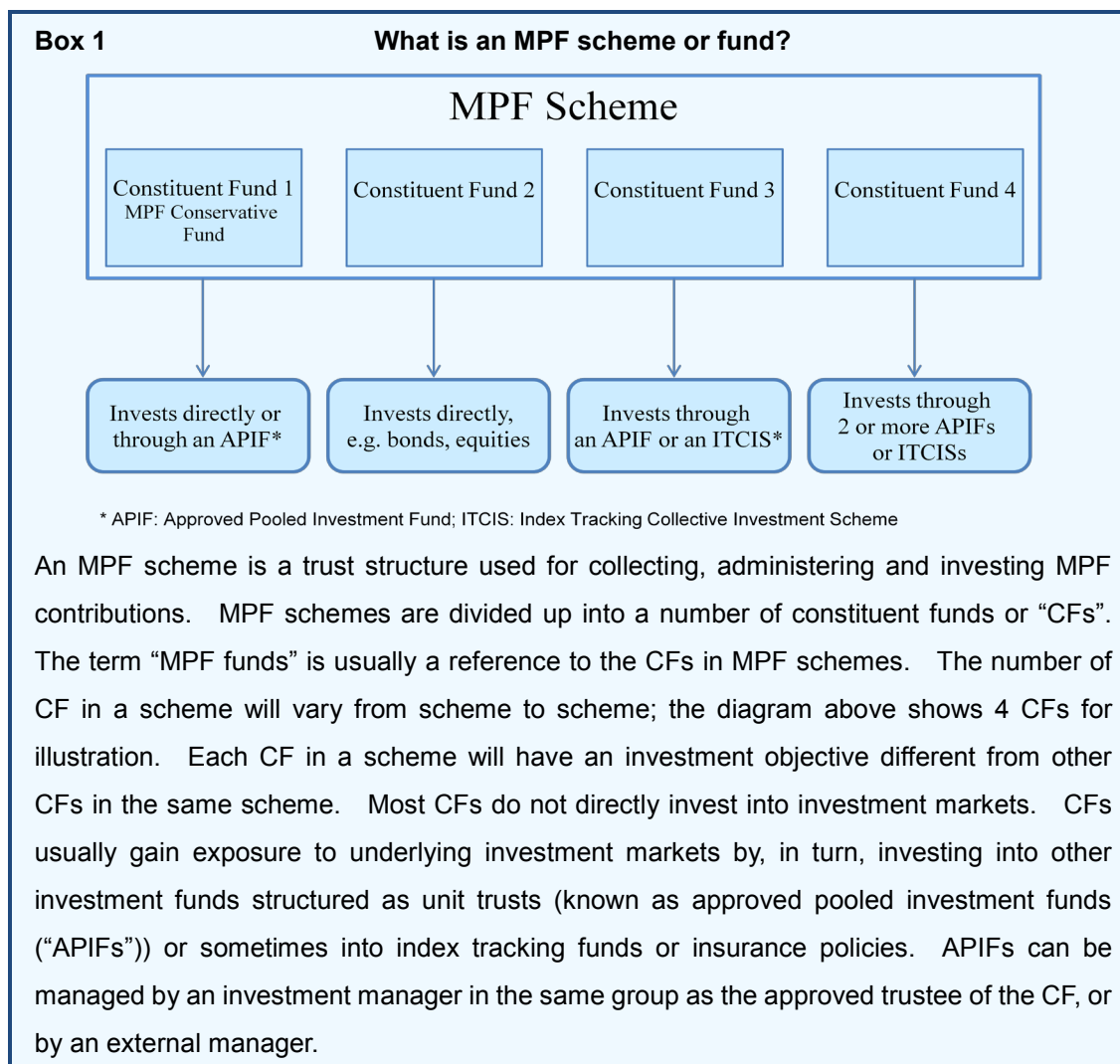
## **I.6 Way forward**

12. The Consultation Paper will be open for comment for three months after which the MPFA will consider the views and opinions obtained before making more concrete proposals to the Government. In parallel, the MPFA will seek views from the industry and others on technical details and how best to launch the core fund. The Government and the MPFA aim to have the necessary legislative processes and operational issues completed in a timely manner, and subject to that, the new core fund arrangement in place within 2016.

## II. Investment Decision-making in MPF – Issues and Concerns

### II.1 Retirement investment decision-making and risks

13. Under the MPF system, all relevant employees, their employers and self-employed persons are required to contribute a percentage of income towards an MPF scheme. For employed persons, the employer has the right to choose the scheme that employees will be enrolled into<sup>5</sup>. Employees have the right, but not the obligation, to make investment decisions by choosing between various investments options, called constituent funds (“CFs”) offered under the scheme in which they are enrolled. For self-employed persons, they have the right to choose both the scheme and the CFs.



<sup>5</sup> The Employee Choice Arrangement is further explained in the Glossary to this Consultation Paper.



14. The right to make investment decisions by choosing between CFs, is a key right of scheme members. The investment return generated by those investment decisions is a key determinant of how much the member is likely to generate in retirement savings. It is through making choices about the type and combination of CFs that members put into effect decisions about the types of asset classes, securities and geographies they wish to gain investment exposure to. Implicit in these decisions is the extent and type of risks that members are willing to accept as a part of their retirement savings strategy.

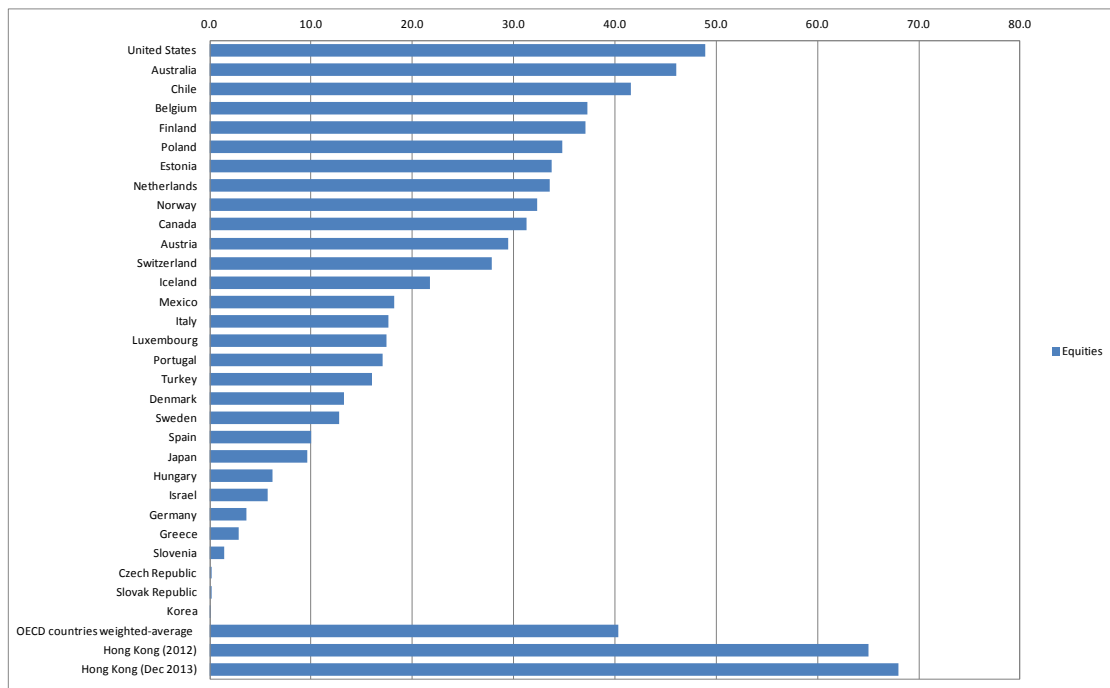
15. The outcome of the retirement savings strategy in second pillar savings systems like the MPF system will have an impact on arrangements in other pillars such as government social security programmes. Any shortfalls or extremely negative outcome in the second pillar will affect fiscal arrangements and public finances supporting the other pillars.

16. Making decisions about investment for retirement purposes is quite different from other day-to-day investment decision-making. Investing for retirement is a long-term process, involving the investment of contributions made at regular intervals over the whole of the working life which is typically considered to be around 40 years. Making regular contributions can help to smooth annualized returns over time (often referred to as “dollar cost averaging”); however, the long-term nature of investment for retirement will expose investments to multiple investment and market cycles which will result in short- and medium-term volatility. Following a typical career path, larger contributions will be made towards the end of the working life, which, combined with benefits accrued over the years, means that retirement savings are exposed to substantially greater risk of loss in years immediately prior to retirement. These risks are compounded by the fact that persons closer to retirement have little opportunity to remedy the damage that a couple of very bad years of investment returns can have on their investment savings. These investment considerations are in sharp contrast to shorter term, retail-driven investment strategies and behaviour which might appropriately focus on shorter-term trends and opportunities. Balancing all of these investment implications can be quite difficult for the average worker who may not be very knowledgeable or experienced in investment, particularly over such long-term horizons.

## II.2 Range of investment choices

17. Currently, there are various types of CF available in the MPF system, ranging from lower risk money market and bond funds, to higher risk funds like equity funds. The majority of MPF assets are invested in mixed assets funds, which comprise investments in both equities and bonds at varying proportion, although equity funds are also a popular choice. In sum, this results in a total exposure to equities of some 68% as of December 2013<sup>6</sup>. This is very high by global standards with the average equity exposure for private pensions in OECD countries being only 40%<sup>7</sup>. An inevitable consequence of this high exposure to equities is that MPF system-wide returns can be very volatile over short time frames. Such volatility needs to be managed, particularly in the period leading up to retirement.

**Chart 1: Pension fund exposures to equities as a percentage of total investment in 2012**



Source: OECD Global Pension Statistics and MPFA Statistical Digest

18. In the MPF context, the number of CFs available for choice by members in an MPF scheme ranged from 3 to 27 funds in May 2014. On average, an MPF scheme offers around 12 CFs as investment choices. Many schemes also allow members to choose and spread their contributions across

<sup>6</sup> Mandatory Provident Fund Schemes Statistical Digest.

<sup>7</sup> Pension Markets in Focus, OECD, 2013.

several CFs in the scheme. The total number of CFs in MPF schemes increased from 299 at the commencement of the MPF system in 2000 to 477 in May 2014<sup>8</sup>.

19. Whilst initially there was a greater focus on mixed asset funds, it is noted that over time, more of the newer funds were less diversified and providers were keen to offer funds that focused on narrower categories of investments such as less developed equity markets or specific sectors. Whilst a greater range of CFs meets the needs and wishes of some members, there were concerns that this may, over time, expose some MPF members to risks that they could not fully appreciate. Also, constantly expanding fund range means that MPF assets are getting more fragmented, which is not conducive to achieving scale benefits that can drive down costs. In view of these developments, and having regard to the balance of arguments for and against greater CF range, the MPFA has tightened up its approval policy for new CFs. The revised policy seeks to ensure that newly approved CFs have a diverse investment profile with a different investment policy from the existing funds in the same scheme and that addition of the new CFs would be in members' interests, such as having lower fee than similar funds.

### **II.3 Default investment choice in MPF**

20. In practice, members indicate their choice of CF by completing a form, either in hard copy or on a website, which sets out all available choices of CFs. This is often done as a part of the membership enrolment process.

21. If a member does not indicate a choice of CF, the approved trustee of the scheme will, by default, invest the contributions received for that member in one or more of the CFs under the scheme as specified in the offering document or the member enrolment form. Such funds are commonly known as "default funds". These default CFs, just like other CFs, are also available as a choice for members who do make investment decisions.

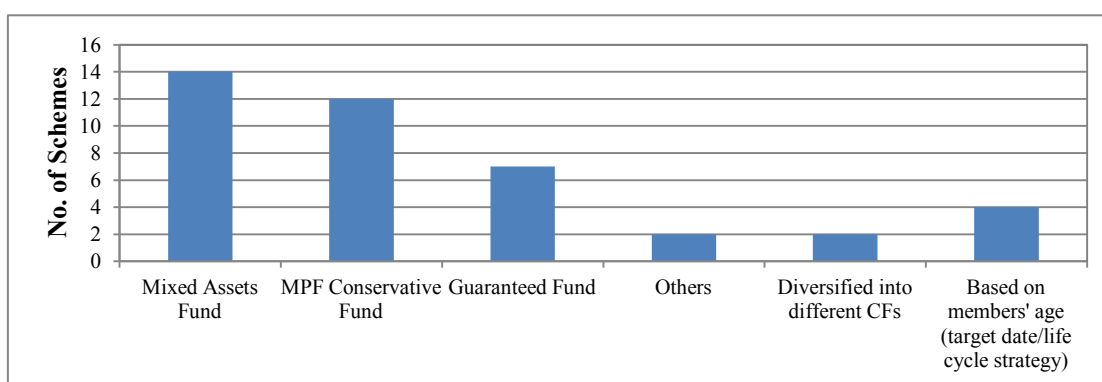
22. At present, there are no regulatory requirements stating which type of fund should be the default fund in a scheme. As a result, CFs designated as

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<sup>8</sup> A list of registered MPF schemes and constituent funds is available on the MPFA website at [www.mpfa.org.hk](http://www.mpfa.org.hk) under "Public Registers".

default funds as set out in the scheme rules differ substantially, as shown in Chart 2 below. In May 2014, existing MPF schemes used the following types of funds as default funds: mixed assets funds (14 schemes), MPF Conservative Funds (i.e. a type of money market fund, 12 schemes), guaranteed funds (7 schemes), target date/life cycle funds (4 schemes), others (investing in short-term debt securities and deposits, 2 schemes); and 2 schemes have opted to distribute contributions into a number of different CFs in the same scheme if the scheme member does not, make a fund choice<sup>9</sup>.

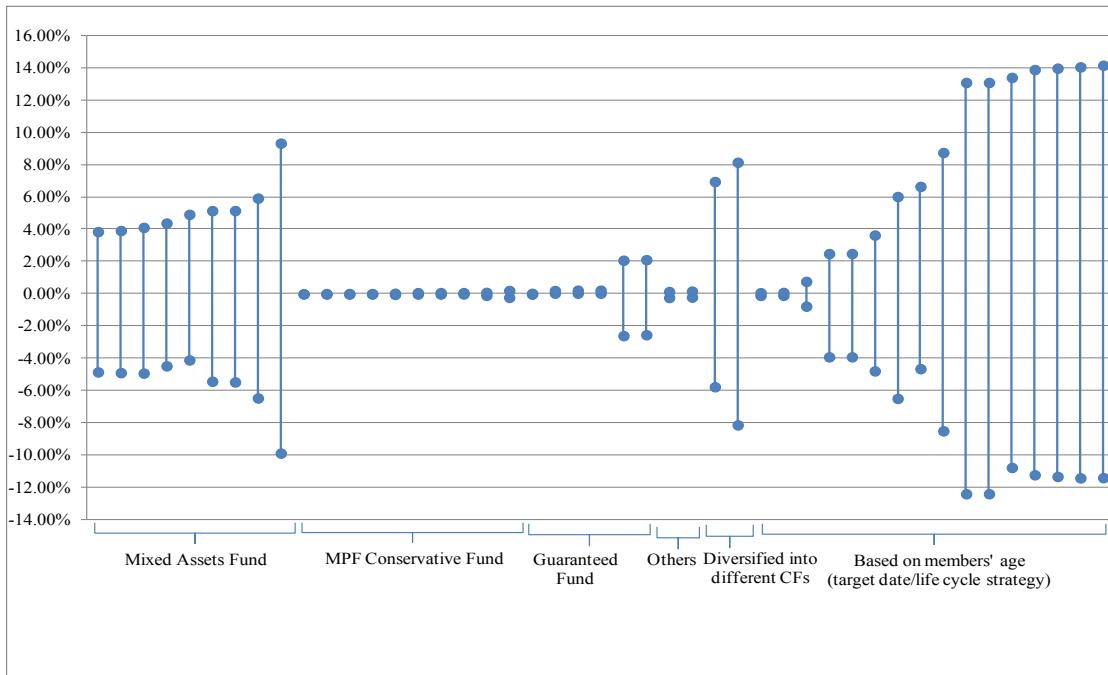
**Chart 2: Types of default funds in MPF schemes as at 31 May 2014**



23. As the investment objectives, risk levels and the fee levels of these default funds vary widely, the investment outcomes for members investing in these default funds in different schemes also differ significantly. Chart 3 below illustrates the variety of outcomes in defaults across different schemes by showing the range of monthly returns of each fund used as a default over the past 5 years.

<sup>9</sup> A list of the current default funds in MPF schemes is available on the MPFA website at [www.mpfa.org.hk](http://www.mpfa.org.hk) under “Information Centre” / “Consultation and Conclusions”.

**Chart 3: Highest and lowest monthly returns for MPF default CFs in the 5 years from April 2009 to March 2014**



24. All MPF schemes (except for contribution purposes, two industry schemes and one employer sponsored scheme) have the same potential membership profile as all are open to all types of employers, all self-employed persons and all employees wishing to transfer accrued benefits<sup>10</sup>. As such, there seems to be no reason in principle why there should be such diversity in default funds across schemes. Currently, two employees who are in identical circumstances, except that they are enrolled into two different schemes by their employers, could be defaulted into substantially different types of CFs, exposing them to significantly different risks and return outcomes.

25. According to a member survey conducted by the MPFA in 2013 (“MPF Survey”)<sup>11</sup>, some 24.1% of members indicated that they had never made a fund choice. These survey results are somewhat higher than an earlier industry survey<sup>12</sup> which suggested that less than 20% of members (involving less than 10% of total assets) were in default funds.

<sup>10</sup> Members who can freely transfer benefits include self-employed persons, holders of person accounts and holders of special voluntary contribution accounts. Employees can also transfer accrued benefits relating to their own contributions and all accrued benefits on a change of employment.

<sup>11</sup> Survey on Members’ MPF Investment Knowledge 2013.

<sup>12</sup> “The evolving MPF system: an objective assessment”, Ernst & Young, commissioned by the Joint Industry Group, comprising Hong Kong Federation of Insurers, Hong Kong Investment Funds Association and Hong Kong Trustees’ Association, May 2012.

26. The MPF Survey indicated that certain groups, e.g. the youngest and the oldest age groups are more likely not to make a choice. The reasons for not making a fund choice were identified as (i) not knowing how to make a choice (33.5%); (ii) being too busy (14.6 %); or (iii) relying on existing defaults (11.2%). This outcome suggests that a significant portion of MPF members are not inclined to make fund choices. This is not surprising, for although making investment decisions by choosing CFs may be a simple process, they are, in effect, complex decisions about asset allocation, the long-term trade-offs between risk and return, and the impact on future earning potential of an investment approach. This decision is complicated by the range and variety of CFs that are available to members and the ability to invest in multiple CFs at one time. As indicated in paragraph 18 above, there are currently 477 CFs available across 41 MPF schemes. The unrestricted ability of self-employed persons to choose between schemes and the rights of employees to choose schemes (under the employee choice arrangement or when changing employment) complicate this decision-making task as the choice of scheme opens up choices between several hundred CFs.

27. Many MPF members may welcome more choices but studies have shown that too many choices may actually make it more difficult for members to make a choice. Some psychologists refer to this as a “seemingly intractable information problem, in which the “cost of thinking” is too high”.<sup>13</sup> The proliferation of MPF funds can have an impact on the ability of members to make appropriate fund choices.

28. Members can, however, be assisted in these important decision-making processes. Some might seek professional advice and assistance from registered MPF intermediaries in making these decisions. Not all members will, however, have the time, inclination or resources to access professional assistance. Some members will rely on the advice, views and assistance of friends and public commentators, which will be of variable reliability and applicability to an individual’s circumstances. In addition, for those who want to make such decisions on their own, there is a constantly evolving range of educational resources and tools available for them. However, even with the best investor education resources and tools, there will be many

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<sup>13</sup> Josh Fear, “Choice Overload: Australians Coping with Financial Decisions”, Discussion Paper Number 99 (The Australia Institute: 2008).

MPF members who would not have the time, inclination and skills to make difficult decisions about various risk and return trade-offs involved in choosing CFs. Ultimately, it is likely that many members who do make decisions will do so based on limited information and understanding, often relying on potentially unreliable indicators such as relative past investment performance of individual funds. For example, according to the MPF Survey, when making a fund choice, 38.2% of members took into account past performance of the funds and 14.9% relied on recommendations of friends, relatives or colleagues. If a well-designed default investment arrangement is in place, it is likely that some scheme members who have made investment choices might have their contributions invested in such a default fund.

#### **II.4 International research and approach to default funds**

29. Given the complexities of investment choice referred to above, there has been an emerging body of research internationally which highlights the importance of having well-designed default funds in the event that scheme members do not, or do not want to, make a choice of funds. For example, the “Roadmap for the Good Design of Defined Contribution Pension Plans” issued by the OECD suggests that whether, and how to, regulate fund choice and asset allocations during the accumulation phase is an important, if controversial, issue. The OECD suggests that a range of tools, including default fund arrangements, should be used alongside information and disclosure to help facilitate the working of a defined contribution pension system. The OECD suggests that consideration should be given to making the default fund an age-dependent, life cycle/target date fund that reduces equity risk over time. The starting point and speed with which the risk is adjusted should be determined by a panel of experts having regard to local circumstances. These findings are generally supported and supplemented in the Working Papers of the IOPS<sup>14</sup>.

30. It is noted that many countries set rules about which funds are used as the default funds in mandatory defined contribution pension plans<sup>15</sup>. The rules differ between jurisdictions and the main difference lies in the degree of official regulatory prescription. There are differences on whether a default fund is required or prescribed, the type of investment fund used as a default and how it

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<sup>14</sup> IOPS Working Paper No. 18 “Supervising Default Investment Funds”, December 2012.

<sup>15</sup> Examples include Australia, Chile, the United Kingdom, the United States, Sweden, Turkey, many Eastern European and Latin American countries.

is administered. The OECD notes that the default fund used is usually a target date or life cycle fund that varies the asset allocation with the age profile of the investor by lowering the exposure to equities as the investor approaches retirement. It can also be the most conservative option available. In some countries, mixed assets/balanced funds and global equity funds are used.

31. Some pension systems adopt a more directive approach with prescribed or mandated default arrangement, e.g. Chile, Mexico, Peru and India (National Pension System), Estonia, New Zealand and Slovakia. Some adopt a lighter regulatory regime and regulate by way of guidelines and criteria for default fund arrangement, e.g. Australia (MySuper), the United Kingdom (work-based DC pension schemes) and the United States (401(k) plans). In many countries, the level of investment into defaults is much higher than in Hong Kong. The high rates of investment in the default option in places such as Sweden, Chile and Australia might not be a result of members being less engaged than members in Hong Kong, but may relate to comfort about the design and features of the funds used as the default.

32. The issue of default investment options has also been reviewed by the EDHEC-Risk Institute Asia (“EDHEC”). The EDHEC evaluated issues such as information overload, procrastination and over-confidence and considered that they severely affect the ability of investors to decide on optimal strategic asset allocations and make good active choices. As a result, the default asset allocation is very important and the regulation of default funds is likely to be the most important part of the design of a defined contribution pension system. Default funds should be designed in a way that corrects for behavioural and cognitive biases of members and helps avoid old age poverty. It considered that in Hong Kong, active choice by members were sub-optimal for the behavioural reasons mentioned previously, leading to over-allocation to equities as a result of short-term speculative behaviour combined with bad timing. Their work suggests that there should be a well-designed default fund that helps channel retirement savings to invest for the long term.



## **II.5 Conclusions**

33. **The issues and key highlights from the above are that:**

- **saving for retirement involves different strategies and considerations than shorter term, retail-driven investment strategies;**
- **investment decision-making in defined contribution systems like the MPF system is complex and has significant impact on the retirement savings outcomes for individuals;**
- **many members do not make an investment choice and even many more may have made a choice in the past without the requisite skills or resources;**
- **in contrast to the position in many other jurisdictions, decisions about the default investment arrangements in MPF schemes are left to the discretion of scheme providers;**
- **this has resulted in a diversity of defaults, leading to substantial differences in risk and consequentially, performance and return for those who do not make decisions;**
- **international thinking is converging on the importance of having well-designed defaults and, to some extent, on the preferred investment structure for such defaults.**

34. **Based on the background data and analysis set out above, the Government and the MPFA have come to the view that, as a part of the reforms under consideration, it is important to enhance the regulation of the default arrangement in MPF schemes. In doing so the opportunity is taken to ensure that all MPF scheme members have access to a standardized, low fee core fund.**

35. In the following parts of this Consultation Paper, we have set out specific proposals on the core fund and its relationship to the default fund arrangements in each scheme.

### III. Proposals – The MPF Core Fund Based on Standardized Default Funds

36. In the light of the discussion set out above, the Government and the MPFA are proposing to enhance the regulation of the investment choice framework in MPF schemes by ensuring that all MPF scheme members have access to a standardized, low fee core fund that is designed in a manner consistent with the overall objective of retirement savings. In developing proposals about the core fund, we have started from the point of looking at how default funds can, and should be better designed. The key elements of the core fund proposals are that:

- a. **the core fund will be based on standardized default funds.** The default fund in each MPF scheme should be substantially the same. These default funds will be used as the investment destination for those members who have not made any choice of CF and adopted as the core fund (paragraphs 37 to 40);
- 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.** The investment approach of the default fund must specifically address its use as a long-term retirement savings strategy for those members who do not, or do not wish to, make a choice. The preferred investment design may be the adoption of a “life cycle” or “target date” approach (paragraphs 41 to 49);
- c. **the core fund should be good value.** The MPF core fund must be designed and delivered in a manner that represents good value to scheme members (paragraphs 50 to 73);
- d. **the core fund is available to all MPF scheme members to choose.** Although designed as a default fund for those who do not make an investment choice, the core fund will also be available as an investment choice to members who do want to make an investment choice, as it is designed for use as a long term investment retirement saving vehicle with low fees (paragraphs 74 to 77).

Q1. Do you support the direction of introducing a core fund in the manner set out in paragraph 36 (a) to (d) above?
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### **III.1 The core fund will be based on standardized default funds**

37. Some may argue that there is no need for rules or regulations about default funds and that all aspects of the design of default investment arrangements should, as now, be left to individual scheme operators (trustees and/or sponsors) having regard to the needs and characteristics of members in their own scheme. As set out in paragraphs 22 and 23 above, the CF that is used as the default fund or funds in existing schemes, vary substantially from scheme to scheme. A consequence of the current approach is that two employees who do not make an investment choice, whose circumstances are identical in all respects excepting their employer, could face materially different retirement outcomes only because their employers enrolled them into different schemes. Furthermore, as discussed in paragraph 24, given that transfer rights within the system mean that MPF schemes, on the whole, have the same potential membership profile, there seems no reason in principle why the investment of contributions for members who do not make an investment choice should be different scheme to scheme.

38. The issues identified in the previous paragraph suggest that the current approach is not optimal. It is therefore proposed that each MPF scheme will be required to offer substantially the same type of CF or CFs as the default fund for the scheme. What type of CF should be used and the investment approach to be used is discussed further under Part III.2 below. That part also considers whether consistency is required in all aspects of the default funds or whether some elements can be left to the decision of individual product providers.

39. We also expect that designating a standardized approach to defaults and adopting it as the core fund will facilitate better benchmarking and comparison of investment performance and fees across and within MPF schemes. At the moment, meaningful comparison across schemes and providers is inhibited by the differences in the range and type of CFs in each scheme. A standardized default fund, adopted as the core fund, will enable scheme members and commentators to focus on a single point of primary comparison. Any material differences which are a result of higher fee or expense levels dragging on performance, will be readily apparent and should provide greater market discipline for operators to ensure that their fees and investment structures are optimized to deliver better outcomes for members. Consequently, over time,

the core fund will be a driving force for competition and fee reduction for other funds in the MPF system.

40. Standardization of the default funds can also provide the opportunity for greater structural efficiencies that can ultimately deliver lower operational costs that can flow through as lower fee impact on members; an issue discussed further under “good value” Part III.3 below.

- Q2. Do you agree that the CF that is the default fund should be substantially the same in all MPF schemes?
- Q3. Do you agree that it is appropriate that the core fund be based on a standardized default fund?

### **III.2 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**

41. If, as proposed above, substantially the same type of CF or CFs is to be used as the MPF default fund and adopted as the core fund, then a key issue is the investment approach that the CF should adopt and the process for deciding that.

42. The investment approach will need to be designed having regard to the purpose of providing a long-term savings solution designed for MPF members who do not, or do not want to, make an investment choice. Maximizing returns over the long term is an obvious objective, but investment always involves a trade-off between risks and likely returns. Taking on more risk increases the probability of achieving higher returns over the long run but also increases the probability of bad investment returns, particularly over the short term but also over the long term. Short-term volatility as reflected in changes of CF prices can increase member anxiety even where it has no immediate impact, for example, if they are not withdrawing benefits for many years into the future. On the other hand, taking on less risk reduces the probability of bad outcomes, but also reduces the probability of high returns and also reduces average outcomes. The difficult issue then becomes what is the appropriate attitude to risk that should be adopted for the target group (those who

do not, or do not want to make investment decisions) that delivers the appropriate balance between long-term risks and returns.

43. As outlined earlier in this paper, a particular characteristic of investment in retirement savings systems like the MPF system is that members are particularly at risk from investment shocks in the years immediately preceding retirement. Younger workers who suffer a couple of bad years of investment returns, such as those experienced in equity funds around the Global Financial Crisis in 2007 and 2008, have time to adjust to remedy the damage. They can adjust savings habits, change investment strategies, make changes in their career, adjust expectations about when they will retire or even rely on longer-term adjustment of returns to normalized levels. Workers close to retirement have far less opportunity to remedy the damage that a couple of very bad years can have on their retirement savings. Not only do they have fewer years until retirement but are likely to have a larger pool of savings affected by the investment shock.

44. There is a growing body of evidence and consensus that an investment approach that reduces risk quite substantially as a person gets close to retirement is the preferred approach as the default investment strategy for retirement savings schemes. According to a report prepared for the MPFA by the Hong Kong University of Science and Technology<sup>16</sup>, funds that automatically reduce risks over time are suitable as default funds as they can address the issue of overly conservative default funds by matching the age and employment characteristics of scheme members and helping them get potentially higher returns. Studies from the OECD and the EDHEC also provide support for the investment approach of reducing equity risk over time.

45. As referred to in paragraph 29, the OECD Roadmap for the Good Design of Defined Contribution Pension Plans recommends the establishment of appropriate default investment strategies, and considers the merits of establishing an age-dependent, so called “life cycle”, investment strategy as a default option to protect pension plan members against extremely negative outcomes as they approach retirement.

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<sup>16</sup> Report on Target-date Life-cycle Funds and their Suitability for the MPF System, Centre for Fund Management, Hong Kong University of Science and Technology (November 2007).

46. More recently, the MPFA has collaborated with the OECD to test these global findings in the Hong Kong context by reworking the original research using Hong Kong data. Findings from this research confirm that, if the policy objective is to balance the need to protect default members from extremely negative outcomes for those approaching retirement against the desire to produce better median returns, then a life cycle/target date approach, that reduces exposure to risky assets as a member gets close to age 65, is the preferred investment approach.

**Box 2**                      **What are target date, life style, life cycle funds?**

Different types of investment structures can be used to automatically reduce the risk exposure of members over time. Some industry terminology has been developed to describe these different structures, although the terminology is sometimes used inconsistently and means different things in different countries. Broadly though, there are two different approaches: both are automatic and deliver the same investment outcome but are structured differently.

**Target Date Funds:** In the MPF context, if target date funds were adopted, it would mean having a series of CFs in a scheme, each targeting a different retirement year. Members would be invested into the CF that is closest in date to the year that the member will turn 65. Some MPF schemes already offer target date funds. Of those, most have a CF each 5 years (e.g. a 2020 Fund, 2025 Fund, 2030 Fund, 2035 Fund, 2040 Fund and a 2045 Fund) although one has a CF each ten years (i.e. 2018 Fund, 2028 Fund, 2038 Fund and 2048 Fund). The asset allocation within each CF would be adjusted over time to reduce risk.

**Life Style or Life Cycle Approach:** An alternative approach to adjusting the risk exposure of investing members over time is to invest the member's contributions across several CFs and then automatically adjust the proportion of that member's investments in those CFs over time. This does not adjust the asset allocation within each CF itself but reduces risk by increasing the proportion invested in less risky CF over time. As a simple example, this could mean that a young member has 75% of contributions invested into a global equity CF and 25% invested into a global bond CF. As the member gets older the trustee would automatically invest a greater proportion of the member's contributions and/or accrued benefits into the global bond CF as a way of reducing risk.

47. Based on the above, it is proposed that the investment approach for the MPF default funds should be a series of target date CFs or a combination of life cycle CFs in a way that automatically reduces risk as a member approaches

65 years of age. This strategy would be globally diversified both as to geography and asset class although focused principally on traditional equities and bonds. Exposure to underlying asset classes would be adjusted over time to reduce, but not eliminate, net risk exposure as members get closer to age 65. Generally, this would be achieved by reducing exposure to equities and increasing exposure to less risky asset classes like bonds.

48. Within such a general approach there would be numerous interconnected issues of technical detail to work through with the industry, including the following:

- 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;
- 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;
- 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;
- d. which investment building blocks are more appropriately managed in a passive manner;
- 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;
- 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; and
- 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.

49. Even if the consensus is that a diversified target date or life cycle fund approach is preferred as the core fund, it will be important to appreciate that such an investment approach, like any other, will come with some inherent risks and limitations. Even with the best design inputs, the following limitations will apply:

- a. the core fund will be designed as an average best fit solution for the target group of those who do not, or do not want to make an investment choice. It will not have regard to the individual circumstances of members except for their age (although there may be capacity built in to take other factors, such as account balances, other sources of income or savings, into account later). Members who want an investment solution that is tailored to their individual circumstances, other than their age, will have to consider the available range of funds and make choices of CF that meet their own needs;
- b. the value of investments in a target date or life cycle fund are not guaranteed and will still fluctuate in line with underlying investment markets. Members invested into these funds may still incur investment losses, although the advice from the OECD is that the probability of this is extremely low for members who stay with the proposed strategy long term;
- c. the probability of investment losses in a target date or life cycle fund increases for members who do not invest in the same strategy on a long-term basis. Fluctuations in accrued benefit levels (i.e. unrealized gains and losses) are also more likely for younger members when exposure to equities is at its highest under such an approach;
- d. while diversified investment across different asset classes reduces risk in the long run, it is inevitable that a globally diversified target date or life cycle approach will underperform single sector funds at different times of the investment cycle. Higher volatility funds, like Hong Kong equity funds would inevitably outperform a globally diversified target date or life cycle fund some of the time; it will also underperform some of the time and will expose holders to greater risk of an extreme negative shock at all points in time. Conversely, a globally diversified target date or life cycle fund should outperform a very conservative fund like an MPF



Conservative Fund in the long run, but may underperform in some periods. Members who want exposure to higher or lower risk strategies will continue to be free to make that choice by making a selection between available CFs.

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?

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?

### **III.3 The core fund should be good value**

50. The MPF core fund will be designed and delivered in a manner that represents good value for money. From the system-wide perspective, as mentioned in paragraph 39 above, we expect that the core fund will become a benchmark and driving force for competition and fee reduction in other funds in the system. Members will be able to see, and take the benefit of a low fee benchmark, whilst retaining the right to choose a more expensive fund option, if that suits their needs for some reason not related to price. The concept of “good value” is not only about the price (i.e. the fee impact) but also needs to be balanced against what the member gets in terms of associated services and investment outcomes. It includes various components, but at a minimum means that:

- fees are kept low so that the maximum amount of investment returns are delivered through to members;
- the range of services associated with the strategy must be reasonable, having regard to how much is paid for those services by way of fees and charges;
- the investment product is structured in a way that is efficient thus facilitating lower cost outcomes that can allow for lower fee outcomes; and
- the investment design appropriately manages the types of risks faced by members who do not, or do not want to make investment

decisions.

51. **Low Fees:** It is acknowledged that the issue of the fee impact on members will be important to the success of the MPF core fund. The level of fees charged in MPF schemes remains a controversial issue and it is important that the core fund should have fees that are low compared to other MPF funds.

**Box 3 Fees, costs and expenses in MPF schemes**

In common with other collective investment structures, various fees, charges and other outgoings are deducted in MPF schemes to cover the cost of providing services by various service providers and for direct out-of-pocket expenses.

For the vast majority of MPF scheme members, the impact of most fees, charges and expenses is indirect, in that they are not deducted from the member's contributions or account, but are deducted from the CF the member invests into, or the APIF that the CF invests into. Deductions from APIF and CF do ultimately affect scheme members by lowering the value of the members' investment into the relevant CFs.

The types and names of fees and expenses vary from scheme to scheme, but general examples of the types of fee and expenses deducted from a CF include (a) fees of the trustees, custodian, administrator, investment manager and sponsor; (b) guarantee charge (for guaranteed funds); (c) compensation fund levy (currently not levied) (d) audit fees and legal costs and (e) miscellaneous items such as establishment costs, indemnity insurance, and other out-of-pockets disbursements like postage. An even more indirect impact occurs when a CF invests in other underlying funds such as APIFs (see Box 1 above). Various types of fees and expenses may be incurred which are deducted out of the APIF.

This fee arrangement may seem complicated, but is commonly used for collective investment structures. All of the fees and expenses that can be charged to a member, a CF or underlying APIF will be fully disclosed in the **Fee Table** for the scheme. MPFA regulations require standardized language and set-out for Fee Tables of MPF schemes. Sometimes, some of the fees that can be charged according to the Fee Table are not deducted in part or in full. For more details, and a sample of a Fee Table, see the Code on Disclosure for MPF Investment Funds on the MPFA website at <http://www.mpfa.org.hk>.

Where the term "costs" is used in this Consultation Paper, it means the costs to providers, such as trustees, in providing their services. Obviously, if the cost of providing services is high, then this limits the ability of that provider to lower the fees that are charged to CFs.

52. The level of fees that are charged is the outcome of the interaction of a number of factors including the following:

- the cost of providing services to members such as those set out in paragraphs 59 and 60 below;
- the cost of providing scheme and fund level services such as custody of assets, investment management, audit, legal, compliance and other out of pocket expenses;
- the strength of market forces to ensure pricing efficiency; and
- regulatory controls of fee levels and/or fee charging mechanisms.

53. Although the MPFA is not empowered to directly set fund fees, it has over the years been working towards delivering better fee outcomes for members, such as continuing to improve disclosure and improve the efficiency of the MPF system to facilitate further fee reduction. Since 2004, the MPFA has required the production of a standardized fee measure, the FER, to materially improve the comparability of fees and charges across different schemes and CF (see Box 4 below). Some examples of the more recent short- and medium-term measures include:

- in 2013, the MPFA worked with trustees to make available low fee funds invested in equities and/or bonds in all MPF schemes for members to choose from. All schemes, except one, now have such funds available;
- to help market forces to work better, the MPFA has enhanced and standardized disclosure, and developed and made available tools for scheme members to compare schemes and funds. On the website of the MPFA, a Trustee Service Comparative Platform is available to help members compare the services offered by trustees. Since June 2013, the investment returns of funds have been set out alongside the FERs on the Fee Comparative Platform. There is also a separate “Low Fee Funds List” to help members identify CFs that have lower fee impact;
- progress is being made on the elimination of less efficient schemes and funds. Some funds that were smaller in scale have been terminated. Two smaller schemes have been merged with more sizable schemes. These market developments will help bring down the operating cost of the system in the long run;

- the MPFA has been enhancing the use of electronic processing to further improve operational efficiency of the system. These cover the interface between trustees, employers and employees, via various electronic platforms and means. Legislative proposals to facilitate greater use of electronic communication are to be introduced into the Legislative Council shortly; and
- in the second half of 2013, the MPFA conducted a large-scale campaign to facilitate consolidation of MPF personal accounts by members who had multiple accounts. To facilitate the process, the MPFA developed a simple application form for consolidation of multiple personal accounts under different schemes in one go.

54. Because of their differing design, operating cost and response to the competitive environment, the fee impact varies across different CFs. The average FER was 1.69% as at 31 May 2014, with the range indicated in Table 1 below:

**Table 1: FERs by Fund Type**

	<b>Average FER*</b>	<b>Highest FER</b>	<b>Lowest FER</b>
<b>Equity Fund</b>	1.71%	2.74%	0.56%
<b>Mixed Assets Fund</b>	1.84%	2.67%	0.41%
<b>Bond Fund</b>	1.50%	2.45%	0.60%
<b>Guaranteed Fund</b>	2.18%	3.83%	1.33%
<b>Money Market Fund – MPF Conservative Fund</b>	0.71%	1.35%	0.23%
<b>Money Market Fund – non-MPF Conservative Fund</b>	1.13%	1.13%	1.13%
<b>Others</b>	1.45%	1.46%	1.34%
<b>Overall</b>	<b>1.69%</b>	<b>3.83%</b>	<b>0.23%</b>

\* Weighted by the net asset values of CFs. The average FER is the average of the FERs of the relevant CFs published on the MPFA Fee Comparative Platform on 31 May 2014.

55. The average FER for all MPF CFs has declined by 20% over the past six years from 2.10% in 2007 to 1.69% in May 2014. The 2012 Consultancy Report indicated that, at the time of that report, when the weighted average FER was 1.74%, the weighted average cost to trustees of administration of MPF funds was equivalent to 0.75% of assets under management (“AUM”) per annum and the investment management fee was equivalent to 0.59% of AUM.

The remaining 0.40% represented other costs such as for distribution. Each of those three parts contains some profit element.

**Box 4**

**What is the FER and the OCI?**

Box 3 explains the fee arrangements in MPF schemes. Even though the disclosure of fees and expenses is standardized in the Fee Table, it can still be difficult for scheme members to compare them scheme to scheme. A great variety of fees and structures are in use. Each scheme uses a slightly different structure and has different types of fees. Some fees are in fixed amounts and some are not. Some are expressed in dollars, most as percentage of some value and some are shown as a maximum or ranges. In some cases, fees that can be charged are waived and not charged to the relevant CF or APIF.

Because of the difficulty in understanding and comparing the cumulative effect of these various fees and charges, the MPFA introduced two tools that help compare the totality of the impact of fees and expenses.

The first of these is called the **fund expense ratio (“FER”)** which is a synthetic indicator that shows, based on the most recent financial statements, the yearly level of fund fees and expenses that were deducted from a CF plus any underlying APIF or other funds. Fees that are waived are reflected in the FER, but fees that are rebated to only some members are not reflected in the FER. The FER shows this as a percentage of the size of the fund. MPFA requirements in the Code on Disclosure for MPF Investment Funds ensure that the FER is calculated the same way for each CF so that it is an effective tool for comparing the impact of fees and charges across CF and across schemes. The FER is disclosed in the fund fact sheet of each scheme, the annual returns of the scheme to the MPFA and the FER of all CFs is set out in the Fee Comparative Platform on the website of the MPFA.

Because it includes expenses, not just fees, the FER will always be higher than simply adding up all the different fees that are deducted from a CF and its underlying APIFs. It is important to remember that the FER is a tool for making like-to-like comparisons; it is not the primary disclosure of fee levels (that is set out in the offering document and Fee Table). It is also important to note that the FER is a lagging indicator, based as it is on the previous year’s financial statement.

The second tool is the **Ongoing Cost Illustration (“OCI”)** which illustrates prospectively, in dollar terms, the total effect of fees and charges on a standard \$1,000 investment over 1, 3 and 5 years. The OCI in effect adds the FER to any member level charges to illustrate, as a dollar figure, the overall effect of fees and charges. This was developed to assist those members who could not easily understand percentages, like those used in the FER.

56. How low fees can be for the core fund, as compared to other MPF funds, will be influenced by the structure and nature of the investment strategy (see Part III.2 above). It is known, for instance, that funds with higher equity content incur higher operating costs and active management incurs higher investment management fees than passive strategies. We are also aware that a number of providers are able to provide CF for combined fees (both CF and underlying APIF level) of at or under 1.0%, noting that this is lower than the combined cost of administration and investment management indicated in the 2012 Consultancy Report. The MPFA has set out a list of funds with fees at or under 1.0% or total expenses of at or under 1.3% in the “Low Fee Fund List” on the MPFA website.

57. The Government and the MPFA would expect that the total fee impact for the core fund should be materially lower than the thresholds for the Low Fee Fund List. We are seeking views from the industry and the public on requiring that fees for CF comprising the core fund<sup>17</sup> should be at or under 0.75% of AUM. Over the longer-term, as the MPF system grows, and as more efficient structures are considered and developed, this level should reduce even further. The 0.75% would relate to all ongoing fees (for trustees, administration and distribution (however described), investment management and custody) both at the CF level and at any underlying APIF or index fund level. Whilst this is an ambitious target, the Government and the MPFA will work with the industry on the proposal, including arrangements to achieve operational efficiency for the core fund. Legislative means will be pursued to reflect the consultation outcome as necessary.

58. The FER outcomes driven by such fee levels will be correspondingly lower than current FERs. As described in Box 4 above, FER figures include costs as well as fees so they are higher than simple fee levels. FER figures also take some time to stabilize given the impact of establishment costs for new funds, but we expect that over the medium term (e.g. 3 years after implementation), total expense impact (i.e. not just fees but including other expenses deducted from funds) as measured by the FER for the CF in the core fund should be kept at or under 1.0%. This figure should also fall further over the longer term, as the relevant CF grows.

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<sup>17</sup> Based on proposals in Part III.2, the core fund may be a series of funds rather than a single fund.

**Box 5****Fee Comparative Platform and Low Fee Fund List**

The MPFA website includes two important tools for understanding and comparing the fees applicable to MPF schemes. The Fee Comparative Platform sets out detailed information about all MPF schemes and CFs including all available FER and OCI (see Box 4). The Low Fee Fund List was developed when the MPFA noticed the emergence of a range of CFs with fees set at or under the important 1.0% benchmark. It provides a short cut for identifying those CFs that have management fees at or under 1.0% or a FER at or below 1.3%. If fees are kept at or under 1.0%, the resultant FER (incorporating non-fee elements such as establishment costs and other expenses) should, over the medium term, stay at or under 1.30%.

As at 31 May 2014, the range of FERs on the Fee Comparative Platform was from 0.23% up to 3.83%. The weighted average was 1.69%.

Currently, only 13% of CFs have FERs that are below the FER proposed for the core fund at or under 1.0%.

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

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?

59. **Range of services:** The range of services associated with MPF schemes are reasonably similar scheme to scheme. A wide range of minimum service elements are set as statutory requirements and are thus available in every scheme. This includes services like:

- a. marketing and product management: developing, maintaining, distributing marketing and enrolment material, including offering documents;
- b. member support: MPF enrolment, managing member register, handling member/employer enquiries, handling complaints, regular communications with members, fund switching;
- c. contribution handling: contribution collection, assisting in recovery of outstanding contributions, allocation of contributions for investment, establishing and maintaining voluntary contributions;
- d. reporting: regular reporting to members (e.g. member benefits

statement and fund fact sheet); and

- e. benefit payments: transfer of benefits, payment of benefits upon cessation of membership and handling unclaimed benefits.

60. Beyond those statutory requirements, different providers provide different services relating to issues like frequency of additional account reporting, access to electronic facilities, frequency of CF switching, availability of facilities for special voluntary contributions etc. To help members compare what is available scheme to scheme, a Trustee Services Comparative Platform is available on the MPFA website.

61. The range, type, level and quality of services provided have a major impact on the costs of operating a scheme and CFs within a scheme. More services inevitably mean higher operating costs which limit the ability of the provider to charge lower fees. As fees are one part of the “good value” proposition, consideration has been given to whether some service elements related to the core fund could be simplified, reduced or dispensed with so that lower cost and fee outcomes can be more easily delivered to members.

62. It is difficult to identify opportunities for doing so as the range of services does not generally vary for different CFs in a scheme, so generally, whether a member invests in the core fund or any other CFs, the range of services will not vary.

63. The MPFA has explored with the industry and other stakeholders whether costs can be reduced if the following services are varied, just for the core fund in each scheme:

- a. limiting switching in and out (i.e. currently many schemes allow relatively unrestricted ability for members to change their CF holdings. For the core fund, given its long-term investment purpose, consideration can be given to only allowing a change of investment instructions once or twice per year);
- b. preventing combination holdings (i.e. currently most schemes allow members to invest into any combination of CFs in the schemes. For the core fund, given that it will be designed as a stand-alone



investment solution for members who do not, or do not want to make an investment choice, consideration can be given to not allowing combinations of the core fund with other CFs); and

- c. standardized disclosure for the core fund in different MPF schemes (i.e. using the same agreed wording for disclosure about the core fund in offering documents for all MPF schemes).

64. While there may be good reasons in principle to think that reducing these particular services would reduce operating costs, industry participants have advised us that these changes would not have the impact of actually reducing operating costs. This would appear to be a consequence of the fact that there would be costs associated with making special administrative and operational adjustments that only relate to some members (i.e. those investing in the core fund), but not all members of a scheme.

65. While there appears to be limited scope to reduce services in a way that will reduce the costs of operating the core fund, the MPFA will continue to discuss with the industry on whether there are opportunities to simplify, reduce or dispense with some service elements for the core fund, so that there is greater scope for cost, and consequentially, fee reductions.

66. **Structural efficiency:** One way of keeping costs and fees as low as possible is ensuring that investment structures are designed efficiently. As described in Box 1 under paragraph 13, the general investment structure for MPF schemes is that members invest into CFs which, in turn, invest into APIFs or other funds, such as index funds (collectively referred to as “underlying funds” below). Decisions about which individual securities to purchase (e.g. shares, bonds) are usually made by the investment manager of the underlying fund, not at the CF level. These underlying funds can be seen as the investment building blocks which may or may not be part of the same group as the approved trustee of the scheme.

67. Decisions about which APIFs or other funds a CF will invest into can have a big impact on investment management costs and consequentially, fees. If different MPF schemes were to invest into the same underlying APIFs (see Box 1), rather than just use APIF within their own group, then those APIFs will

be larger and consequently will have greater opportunity to benefit from scale efficiencies that will in turn flow back to benefit members of the CF. Some larger providers might however be able to achieve similar scale benefits within their own schemes.

68. In implementing the new core fund, providers will need to ensure that in making decisions about which underlying funds to use as the investment building blocks, they give proper consideration to the range of APIFs and other funds that are available. If using an APIF or index fund of another provider reduces the ultimate fee impact on members, then consistent with their existing duties to act in members best interests, providers should use that APIF or index fund unless there are compelling reasons not to do so that are not related to fees or costs. Legislative support will be pursued as necessary.

69. When the investment structure is more developed and the investment building blocks identified, mechanisms will be put in place to ensure that providers know which existing underlying funds offer the lowest fees so that they can factor that into their structuring decisions.

70. Another element of design efficiency is whether passive, index based, investment strategies should be the predominant investment approach in the core fund, either at the CF or underlying fund level. There is an ongoing debate about the relative advantages of active and passive investment strategies. Globally there is much debate about whether the extra costs for active management are reflected in better after fee performance. In the MPF context, the MPFA engaged the Polytechnic University of Hong Kong to examine a number of issues relating to the performance of MPF funds in 2008, 2009 and 2013. Their findings were generally consistent over the years, indicating that (a) MPF funds as a whole do not exhibit positive stock selection and market timing skills concurrently; (b) there is no relation between annual fees and fund performance, questioning the value of higher fees to investors; and (c) actively managed MPF funds do not deliver better returns than corresponding passive index tracking funds.

71. Whilst some might debate whether active management can actually achieve superior returns to passive management, what appears unarguable in the

debate is that passively-managed funds incur lower costs and fees than actively-managed ones. Table 2 below shows the FER difference between actively- and passively-managed MPF funds.

**Table 2: FERs of actively-managed and passively-managed MPF equity CFs**

	<b>Weighted Average FER*</b>	<b>Simple Average FER*</b>
<b>Overall Equity Fund</b>	1.71%	1.71%
<b>Actively-managed Equity Fund</b>	1.88%	1.76%
<b>Passively-managed Equity Fund (Index Tracking Fund)</b>	0.98%	1.04%

\* Weighted by the net asset values of CFs. The average FER is the average of the FERs of the relevant CFs published on the MPFA Fee Comparative Platform on 31 May 2014.

72. We therefore believe that there are strong reasons to propose that the core fund should predominantly use passive investment strategies where it is possible to do so. For members who are prepared to incur higher fees in the search for above index performance, they will be free to make choices amongst the range of pre-existing actively managed CFs. We believe that the interests of members who do not, or do not want to make investment choices, will be better protected if the core fund uses passive investment strategies where it is possible to do so. Exactly how passive investment management can be used and the extent to which passive management can be used in the core fund will be subject to final identification of the investment building blocks. Some asset classes, such as global equities, are more appropriate for passive management than, for example, local money market exposure.

73. As the core fund will be investing for retirement purpose entailing a long-term investment horizon, broad diversification of investments between assets and geography is important as a risk management tool. Diversification will ensure that investments are not overly concentrated in any one asset or geographic region, and limiting portfolio risk and exposure to volatility in any specific market.

- Q8. Do you agree that passive, index based, investment strategies should be the predominant investment approach in the MPF core fund?
- Q9. Are there particular asset classes which you think would not appropriately be invested on a passive, index based approach?

#### **III.4 The core fund is available to all MPF scheme members to choose**

74. As set out in Part III.1 above, the core fund is based on a standardized default fund for those who do not make an investment choice, and based on available research, should be a series of target date CFs or a combination of life cycle CFs in a way that automatically reduces risk as a member approaches 65 years of age.

75. Different circumstances might lead an MPF member to not make an investment choice and consequently be “defaulted” into the core fund/default fund. Some members might simply forget to complete the relevant forms on joining a scheme whilst other members might consciously decide not to complete the instructions on the understanding that they will then be invested into the disclosed default funds in any event. Going forward, if the proposals to better regulate the default fund proceed, sales and distribution practices should not pressure members to make a choice if they do not wish to make a choice. MPF scheme disclosure documents should also make it clear that members are entitled to make an investment choice if they wish but they are not obliged to do so. The disclosure documents should also clearly set out that if the member does not make a choice of CF that contributions will be invested in the core fund.

76. It is likely that many, perhaps most members, will continue to exercise their right to best protect their own interests by making a choice of CF. Sales and distribution practices, relevant forms and disclosure documents should make it clear that the core fund is one of the investment choices available to the member and should clearly identify which CF is the core fund. Standardized names should be used for the core fund in every scheme so that there is no confusion scheme to scheme.

77. The term “core fund” has been used above as an easy reference, but other names could be used, and will have to be considered in light of the scope,

purpose and design of the strategy as set out in other parts of this Consultation Paper. There could be many possibilities including:

- “**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)

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?

## **IV. Implementation and Transitional Arrangements**

78. As with any major reform, implementation and transitional arrangements in moving from the current position to a new position can present many challenges. Details cannot be fully considered until final decisions are made about the many issues raised earlier in this Consultation Paper, although, in implementing any new core fund, a key transitional issue will be determining the extent to which (a) current accrued benefits and (b) future contributions should be invested into the new core fund. For MPF scheme members who have made a clear choice previously as to how their MPF benefits should be invested, the new core fund will not affect how their accrued benefits or contributions are invested. All existing MPF members should however be made aware of the new core fund arrangements in case, in the future, they wish to take that into account in reconsidering their current MPF investment choices and in particular whether they wish to choose the new core fund for existing accrued benefits and/or future contributions.

79. In broad terms, for those existing MPF scheme members who have not previously made a choice of CF, their accrued benefits and future contributions should be invested into the new core fund unless the member makes an election to invest into some other CF or CFs of their choice. They 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. The contributions of new members of a scheme (e.g. because they start employment with a new employer, they transfer benefits for the first time to a scheme or they open a new special voluntary contribution account with a scheme) will be invested in the new core fund unless the member makes an election to invest into some other CF or CFs of their choice.

80. We understand, from trustees and administrators that it may be costly, or in some cases, impossible to identify which members have not previously made a choice of CF. It is not simply a matter of checking who is invested in the existing default fund as not all members who are invested in the default fund in each scheme were “defaulted” into that fund. Some, perhaps most, members invested in that CF may have chosen to invest into that CF and it may be difficult or not possible in some schemes to identify which members

chose to be in the default and which members were defaulted into it.

81. We therefore propose that, subject to comments received from this consultation and further legal analysis, that where the trustee or administrator of a scheme cannot readily identify those members who have never made an investment choice, then all members who wholly invest contributions into the existing default CF or CFs, will be given a fresh opportunity to make a choice of fund, failing which their accrued benefits and future contributions will be invested into the new core fund.

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

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?

## **V. Comments Sought**

82. Comments are sought on all of the issues discussed above and in particular on the 12 questions set out in this Consultation Paper and repeated in the Form for Responding to Consultation Questions attached at the end of this Consultation Paper. Contributors are invited to comment on all, or any, of the questions they wish. Some of the questions, in particular questions 4 to 9 tend to relate to more technical points, which may be of greater interest to industry and academic contributors, however all contributors are invited to comment on whichever questions they wish to. Where possible, please provide reasons for answers, especially where you are in disagreement with a stated proposal, so that we can better understand your views.

83. Comments should be submitted to the MPFA on or before 30 September 2014.

84. If you wish to provide comments on the proposals as a representative of an organization, please provide details of the organization whose views you represent.

85. Submissions will be received on the basis that the MPFA may freely publish, reproduce, quote or summarize them in whole or in part, and in any form, without seeking permission from or providing acknowledgment of those who provide comments. Please note that the names of those who provide comments and the contents of their submissions may be posted on the MPFA's website or referred to in other documents published by the MPFA. In this connection, please read the "Personal Information Collection Statement".

86. If you wish to make a submission but do not wish your name to be published by the MPFA, please state that you wish your name to be withheld from publication when you make the submission.



87. Comments may be sent through any of the following means:

By mail to: 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

By fax to: (852) 3183 0502

By email to: [mpfinvest@mpfa.org.hk](mailto:mpfinvest@mpfa.org.hk)

Through MPFA website: <http://www.mpfa.org.hk>

## Glossary

Accrued benefits	The amount of scheme member's beneficial interest in an MPF scheme, including amounts contributed by or in respect of that scheme member, together with any profits or losses arising from the investment of those contributions.
Approved pooled investment funds (APIFs)	A type of investment fund that a constituent fund invests into. See Box 1 of this Consultation Paper for a more detailed description.
Balanced fund	A fund that aims to provide some combination of growth, income and preservation of capital by investing in a mix of stocks, bonds, and/or money market instruments. (Also called mixed assets fund)
Bond fund	A fund or a class of units of a fund that has no less than 70% of its assets invested in bonds.
Constituent fund (CF)	An investment fund that forms part of a MPF scheme. See Box 1 of this Consultation Paper for a more detailed description.
Default fund	A fund in each MPF scheme, into which a scheme member's contributions are invested where the scheme member does not make a choice of fund.
Defined contribution pension plan	A retirement plan in which accrued benefits of a scheme member depends on the contributions made by the employer and the employee, and on the investment returns in respect of such contributions.
Employee choice arrangement	The legislative arrangement under which employees are allowed to transfer the accrued benefits arising from the employee's mandatory contributions in their MPF contribution accounts to a trustee and a scheme of their own choice on a lump sum basis once every calendar

year.

Equity fund	A fund or a class of units of a fund that has no less than 70% of its assets invested in equities.
Fund expense ratio (FER)	The fund expense ratio, FER, is a ratio that measures the expenses of an MPF fund as a percentage of fund size. See Box 4 of this Consultation Paper for a more detailed description.
Guaranteed fund	A fund with some form of guarantee provided to scheme members investing in the fund, usually on the capital invested or on a minimum rate of return, according to the features of the guarantee. The guarantor usually charges a guarantee fee or reserve charge for providing such a guarantee.
Index tracking fund / index fund	<p>An index fund normally has the sole investment objective of tracking the performance of a particular index, with the aim of achieving investment returns that closely match or correspond to the performance of the index.</p> <p>A typical index fund is passively managed, which means that constituent securities of the relevant index are bought and sold within the fund in accordance with their respective weightings in the index.</p>
Index tracking collective investment scheme (ITCIS)	A type of index tracking fund that is approved by the MPFA as being a permissible investment for MPF constituent funds.
Mixed assets fund	A fund or a class of units of a fund that invests no less than 70% of its assets in bonds and equities, with a specified maximum level of exposure to equity.

Money market fund	A fund that invests no less than 70% of its assets in short-term deposits and debt securities.
MPF conservative fund	A conservative fund is a type of money market fund which invests in Hong Kong dollar based assets such as short-term bank deposits and high quality debt securities. Every MPF scheme is required by law to provide a conservative fund.
Multi-pillar retirement protection model	The World Bank suggests pension design be based on a multi-pillar model. Originally proposed as a three pillar framework, it was later extended to a five pillar framework. The five pillars are a non-contributory “zero pillar” (e.g. basic or social pensions, universal or means tested); a mandatory “first pillar” with contributions linked to earnings; a mandatory occupational “second pillar” that is typically a defined contribution plan; a voluntary occupational “third pillar” and a non-financial “fourth pillar” which includes access to informal support such as family and formal social programmes such as medical care.
Scheme members	In relation to a registered scheme, means an employee or a self-employed person who has a beneficial interest in the registered scheme.

## 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:

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

Yes       No

Comments:

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:

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:

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:

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:

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

Yes       No

Comments:

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

Comments:

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:

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:

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:

**Information of Respondent**

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

**Name (optional):**

**Organization (where applicable, optional):**

**Address (optional):**



## **Personal Information Collection Statement**

1. This Personal Information Collection Statement (the “PICS”) is made in compliance with the requirements of Personal Data (Privacy) Ordinance, Cap. 486 (the “PDPO”). The PICS sets out the purposes for which your Personal Data<sup>18</sup> will be used following collection, what you are agreeing to with respect to the MPFA’s use of your Personal Data and your rights under the PDPO.
2. Supplying your Personal Data in your submission to the MPFA in response to this Consultation Paper is voluntary.

### **Purpose of Collection**

3. The Personal Data provided in your submission to the MPFA in response to this Consultation Paper may be used by the MPFA for one or more of the following purposes:
  - in exercising its statutory functions under the Mandatory Provident Fund Schemes Ordinance;
  - for research and statistical purposes;
  - for the purpose of open consultation for this Consultation Paper, and/or;
  - for any other purposes directly related to the above purposes.

### **Disclosure of Personal Data**

4. Personal Data provided in your submission on this Consultation Paper may be disclosed by the MPFA to members of the public (whether in Hong Kong or elsewhere), as part of the open consultation on this Consultation Paper. The names of persons who submit comments on this Consultation Paper together with the whole or part of their submission may be disclosed to members of the public. This may be done by publishing this information on the MPFA’s website and in documents to be published during the consultation period, or at, or following its conclusion.

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<sup>18</sup> Personal Data means personal data as defined in the Personal Data (Privacy) Ordinance.

### **Access to Data**

5. You have the right to request access to and correction of your Personal Data held by the MPFA in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your Personal Data provided in your submission on this Consultation Paper. The MPFA has the right to charge a fee as permitted under section 28 of the PDPO for complying with any data access request.

### **Retention**

6. Personal Data provided to the MPFA in response to this Consultation Paper will be retained for such period as may be necessary for the fulfillment of the aforementioned purposes.

### **Enquiries**

7. Any enquiries regarding the Personal Data provided in your submission on this Consultation Paper, or requests for access to such Personal Data or correction of such Personal Data, should be addressed in writing to:

The Personal Data (Privacy) Officer  
Mandatory Provident Fund Schemes Authority  
Units 1501A and 1508, Level 15, International Commerce Centre  
1 Austin Road West, Kowloon  
Hong Kong