

For discussion
7 January 2013

Legislative Council Panel on Financial Affairs

**Results of the MPFA's Consultancy Study on
Trustees' Administration Cost and
Reform Directions to Lower MPF Fees Proposed by the MPFA**

PURPOSE

1. This paper provides information to Members on –
 - (a) the findings of a study on the costs incurred by trustees in performing MPF scheme administration functions (“Cost Study”) commissioned by the Mandatory Provident Fund Schemes Authority (“MPFA”) and conducted by Ernst & Young Advisory Services Limited;
 - (b) the short-term measures that the MPFA have adopted in response to the Cost Study findings to further drive down MPF fees; and
 - (c) the long-term reform approaches that the MPFA has put forward to the Government for consideration to fundamentally improve the MPF System to provide better retirement protection for the working population of Hong Kong.

BACKGROUND

2. The MPF System has been in place for 12 years. A defined contribution retirement system takes 30 to 40 years to mature, hence the MPF System is still a relatively new system with much room for improvement.

3. Since implementation, there have been many comments and criticisms in the community concerning the MPF System, and the MPFA has been continually refining it. To reduce the fees of the System so that scheme members may benefit from higher investment returns after fees, the MPFA has streamlined scheme operations and improved disclosure of fees and charges, and the Employee Choice Arrangement (“ECA”) implemented from 1 November 2012 is expected to facilitate market competition. Details of the measures and legislative amendments are set out in Annex A. With these measures, the weighted average fund expense ratio (“FER”) of the System has dropped from 2.1% in early 2008 to the present level of 1.74%, representing a reduction of around 17%. The annualized internal rate of return of the MPF System (net of fees) since inception is 3.4%, compared with annualized Composite Consumer Price Index change of 1.0% over the same period.

4. Last year, the Management Board of the MPFA set up a working group to study how to reform the MPF System to further bring down fees. An independent consultancy firm, Ernst & Young Advisory Services Limited (“EY”), was appointed to conduct a detailed study on the costs incurred by trustees in performing the different MPF scheme administration functions¹ (“Cost Study”) in December 2011. EY has released its report in November 2012. An executive summary of the report is at Annex B.

¹ MPF trustees have to perform a range of statutory administration functions, include enrolling employers and employees into MPF schemes, collecting contributions and checking calculation accuracy, allocating contributions to individual members’ accounts for investment, assisting in recovering default contributions, processing fund switches, processing benefit transfers and payments, reporting regularly to the MPFA and scheme members, as well as providing member support services. The performance of such functions generates certain administration costs (which retail funds would not incur).

RESULTS OF THE COST STUDY

Administration Costs as a Percentage of the FER

5. EY identified that, of the average FER of 1.74%, the administration cost of trustees took up 0.75%, with breakdown as follow:

- (a) Scheme administration cost (expenditure incurred by trustees in performing MPF administration functions, for example, general administration, member support, contribution handling, etc.): 0.75%;
- (b) Investment management fee (charges by investment managers for managing MPF funds): 0.59%; and
- (c) Other expenditure (for example, scheme sponsor fees, trustee profit, rebates to scheme members, etc.): 0.4%.

Administration Cost Drivers

6. EY also identified the major reasons for the higher administration costs of the MPF System compared with those of selected international pension systems (Australia, Chile, Mexico and the USA). EY pointed out that transaction volume is high, and many transactions are manual and paper-based. The MPF System is more flexible and provides a wider range of member services. The relatively smaller scale of MPF assets under management limits the benefits of economies of scale. There is insufficient industry co-operation and pricing competition.

Recommended Strategic Responses

7. To manage the cost drivers identified above, EY suggested the MPFA to consider:

- (a) Implementing industry-wide initiatives to deliver end-to-end online and electronic payments and data processing;
- (b) Introducing measures to facilitate account consolidation,

while transitioning to full member choice;

- (c) Facilitating industry consolidation of MPF schemes, investment funds, trustees and administration platforms;
- (d) Clarifying the objectives of the MPF System; and
- (e) Improving governance and transparency.

8. If all the above recommended initiatives are implemented and benefits are fully realized, EY predicted that administration costs could be reduced by 0.35% of assets under management (“AUM”) per annum. Should the MPF System continue to grow at its historic rate and costs increase at a rate of 3-4% per annum, EY expected that the FER as a percentage of AUM could naturally be reduced by 25 basis points by 2018. In other words, if all initiatives suggested by EY are fully implemented, coupled with the natural growth of MPF assets, the FER could be reduced by a maximum of 60 basis points in total in about five years.

RESPONSE OF MPFA TO COST STUDY RESULTS

9. Upon deliberation of the findings and recommendations of EY, the MPFA considers that further fee reductions would require the collaboration of the following four parties:

Trustees & Sponsors	Scheme members & Employers
Provide low-fee funds and step up the promotion of these funds to scheme members.	Change their ways of managing their MPF accounts, including consolidating accounts and using electronic or online services.
MPFA	Government
Continue to carry out improvement measures, including facilitating trustees to adopt electronic platforms and to merge less efficient schemes/funds.	Clearly define the role of MPF in providing retirement protection, making legislative changes as and when necessary.

SHORT-TERM IMPROVEMENT MEASURES

10. The MPFA is committed to further driving fees down and has launched four programmes in response to the Cost Study results to:

- (a) urge trustees to provide various types of low-fee funds for each scheme and to promote these funds;
- (b) facilitate trustees in further automating and streamlining their administration processes;
- (c) facilitate members in consolidating their personal accounts; and
- (d) facilitate trustees to merge smaller scale or less efficient schemes/funds.

11. The MPFA will work closely with the industry, employers and scheme members on the programmes set out above. Further details and the expected implementation time frames are set out at Annex C.

LONG-TERM FUNDAMENTAL REFORMS

12. Full implementation of the above short term measures,

together with the natural growth of MPF assets, would reduce the administration cost, at most, by 60 basis points. Nevertheless, some of the measures require the collaboration of the industry and scheme members, and cost savings might not be entirely passed on to scheme members in the form of lower fees and charges. The MPFA considers that long-term fundamental reforms to the MPF System would be necessary to further drive down MPF fees.

13. The MPFA has therefore proposed to the Government to consider making fundamental changes to the MPF System such that the System would:

- (a) have a clearly defined role in retirement protection;
- (b) have a stronger member advocate function;
- (c) be member driven;
- (d) be reasonably simple to users; and
- (e) be maintained at a reasonable cost to members.

14. The MPFA has suggested the Government to consider the following approaches in bringing fundamental changes to the MPF System:

- (a) capping the fees of MPF funds;
- (b) mandating the provision of low-fee funds in MPF schemes;
- (c) providing a basic, low-fee, default fund arrangement; and/or
- (d) introducing a not-for-profit operator to operate a simple and low-fee MPF scheme.

15. The above are conceptual suggestions and would need to be further elaborated, thoroughly studied, analysed and debated in the community. Vested with the statutory function to propose reforms of the

law relating to provident fund schemes, the MPFA will work with the Government in formulating reform measures for the MPF System to provide better retirement protection for the working population of Hong Kong.

Mandatory Provident Fund Schemes Authority
28 December 2012

Measures by MPFA and Legislative Amendments to Reduce Fees

<u>Year</u>	<u>Details</u>
Aug 2001	<ul style="list-style-type: none"> Established MPF Schemes Operation Review Committee to identify particularly measures for streamlining the operation of MPF schemes, and propose legislative amendments
Feb and Jul 2002	<ul style="list-style-type: none"> Legislative amendments for streamlining the operation of MPF schemes enacted
Jun 2004	<ul style="list-style-type: none"> Issued the “Code of Disclosure for MPF Investment Funds” to improve disclosure of fees and charges of MPF funds
2007	<ul style="list-style-type: none"> Started urging trustees to lower fees and introduce low fee funds
Jul 2007	<ul style="list-style-type: none"> Launched Phase I of the MPF Fee Comparative Platform
Jan 2008	<ul style="list-style-type: none"> Legislative amendments for further streamlining the operation of MPF schemes enacted
Oct 2008	<ul style="list-style-type: none"> Launched Phase II of the MPF Fee Comparative Platform
Jul 2009	<ul style="list-style-type: none"> Legislative amendments for ECA enacted
Sep 2009	<ul style="list-style-type: none"> Required trustees to enhance disclosure in relation to Annual Benefit Statements in order to increase transparency and promote competition
Sep 2012	<ul style="list-style-type: none"> Launched the Trustee Service Comparative Platform
Nov 2012	<ul style="list-style-type: none"> ECA commenced operation Launched Electronic Portability Automation Services System (“ePASS”) to facilitate ECA Announced results of Consultancy Study on Administration Costs of MPF Trustees

Executive Summary



The Mandatory Provident Fund (MPF) system continues to evolve in response to the developing needs of its members and their long-term retirement goals. In the 11 years of the system's existence, Hong Kong has experienced many changes that have had an impact on the retirement savings system. Despite the fact that MPF is relatively young, it is already more advanced in some areas than the more mature models in some other countries (see figure 3). It is an opportune time to review what the MPF system has achieved, revisit fundamental objectives, identify opportunities for potential improvement and agree upon decisive actions to improve outcomes for members.

Ernst & Young was engaged by the Mandatory Provident Fund Schemes Authority (MPFA) to perform a cost study of the trustee and scheme administration costs of the MPF system. We conducted this study via analysis of the overall Hong Kong MPF industry structure and stakeholders as well as analysis at the individual trustee administration process level. The findings were compared with information from selected international pension systems.

The objectives of the study were:

1. To identify the more costly areas of administration, and the reasons for such costs
2. To review lessons learned from comparable international pension systems and
3. To make recommendations on how to achieve simplicity, economies of scale, and cost reductions.

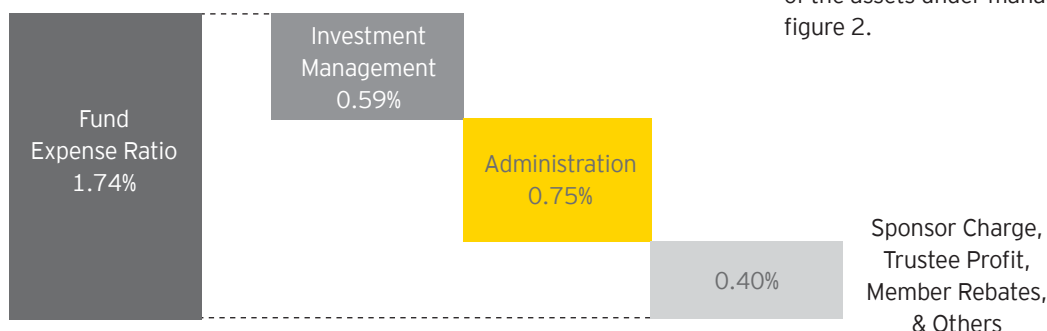
Fee and cost analysis

The introduction of the fund expense ratio (FER) by the MPFA in 2004 was an important landmark in providing a single indicator disclosed for all MPF funds, aggregating fees and other expenses charged to MPF funds and underlying investments. Our analysis allowed us to break down the FER ratio as follows (figure 1) based on the published weighted average FER of 1.74% (the weighted average of the FERs of MPF constituent funds for financial periods from 1 July 2010 to 30 June 2011).

The three major components of the FER are as follows:

1. The investment management fee represents charges for managing MPF funds, based on fees disclosed in scheme documents.
2. The administration cost is the focus of this report and represents the total expenditure incurred by trustees in performing MPF administration functions, including charges from outsourced third party administrator and other service providers. Data collected from trustees and administrators indicates the administration cost is a weighted average of 0.75% of the assets under management (AUM), breakdown shown in figure 2.

Figure 1: Indicative breakdown of fund expense ratio (FER)





3. The remaining balance includes (i) trustee profit (our estimate is based on their most recent annual financial statements that the weighted average profit of trustees which relates to MPF, by adjusting for the possible profit from ORSO schemes, is between 0.09% - 0.15%), (ii) member rebates and (iii) sponsor fees related to their product support (sponsor fees include items such as disseminating MPF marketing materials and product development activities), and any other costs excluding scheme administration and fund management.

It should be noted that trustees must delegate the investment management function to investment managers, and may delegate the administration function to other parties. There may be a profit element within the fee being charged for such delegated functions.

The FER breakdown components are indicative figures which are derived from professional estimations based on publicly available trustee financial statements, cost data from trustees (not all trustees provided full cost data), and trustee's qualitative explanation of costs.

Data collected from trustees and administrators indicates that the weighted average administration cost, based on AUM, across the system is 0.75% of AUM, i.e. costs of HKD 2.7 billion, based on the 2011 Hong Kong MPF AUM of HKD 356 billion.

We further analyzed these costs using a structural framework based on Ernst & Young's pension administration value chain model, which defines six components in the value chain (refer to figure 6 (p.11) for details). The most costly components within the value chain were member support (representing costs of 0.19% of AUM, HKD 0.7 billion) and contribution handling (0.14% of AUM, HKD 0.5 billion). The full breakdown of the costs across the value chain is shown in Figure 2.

Our analysis then sought to identify the key reasons, or drivers, for these costs with a view to making recommendations that would lead to future cost reductions.

Administration cost drivers

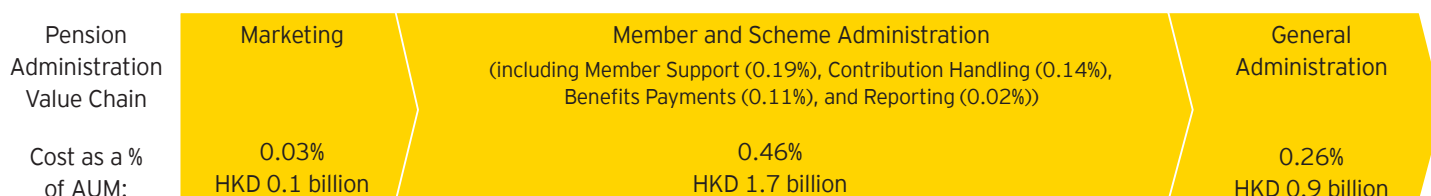
In reviewing industry, process and international data, we identified a number of factors related to system features and maturity, governance structure, and industry practices that explain why Hong Kong's MPF system has the highest fees and administration costs as a percentage of AUM when compared to other selected international pension systems (Australia, Chile, Mexico and the USA). Hong Kong's MPF system has:

1. A higher percentage of manual and paper-based administration processing, meaning that each additional transaction adds costs
2. A larger percentage of small employers and self-employed persons, increasing the volume of the employer transactions for administrators
3. A more flexible, full service system offering wider member services, increasing process complexity and workload for administrators
4. Smaller scale of assets under management, which limits the benefits of economies of scale
5. Lower industry co-operation to resolve industry-wide issues collectively and effectively, limiting the ability to spread infrastructure costs across the system
6. Insufficient pricing competition, reducing the pressure for providers to contain and minimise costs in order to maintain profit margins

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

Figure 2: MPF administration cost and expenses breakdown by value chain

Total Administration Cost: 0.75% of AUM



Strategic responses to cost drivers

We were asked to develop strategic responses within the current framework of the MPF system, which is a privately operated, market driven, and mandatory occupational pension system. We have not considered reforms that would change these system features.

Many of the cost drivers can be managed. We developed five strategic responses which we believe would improve simplicity, scale and drive cost reductions. We suggest the MPFA to consider:

1. Industry-wide initiatives to deliver end-to-end online and electronic payments and data processing, to reduce costs and streamline processing
2. Introduce measures to facilitate account consolidation, to reduce costs associated with member support activities for personal accounts (formerly known as preserved accounts), while transitioning to full member choice to promote competition
3. Facilitate industry consolidation of MPF schemes, investment funds, trustees and administration platforms
4. Clarify MPF system objectives (e.g. low cost vs full service) to guide future reform, which may lead to the consideration of more fundamental changes to the MPF system
5. Improve governance and transparency to facilitate ongoing cost reduction, promote competition and increase public confidence in the system

The first three of these strategic responses are intended to directly reduce processing costs, whilst the remaining two relate to longer term structural considerations which we believe will guide more fundamental reform (or confirm the current system direction), and facilitate ongoing cost reduction in administration activities. In the body of the report we outline more detailed initiatives to give effect to these five strategic responses.

Estimate of potential cost savings

The final section of this report outlines a high level estimate of the potential cost savings that could result from the five strategic responses. We have estimated the total potential savings to be 0.35% of AUM per annum (HKD 1.2 billion per annum), if all initiatives are implemented and benefits are fully realized. This estimate does not take into account the significant effort and capital investment that may be required to implement these initiatives. It is also important to recognise that the full benefits will not be realized without significant behavioural change from all stakeholders in the MPF system.

The MPF is a legislated mandatory pension system operated by the private sector, and as such needs to balance the important goals of ensuring protection of member interests while still providing adequate incentives for providers to reinvest in infrastructure and member service innovation. As an essential next step, we propose that the MPFA conduct a detailed feasibility and cost/benefit study of the recommended initiatives.

We hope the findings from our study will shed light on issues of interest to sponsors, trustees, employers and other stakeholders. Embracing change will create opportunities for the MPF system to innovate and invest in infrastructure, products and capabilities, while generating additional returns for its members.



Short-term Measures being Undertaken by MPFA

Improvement Area	MPFA's Short-term Measure
(A) Provision of different types of low-fee funds	<ul style="list-style-type: none"> - The MPFA has urged trustees to offer various types of low-fee funds, such as index funds, for each scheme and to step up promotion of these funds. - Trustees are required to submit a progress report by end 2012.
	<ul style="list-style-type: none"> - The MPFA has already listed lower-fee funds on its website to facilitate comparison and selection by scheme members.
	(B) Streamlining and automation of procedures
<ul style="list-style-type: none"> - A task force has been set up with trustees to plan and set a timeline by early 2013 for the standardization and simplification of procedures, and wider adoption of electronic solutions. 	
<ul style="list-style-type: none"> - The MPFA will work closely with trustees, labour unions and related organizations in 2013 to encourage and assist employers and employees to adopt wider use of electronic and online platforms. 	
(C) Consolidation of personal accounts	
	<ul style="list-style-type: none"> - The MPFA will launch a large-scale publicity campaign to support this project in 2013.

Improvement Area	MPFA's Short-term Measure
(D) Consolidation of MPF schemes or funds	<ul style="list-style-type: none"> <li data-bbox="555 297 1348 622">- The MPFA has been urging trustees to consolidate MPF schemes or funds that are smaller in scale or less efficient. Since 2003, 10 schemes have been consolidated from 24 MPF schemes and 92 MPF constituent funds have terminated operation, mostly as a result of consolidation. <li data-bbox="555 633 1348 757">- The MPFA will further assist trustees in such consolidation to achieve greater synergy and cost reduction