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11 February 2016

Mr Desmond LAM
Clerk to the Bills Committee
Legislative Council Complex
1 Legislative Council Road
Central
Hong Kong
(Fax No.: 2978 7569)

Dear Mr LAM,

**Bills Committee on
Mandatory Provident Fund Schemes (Amendment) Bill 2015**

**Submission from one of the member banks of
The Hong Kong Association of Banks**

Thank you for your letter dated 4 February 2016, relaying a submission from one of the member banks of The Hong Kong Association of Banks ("HKAB") to the Hon NG Leung-sing on the proposed opt-out transitional arrangements in the Mandatory Provident Fund Schemes (Amendment) Bill 2015 ("the Bill"), which the Bills Committee had discussed at length at the meetings on 15 December 2015, 11 January 2016 and 26 January 2016.

The purpose of the proposed opt-out transitional arrangements is to protect the interests of disengaged scheme members. The justifications for the opt-out arrangements are detailed in our responses to the Bills Committee (vide LC Paper No. CB(1)480/15-16(02) at Annex A and CB(1)553/15-16(02) at Annex B), as well as paragraphs 51 to 55 of the Consultation Conclusions published in March 2015 at Annex C).

We should be grateful for your assistance in distributing the information to Members of the Bills Committee.

Yours sincerely,



(Wendy CHUNG)
for Secretary for Financial Services and the Treasury

c.c.

Chairman of the Bills Committee (Att: Hon TAM Yiu-chung, GBS, JP)

Hon NG Leung-sing, SBS, JP

Mandatory Provident Fund Schemes Authority (Attn: Ms Gabriella YEE)

**Bills Committee on
Mandatory Provident Fund Schemes (Amendment) Bill 2015**

**Responses to Submissions Received and Matters Raised by
Deputations and Members at the Meeting on 11 January 2016**

Purpose

This paper sets out the responses from the Government and Mandatory Provident Fund Schemes Authority (“MPFA”) to issues raised at the Bills Committee meeting on 11 January 2016.

(a) Responses to the deputations’ written submissions received and views expressed at the meeting

2. Our responses are set out at **Annex A**.

(b) Further elaboration on the rationale for adopting the opt-out approach in respect of the Default Investment Strategy (“DIS”) for the accrued benefits of members to whom proposed Division 2 of Part 4AA would apply

3. The policy intent behind the proposed transitional arrangements of the DIS is to protect the interests of disengaged scheme members who have not made investment decisions actively. The proposed approach, which is consistent with similar international precedents that we can identify, was generally supported by over 70% of respondents during the public consultation conducted in 2014. We have also taken into account the concerns about the opt-out approach as expressed in respondents’ submissions to the public consultation when finalising the proposed transitional arrangement (see paragraphs 51 to 55 of the Consultation Conclusions published in March 2015).

4. As set out in paragraphs 1 to 3 of LC Paper No. CB(1)396/15-16(02), approved trustees roughly estimate that around one million, out of a total of 8.8 million accounts, might be subject to the opt-out transitional process. The actual final number is likely to be lower than this when members over 60 years of age and subsequent instructions are taken into account. This means that for around 90% of existing accounts with specific investment instructions already given, the opt out transitional approach will not be applicable to them and they will only be invested in accordance with the DIS if the account holder takes some active step to deliberately choose to do so. Existing choices of members will not be affected by the proposed arrangements. The remainder, around 10% of accounts, relates to disengaged scheme members who have not given investment instructions, who are the focus of the DIS.

5. This is reflected in the notification requirements in the proposed section 34DF which are carefully drafted to balance between protecting the interests of disengaged scheme members and maintaining operational efficiency.

6. Disengaged scheme members have had their contributions invested according to the default investment arrangements (“DIA”) determined by scheme rules, which vary from scheme to scheme. With the development of a consistent framework (i.e. the DIS) for investment of the benefits of such members, it is appropriate that previous benefits for which no instructions have been given be invested in accordance with the highly standardised strategy. From the operational perspective, “opt-in” approach may have some benefits that, with express investment instructions from scheme members, disputes could be minimized. This would be a logical approach if the target group were primarily scheme members who are active and will digest the information about the DIS and then make an informed and conscious decision to choose the DIS or otherwise. However, by their nature, it is less likely that disengaged scheme members who we intend to take care of under the proposed DIS, will do so and as a consequence, adopting the opt-in mode will defeat the objective of helping disengaged scheme members.

7. To further minimize the scope for unintended outcomes, the MPFA will mount a large-scale publicity campaign immediately after the enactment of the Bill (i.e. six months prior to the launch of the DIS) to enhance public understanding of the DIS including the impact of the transitional arrangements. In order to facilitate disengaged scheme members to understand the implications for DIS transfers, we have proposed a 42-day opt-out period to give sufficient time for default scheme members to consider their Mandatory Provident Fund (“MPF”) investments (i.e. the proposed section 34DH of the Mandatory Provident Fund Schemes Ordinance (“MPFSO”) in clause 8 of the Bill). In addition to serving the best interests of disengaged scheme members, the opt-out approach will help facilitate early growth of the relevant funds.

(c) Further elaboration on the rationale for the use of two constituent funds (“CFs”) (i.e. the Core Accumulation Fund and Age 65 Plus Fund) and the de-risking investment principle under the DIS

8. The de-risking mechanism refers to the allocation of the benefits of a DIS member from investing in a CF comprising more higher risk assets to one comprising more lower risk assets based on the member’s age. In considering the optimal number of CFs to be adopted to achieve de-risking, factors such as efficiency of the investment structures and benefits of economies of scale strongly suggest that the fewer CFs used, the more efficient will be the structure. The current proposal, which is developed after consultation with the industry, uses the least possible number of CFs, thus minimising the cost implication for the industry and scheme members.

9. Another element of achieving efficiency is through setting up a DIS under each individual scheme. At present, scheme members’ benefits will be invested into one or more CFs set up under each MPF scheme. The current proposal of requiring approved trustees to set up DIS CFs under each MPF scheme will allow the quickest implementation, as compared to using a single set of funds across all schemes. The use of CF across schemes is inconsistent with the trust-based structure of the current MPF System which requires that contributions be invested within the trust-based scheme into which contributions are made. Changing

these basic elements would require a substantial re-design of the legislation and the whole System.

10. As for the proposed allocation of higher risk assets and lower risk assets in the two DIS CFs, we have made references to the recommendations of the Organisation for Economic Cooperation and Development (“OECD”), international practices and local expert consensus. The proposed asset allocation is effectively 60% exposure to higher risk assets until age 50, which is then reduced gradually to 20% by age 65. We note that there is much diversity in approaches internationally in relation to many of the parameters including starting equity exposure, average equity exposure, terminal equity exposure and the age and speed at which risks are reduced. We consider however that the proposed approach represents a good balance of empirical analysis and observed practice to which has been agreed by industry experts.

11. As for the proposed globally-diversified investment principle, we have taken into account the need to balance the investment risks over a 40-year benefits accumulation period, exposing investments to multiple market investment cycles, as well as the need to prevent concentration of investments in one single market or region. Analysis suggests that focusing on single markets will lead to a greater dispersion of outcomes and increase the probability of extremely negative outcomes not in the best interest of scheme members.

(d) The Fund Expense Ratio (“FER”) (after taking into account the discount on fees and charges offered to scheme members) of the existing MPF CFs which were classified as mixed assets funds

12. As stated in paragraph 6 of our previous paper to the Bills Committee (LC Paper No. CB(1)396/15-16(02)), depending on the maximum equity content of the fund, the FER of existing mixed assets funds range between 1.61% to 1.81%. These FERs have not taken into account the discount on fees and charges offered to scheme members (commonly referred to as “member rebates”) by the approved trustees. We consider it not appropriate to focus on adjusted FERs for disclosure or comparative purposes as these rebate discounts are not available to all scheme members.

- (e) **An itemized list of the fees and expenses other than the management fees permitted to be charged to the Core Accumulation Fund and Age 65 Plus Fund of the DIS under the proposed section 34DC(3), and whether such fees and expenses were recurrent or one-off in nature**
- (f) **Elaboration on the interpretation of the fees and expenses permitted to be charged under the proposed section 34DC(3)(b), including the approximate amount of such fees and expenses currently charged by the approved trustees to the existing mixed assets funds, and to address members' concern on the possibility of the approved trustees circumventing the fee control by alternating fee charging practices**

13. Based on the information disclosed to the MPFA by the industry in relation to existing CFs, these other fees and expenses that could apply to the proposed Core Accumulation Fund and Age 65 Plus Fund of the DIS would primarily be out-of-pocket expenses in relation to discharge of trustees' duties. These expense items are summarized in the table below.

Out-of-pocket expense item	On-going	One-off	Remarks
Auditor's fee	✓	✓	The fees for the regular annual audit are on-going, whereas the fees for any special audit are one-off and incurred when the need for such an audit arises.
Legal and other professional charges	-	✓	-
Preparation cost and publication expenses	-	✓	-
Printing and postage, fund price publication expenses, bank	✓	-	-

Out-of-pocket expense item	On-going	One-off	Remarks
charges			
Governmental fees and charges (including, without limitation, stamp duty, licence fee and other duties)	✓	✓	MPFA charges HK\$5,000 for each CF application. Securities and Futures Commission charges HK\$5,000 for each CF application. Upon the granting of authorization, there is an authorization fee of HK\$2,500 and an annual fee of HK\$4,500.
Other charges and expenses properly incurred and permitted by the MPFSO and its Regulations and the trust deed of the scheme approved by the MPFA	✓	-	-

14. A similar range of items would be applicable for underlying investment funds.

15. According to the MPFA's internal analysis conducted with reference to the fee information available in June 2014, the difference between the average FER and average aggregate management fees (simple average) of mixed asset funds was estimated to be 0.20%.

16. Fee items that approved trustees are allowed to charge under the proposed section 34DC(3)(b) are listed below –

Fee item in section 34DC(3)(b)	On-going	One-off	Remarks
Services provided by a custodian in connection with holding, maintaining or transacting the investments of the fund; and customarily not calculated as a percentage of the Net Asset Value (“NAV”) of the fund	✓	-	<p>Some custodian fees are transaction-based out-of-pocket expenses and are charged on an ex-ante basis. They may vary with asset allocation, or are trading fees resulting from re-balancing, etc. which cannot be taken into account under the fee cap. The amount of non-NAV based custodian fees estimated by some approved trustees is generally not more than 0.03% to 0.04%, based on active investment strategies currently adopted by fund managers. The non-NAV based custodian fees vary due to:</p> <ul style="list-style-type: none"> • investment; • strategies of relevant fund managers; • size of the portfolio; • number of transactions; • transaction

Fee item in section 34DC(3)(b)	On-going	One-off	Remarks
			processing fees of different investment markets; <ul style="list-style-type: none"> • processing fees of corporate actions; and • depository charges of specific markets.
Services relating to establishment or winding up of the fund	-	✓	-
Fees charged to the member for obtaining copies of documents not required to be provided under the MPFSO	-	✓	-

(g) Elaboration on the operation of the transitional transfers of the accrued benefits in pre-existing accounts of scheme members to whom proposed Division 3 of Part 4AA would apply, to and invested in the DIS after commencement of the Bill

17. The operation of the transitional transfers of the accrued benefits in pre-existing accounts of scheme members to whom proposed Division 3 of Part 4AA would apply are set out at **Annex B**.

(h) The estimated number of existing default scheme members whose accrued benefits would not be transferred to and invested in the DIS under the proposed section 34DB(2) (i.e. the member had reached 60 years of age before the commencement of the Bill), and the estimated amount of accrued benefits involved

18. Based on the rough estimate recently provided by the approved trustees to the MPFA, it is roughly estimated that out of about a million MPF accounts investing in existing default funds under MPF schemes as of end December 2014, about 90 000 scheme members are 60 years old and above, involving HK\$6.26 billion (based on the NAV of the MPF System as of the end of November 2015).

(i) Elaboration on the mechanism for reviewing and amending Schedule 10 (in respect of investment principles) and Schedule 11 (the percentage for calculation of the cap on the payment for services relating to the DIS) to the Bill

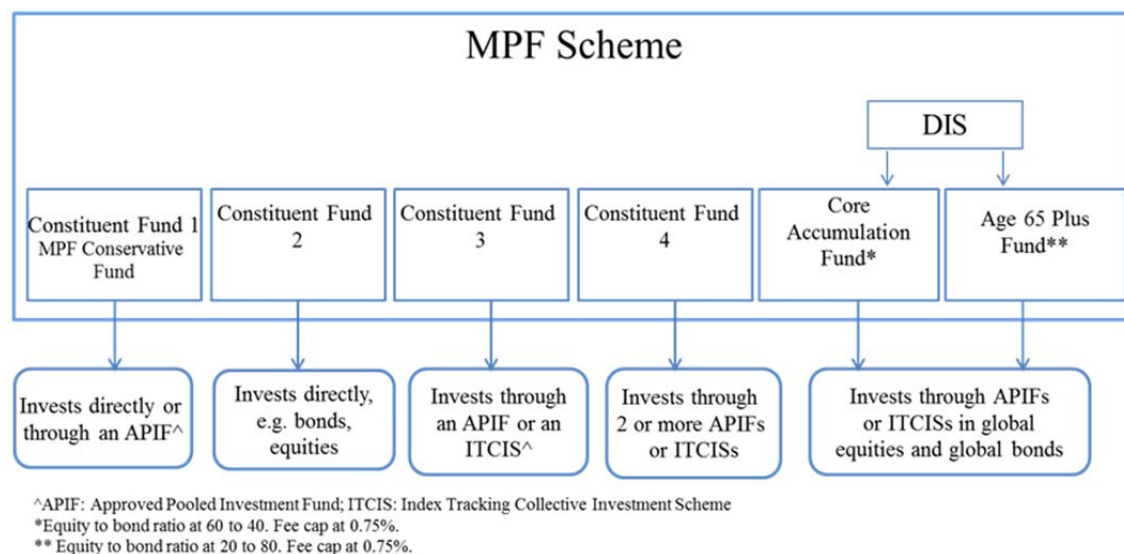
19. Given the need to allow timely changes to the DIS CFs in view of market developments and timely downward adjustment of the fee cap to better protect scheme members' benefits, we propose to include a mechanism in the proposed section 34DD of the MPFSO to empower the Secretary for Financial Services and the Treasury to amend the DIS investment requirements in the proposed Schedule 10 to the MPFSO and the level of the fee cap in the proposed Schedule 11 to the MPFSO. The proposed amendment will be subject to negative vetting by the Legislative Council. Upon the full implementation of DIS, we will evaluate factors such as the effectiveness of the DIS being delivered under the fee cap, the operational efficiency of the DIS CFs, the fee level of other CFs in the MPF System, and the scale of the CFs, etc. before introducing amendments to Schedules 10 and 11 to the MPFSO.

(j) Elaboration on the interpretation of “underlying investment fund” and “underlying investment fund fee” as set out in the proposed section 34DC(5)

20. An MPF scheme is a trust structure used for collecting, administering and investing MPF contributions. MPF schemes are divided up into a number of “CFs”. The term “MPF funds” is usually a reference to the CFs in MPF schemes. The number of CFs in a scheme will vary from scheme to scheme. Each CF in a scheme will have an investment objective different from other CFs in the same scheme. Most CFs do not directly invest into investment markets. They usually

invest into other investment funds structured as unit trusts (known as approved pooled investment funds (“APIFs”)) or sometimes into index tracking funds (known as index-tracking collective investment schemes (“ITCISs”)) or insurance policies. APIFs can be managed by an investment manager in the same group as the approved trustee of the CF, or by an external manager.

21. The DIS will be set up in each MPF scheme. The DIS is not a fund; it is a strategy that uses two CFs to achieve a preferred investment approach. Members whose benefits are invested according to the DIS, either because they have not made or do not want to make an investment choice, or they have actively chosen the DIS, will have their contributions and accrued benefits allocated to one or both of the two CFs, namely, the Core Accumulation Fund and the Age 65 Plus Fund, according to their age. Similar to existing CFs, it is expected that the Core Accumulation Fund and the Age 65 Plus Fund will commonly invest through other APIFs and ITCISs. The two CFs under the DIS are also offered as stand-alone investment options under each MPF scheme.



22. The relevant controls for payment for services as set out under the proposed section 34DC will apply to the two DIS CFs as well those underlying investment funds as described in the proposed section 34DC(4). A detailed illustration of the calculation is set out at **Annex C**.

(k) Elaboration of whether the Administration would consider introducing a performance-based mechanism for charging of management fees by the approved trustee of the DIS CFs

23. It is difficult to include any investment performance-based elements within the fee control proposed for the DIS. Trustee administrative functions, and hence costs, are not in any material way related to investment performance. There would be no logical basis to connect trustee fees to investment performance. Investment performance based fees are sometimes considered in relation to investment management fees but it is difficult to adopt such a fee model in the DIS context. Firstly, a performance related fee introduces a conditionality which would make the calculation and operation of a daily fee control much more difficult. Secondly, we understand that index-based investment may well be a common feature of DIS CFs. Under such an approach, which is encouraged in terms of cost and consistency, investment outcomes are almost exclusively driven by investment markets, rather than the efforts of individual investment managers. It would appear quite arbitrary to attach the manager's fees to the outcome of a particular index over which it has no control.

**Financial Services and the Treasury Bureau
Mandatory Provident Fund Schemes Authority
January 2016**

**Responses to Submissions Received by and Matters Raised by
Deputations at the Bills Committee Meeting**

Views	Responses
(I) Proposed Default Investment Strategy (DIS)	
<ul style="list-style-type: none">Support the introduction of fee-controlled DIS in each MPF scheme for “default” scheme members [CGCC, CMAHK, FHKKLU, HKFI, HKTA, HKSFA, MIMA, MSCI]	<ul style="list-style-type: none">The primary objective of the proposed DIS is to provide default scheme members with a highly standardised and fee-controlled investment strategy which is consistent with the objective of long term retirement savings. Scheme members who consider the proposed DIS suit their investment needs can also proactively choose to invest in the DIS.
<ul style="list-style-type: none">Support the provision of flexibility of developing the appropriate asset class by investment managers [MIMA, MSCI]	
<ul style="list-style-type: none">Support that DIS should be made available to all scheme members [MIMA]	
<ul style="list-style-type: none">Do not wish to raise any comments on the Bill [HKAB]	
(II) De-risking Mechanism	
<ul style="list-style-type: none">Support the use of two CFs in the DIS [HKSFA]	<ul style="list-style-type: none">Please refer to paragraphs 8 to 11 of the main paper for our responses.
<ul style="list-style-type: none">Support the globally-diversified investment principle for DIS CFs [CMAHK]	

Views	Responses
<ul style="list-style-type: none"> Support that there is no restriction on any investment style (e.g. indexing) [MSCI] 	
<ul style="list-style-type: none"> Support the age-based life-cycle investment strategy in the DIS [HKSFA] 	
<ul style="list-style-type: none"> Consider that the proposed allocation of higher risks assets in the Core Accumulation Fund and Age 65 Plus Fund is too conservative [MIMA] 	<ul style="list-style-type: none"> Given the complexities of investment choices, 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 has been an important area of international research. The Organisation for Economic Co-operation and Development (“OECD”), for example, has issued the “Roadmap for the Good Design of Defined Contribution Pension Plans” which suggests that whether, and how to regulate fund choices and asset allocations during the accumulation phase is an important issue. 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.

Views	Responses
	<ul style="list-style-type: none"> ▪ The OECD has conducted research for designing the DIS using Hong Kong data, and reached similar conclusions regarding investment principles for the DIS. Specifically, the OECD recommended that the global equity exposure for an account should be between 50-60% on average and that equity risk be reduced quite close to retirement age.
<ul style="list-style-type: none"> ▪ Suggest that there is no need for an agreed industry benchmark index [MSCI] 	<ul style="list-style-type: none"> ▪ After the implementation of the DIS, the industry will need to develop investment products that comply with the standardised investment approach adopted for the DIS as set out in the MPF legislation. Approved trustees will also be required to report the performance outcomes of the funds used in the DIS in each scheme against an agreed industry benchmark to facilitate comparison by scheme members. ▪ We consider that putting an agreed industry benchmark in place is in the interest of scheme members.

Views	Responses
(III) Fee Control Mechanism	
<ul style="list-style-type: none"> Support the proposed initial fee cap of 0.75% [CGCC, CMAHK, HKTA] 	<ul style="list-style-type: none"> We consider the 0.75% fee cap a suitable starting point.
<ul style="list-style-type: none"> Consider that the proposed 0.75% fee cap is too aggressive, given the current asset base in the MPF System and a cap of 1.00% may be more appropriate at this stage given the MPF's FUM scale and years of operation and fee levels in other countries [MIMA] 	<ul style="list-style-type: none"> When setting the fee cap level for the DIS, we have made reference to the "Report on a study of administrative costs in the Hong Kong Mandatory Provident Fund system" commissioned by the MPFA in 2012. At that time, data collected from approved trustees and administrators indicated that the administration cost is a weighted average of 0.75% of the assets under management ("AUM"), the investment management fees is 0.59% of AUM, and the remaining 0.40% are other costs such as marketing charges.
<ul style="list-style-type: none"> Suggest explaining the fee cap review mechanism in detail [HKSFA] 	
<ul style="list-style-type: none"> Review the fee cap regularly [CP, FHKKLU] 	<ul style="list-style-type: none"> Moreover, we have made reference to the fee level of MPF CFs. In fact, there are already 11 CFs in the market out of the total of 459 CFs with a fee level below 0.75%, which illustrates that the fee cap is not unachievable. We will consider whether this level can be further reduced in the future after having gained experience on the operation of

Views	Responses
	the DIS.
(IV) Transitional Arrangements	
<ul style="list-style-type: none"> ▪ Support the proposed opt-out transitional arrangements for existing “default” scheme members [HKSFA, MIMA] ▪ Suggest adopting an opt-in approach to obtain an informed transfer decision from scheme members [HKFI, HKTA] ▪ Consider that educational marketing campaigns should be conducted prior to having individual scheme members committed to the opt-in or opt-out arrangements [HKRSA] 	<ul style="list-style-type: none"> ▪ Please refer to paragraphs 3 to 7 of the main paper for our responses.
(V) Operator of DIS	
<ul style="list-style-type: none"> ▪ The Government may assign the Hong Kong Monetary Authority, or non-profit-making organisations to manage the DIS in the long run [CGCC, CMAHK, FHKCLU] ▪ The Government may provide subsidy for management and operation of the DIS [CGCC] 	<ul style="list-style-type: none"> ▪ The MPF System, which forms one of the pillars of Hong Kong’s retirement protection system, is eventually introduced in the form of privately managed retirement protection schemes after almost thirty years of deliberation. MPF schemes are administered by professional approved trustees, while the contributions are invested by investment management companies

Views	Responses
	<p>registered with Securities and Futures Commission.</p> <ul style="list-style-type: none"> ▪ This design aims to reduce the administrative burden and costs for employers, protect scheme members' interests and consolidate scheme members' contributions for management and investment in order to achieve efficiency. ▪ Having a public trustee to manage MPF schemes will involve the setting up of a new operation system and repeating the administrative tasks currently undertaken by private trustees. As such, it may not be economically efficient. We are of the view that MPF schemes should continue to be operated by the industry, and will work with the MPFA to continue to enhance the system to facilitate fund competition and fee reduction. ▪ In addition, the statutory function of the HKMA is to maintain the stability of the monetary, banking and financial systems in Hong Kong. The suggestion of having the HKMA operating MPF funds is not in line with

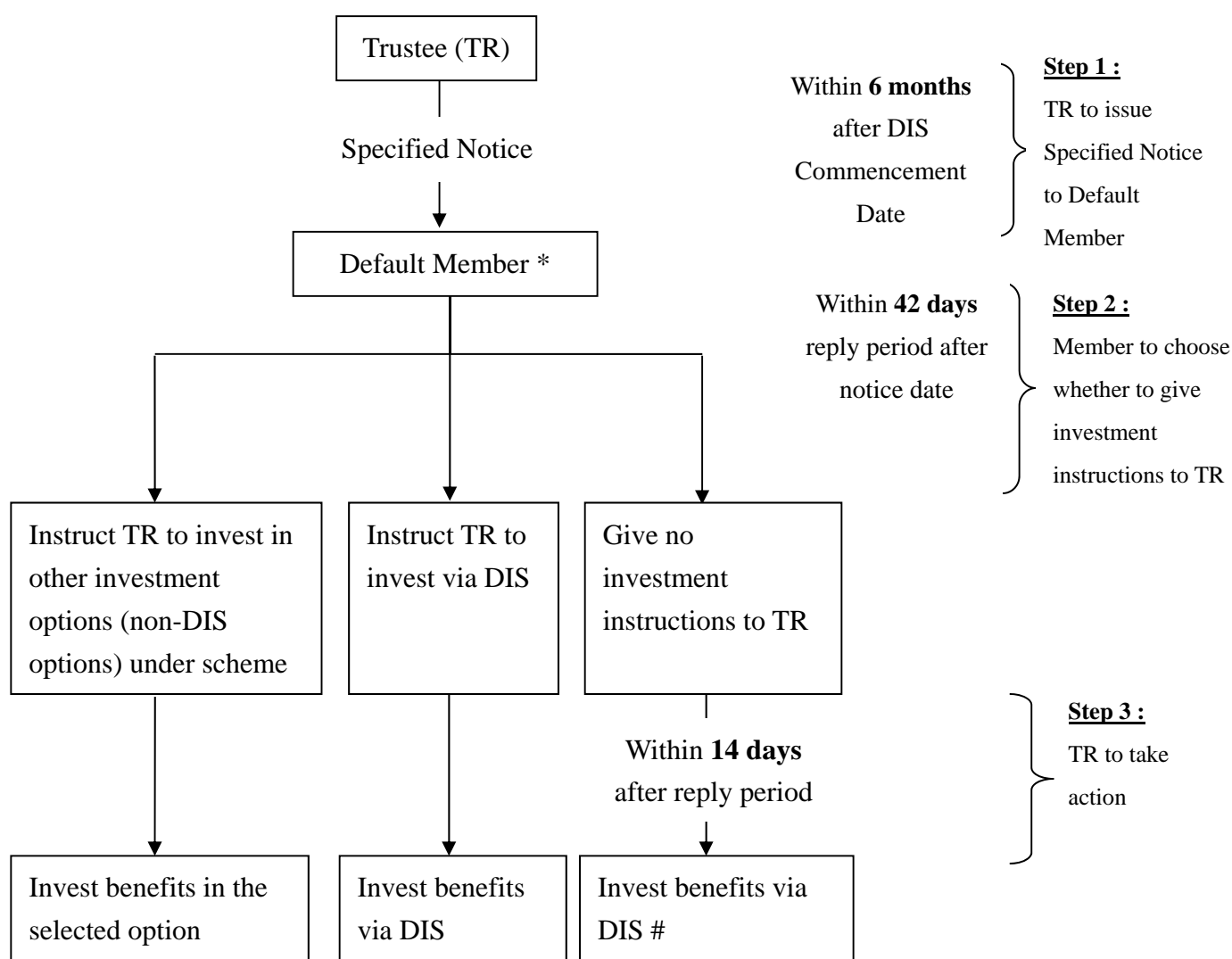
Views	Responses
	the former's statutory function.
(VI) Others Comments on the MPF System	
<ul style="list-style-type: none"> Offsetting severance payments ("SP") and long service payments ("LSP") [A member of the public, CP] 	<ul style="list-style-type: none"> The Commission on Poverty is now conducting a public consultation on retirement protection. One of the issues covered in the consultation is offsetting. We welcome views on this issue from the public.

Legend

CP	Civic Party
CGCC	The Chinese General Chamber of Commerce
CMAHK	The Chinese Manufacturers' Association of Hong Kong
FHKKLU	The Federation of Hong Kong & Kowloon Labour Unions
HKAB	The Hong Kong Association of Banks
HKFI	The Hong Kong Federation of Insurers
HKRSA	The Hong Kong Retirement Schemes Association
HKTA	Hong Kong Trustees' Association
HKPSEA	Hong Kong Professionals and Senior Executives Association
HKSF	The Hong Kong Society of Financial Analysts
MIMA	Morningstar Investment Management Asia Limited
MSCI	MSCI Hong Kong Limited

Financial Services and the Treasury Bureau
Mandatory Provident Fund Schemes Authority
January 2016

Application of the Proposed Section 34DF in Clause 8 of the Bill



*A member is a “Default Member” if -

- (a) the member is below 60 years of age, or becomes 60 years of age, on the DIS Commencement Date, and
- (b) immediately before the Commencement Date, all of the accrued benefits in a pre-existing account of the member have been invested according to a default investment arrangement (“DIA”) of the scheme, and
- (c) the approved trustee of the scheme reasonably believes that it has not received specific investment instructions from the member for those benefits.

If the accrued benefits of the “Default Member” have been invested in a guaranteed fund according to DIA, the approved trustee must not invest those benefits via DIS if, on the last day of the 42-day reply period, the market value of those benefits is less than the value guaranteed by the fund to be paid to the member on that day.

Illustrations for Calculating Daily Aggregate Payment for Services for a DIS Constituent Fund

For the purposes of the proposed section 34DC(4) of and Schedule 11 to the Mandatory Provident Fund Schemes Ordinance (“MPFSO”), examples are set out below to illustrate how to calculate the daily aggregate payment for services (“PFS”) for a DIS constituent fund (“DIS CF”) under four different investment structures and scenarios. They are provided to assist approved trustees in understanding the relevant calculation and in comparing it against the daily percentage rate set out in the proposed Schedule 11 to the MPFSO.

Formula for calculating Aggregate PFS of a DIS CF for the purposes of section 34DC(4) of and Schedule 11 to the MPFSO

Aggregate PFS (%)

= the total amount of all PFS specified in section 34DC(2) that are charged to or imposed on the fund, or a scheme member who invests in the fund and calculated as a percentage of the net asset value (“NAV”) of the fund (%)
+
the total amount of any proportionate underlying investment fund fees chargeable to any underlying investment fund of the fund (%)

where

proportionate underlying investment fund fee = A x B;

and where

A = the underlying investment fund fee (“UIFF”) being calculated as a percentage of the NAV of the underlying investment fund;

B = the proportion of the assets of the DIS CF that is invested in the underlying investment fund

Scenario 1: The DIS CF makes direct investment

Assumptions

1. PFS of the DIS CF = 0.70% p.a. of the CF's NAV

CF

 0.70%

Step 1: Calculate the total PFS at CF level and the total proportionate UIFF at underlying investment fund level:

- (a) Total amount of all PFS at CF level = 0.70%
- (b) Total amount of all proportionate UIFF (A x B) = 0%

Step 2: Calculate the aggregate PFS for the DIS CF:

$$\text{Aggregate PFS} = (a) + (b) = 0.70\% + 0\% = 0.70\%$$

Step 3: Compare daily aggregate PFS with the daily rate specified in Schedule 11 to the MPFSO:

$$\frac{0.70\%}{N} < \frac{0.75\%}{N}$$

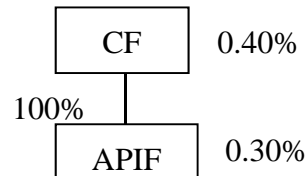
where N is the number of days in the year

Since the daily aggregate PFS does not exceed the daily rate specified in Schedule 11 to the MPFSO, it complies with section 34DC(4) of the MPFSO.

Scenario 2: The DIS CF invests solely in an APIF which makes direct investment.

Assumptions

1. PFS of the DIS CF = 0.40% p. a. of the CF's NAV
2. For the APIF, A= 0.30% p.a. of the APIF's NAV, B =100%



Step 1: Calculate the total PFS at CF level and the total proportionate UIFF at underlying investment fund level:

- (a) Total amount of all PFS at CF level = 0.40%
- (b) Total amount of all proportionate UIFF (A x B) = 0.30% x 100% = 0.30%

Step 2: Calculate the aggregate PFS for the DIS CF:

$$\text{Aggregate PFS} = (a) + (b) = 0.40\% + 0.30\% = 0.70\%$$

Step 3: Compare daily aggregate PFS with the daily rate specified in Schedule 11 to the MPFSO:

$$\frac{0.70\%}{N} < \frac{0.75\%}{N}$$

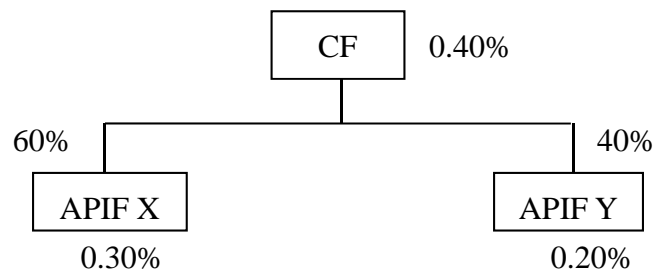
where N is the number of days in the year

Since the daily aggregate PFS does not exceed the daily rate specified in Schedule 11 to the MPFSO, it complies with section 34DC(4) of the MPFSO.

Scenario 3: The DIS CF invests into two APIFs which make direct investment

Assumptions:

1. PFS of the DIS CF = 0.40% p. a. of the CF's NAV
2. APIF X and APIF Y make direct investment.
3. For APIF X, A = 0.30% p. a. of APIF X's NAV, B = 60%
4. For APIF Y, A = 0.20% p. a. of APIF Y's NAV, B = 40%



Step 1: Calculate the total PFS at CF level and the total proportionate UIFF at underlying investment fund level:

- (a) Total amount of all PFS at CF level = 0.40%
- (b) Total amount of all proportionate UIFF (A x B) = 0.30% x 60% + 0.20% x 40% = 0.26%

Step 2: Calculate the aggregate PFS for the DIS CF:

$$\text{Aggregate PFS} = (a) + (b) = 0.40\% + 0.26\% = 0.66\%$$

Step 3: Compare daily aggregate PFS with the daily rate specified in Schedule 11 to the MPFSO:

$$\frac{0.66\%}{N} < \frac{0.75\%}{N}$$

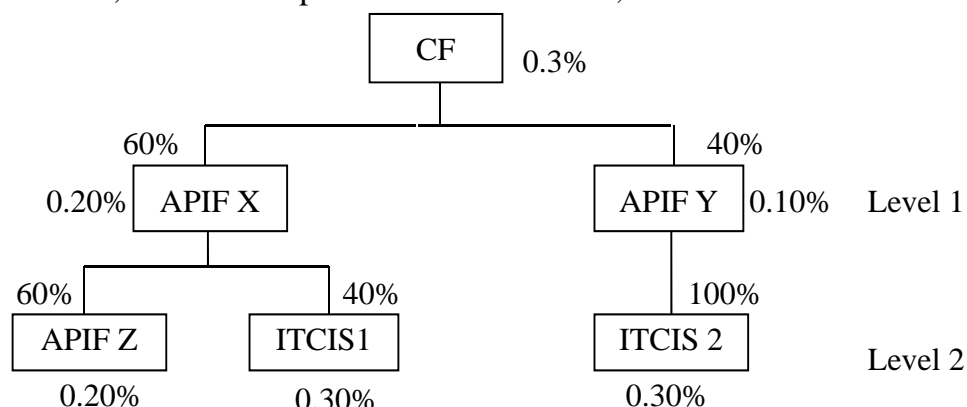
where N is the number of days in the year

Since the daily aggregate PFS does not exceed the daily rate specified in Schedule 11 to the MPFSO, it complies with section 34DC(4) of the MPFSO.

Scenario 4: The DIS CF invests into two APIFs which invest further into ITCIS and/or APIF.

Assumptions:

1. PFS of the DIS CF = 0.30% p. a. of the CF's NAV
2. APIF X invests 60% into APIF Z and 40% into ITCIS 1
3. APIF Y invests solely into ITCIS 2
4. APIF Z, ITCIS 1 and ITCIS 2 make direct investments
5. For APIF X, A = 0.20% p. a. of APIF X's NAV, B = 60%
6. For APIF Y, A = 0.10% p. a. of APIF Y's NAV, B = 40%
7. For APIF Z, A = 0.20% p. a. of APIF Z's NAV, B = 60% x 60%
8. For ITCIS 1, A = 0.30% p. a. of ITCIS 1's NAV, B = 60% x 40%
9. For ITCIS 2, A = 0.30% p. a. of ITCIS 2's NAV, B = 40% x 100%



Step 1: Calculate the total PFS at CF level and the total proportionate UIFF at underlying investment fund levels:

- (a) Total amount of all PFS at CF level = 0.30%
- (b) Total amount of all proportionate UIFF = $[(0.20\% \times 60\%) + (0.10\% \times 40\%)] + [(0.20\% \times 60\% \times 60\%) + (0.30\% \times 60\% \times 40\%) + (0.30\% \times 40\% \times 100\%)] = 0.424\%$

Step 2: Calculate the aggregate PFS for the DIS CF:

$$\text{Aggregate PFS} = (a) + (b) = 0.30\% + 0.424\% = 0.724\%$$

Step 3: Compare daily aggregate PFS with the daily rate specified in Schedule 11 to the MPFSO:

$$\frac{0.724\%}{N} < \frac{0.75\%}{N}$$

where N is the number of days in the year

Since the daily aggregate PFS does not exceed the daily rate specified in Schedule 11 to the MPFSO, it complies with section 34DC(4) of the MPFSO.

Mandatory Provident Fund Schemes Authority
January 2016

**Bills Committee on
Mandatory Provident Fund Schemes (Amendment) Bill 2015**

**Responses to Matters Raised by
Members at the Meeting on 26 January 2016 and
in the letter from the Hon SIN Chung-kai dated 25 January 2016**

Purpose

This paper sets out the responses from the Government and Mandatory Provident Fund Schemes Authority (“MPFA”) to issues raised at the Bills Committee meeting on 26 January 2016 and in the letter from the Hon SIN Chung-kai dated 25 January 2016.

- (a) further elaboration on whether the proposed opt-out arrangements and subsequent transfer of accrued benefits from the existing Default Investment Arrangements (“DIA”) to the proposed Default Investment Strategy (“DIS”) (especially in the case of negative return after transfer) are constitutionally in order;**

2. The proposed transitional arrangements are in compliance with Articles 6, 25 and 105 of the Basic Law¹. Specifically, our legal advice has confirmed that the proposed transitional arrangements would not constitute deprivation of default scheme members’ property. Also, the modification of the subsisting rights of default scheme members to invest their accrued benefits as imposed by the DIS serves the legitimate aim of protecting members’ interests, and that the modification imposed by the proposed transitional arrangements would be fair and not disproportionate, taking into account different aspects of the details of the proposed arrangements as discussed below.

¹ **Article 6:** The Hong Kong Special Administrative Region (“HKSAR”) shall protect the right of private ownership of property in accordance with law.

Article 25: All Hong Kong residents shall be equal before the law.

Article 105: The HKSAR shall, in accordance with law, protect the right of individuals and legal persons to the acquisition, use, disposal and inheritance of property and their right to compensation for lawful deprivation of their property. Such compensation shall correspond to the real value of the property concerned at the time and shall be freely convertible and paid without undue delay. The ownership of enterprises and the investments from outside the Region shall be protected by law.

3. One of the purposes of the DIS is to protect the interests of existing default scheme members who have not given any specific investment instructions for all of their accrued benefits. At present, DIA are not statutorily regulated. The investment objectives, risk levels, fee levels and investment returns of the existing DIA vary widely across different schemes. Some existing DIA do not serve any long-term retirement protection purpose. On the other hand, the fee-controlled DIS is designed to balance long-term investment risks for a 40-year MPF investment horizon and is developed based on the recommendations of the Organisation for Economic Co-operation and Development. As such, the modification of the subsisting rights of default scheme members to invest their accrued benefits as imposed by the DIS indeed serves a legitimate aim of protecting members' interests.

4. To ensure that default scheme members are aware of the potential risks of DIS transfer, the MPFA will mount large-scale publicity and education programmes a few months prior to the commencement of the Bill. The MPFA will also require approved trustees to provide a standardised DIS information booklet to all scheme members around three months prior to the commencement. This booklet will include key features of the DIS and information about likely risks (including the risks of negative returns). The MPFA is consulting industry bodies in preparing this booklet.

5. In addition, to ensure that default scheme members would have sufficient time to consider the implications for the transfer of the accrued benefits to the DIS, we have proposed a reply period of 42 days in the Bill. Other than the reply period, there are provisions in the Bill that require approved trustees to go through necessary steps to locate scheme members when the members cannot be contacted. So long as approved trustees have gone through the proposed requirements to locate and contact the default scheme members, the modification of the members' subsisting rights on their accrued benefits would be fair and would be able meet the proportionality principle.

(b) elaboration on the considerations of the proposed 42-day period for scheme members to opt out from the DIS (also the first enquiry in the Hon SIN Chung-kai's letter dated 25 January 2016), and whether the Government would consider extending the proposed period to give more time for default scheme members to make choices for their Mandatory Provident Fund ("MPF") investments;

6. The 42-day reply period was proposed after extensive discussion between the MPFA and the industry.

7. The MPFA had originally proposed 30 days, drawing reference from some of the notification periods specified in the MPF Schemes Ordinance (Cap. 485) ("MPFSO")² and on the working assumption that a one-month period should be adequate for receiving and processing responses. However, approved trustees suggested allowing for a longer time period to add flexibility in processing replies. After taking into account approved trustees' views, the MPFA considered that the length of the reply period should –

- (i) be reasonably sufficient for default scheme members to understand the DIS and its implications and give a reply to the approved trustees should they prefer to invest their accrued benefits in some other manner;
- (ii) be reasonably sufficient for approved trustees to identify the returned mail cases, process those cases for which replies have been received and handle those cases with no reply received in accordance with the law; and
- (iii) not be too long such that default scheme members would tend to set aside the specified notice for the time being, only to have forgotten all about it by the end of the reply period.

² For example, under section 15 of the MPF Schemes (Exemption) Regulation (Cap.485B), an employer is required to provide specified information to its new eligible employee to enable the employee to elect between joining a relevant ORSO registered scheme and an MPF scheme. The new eligible employee shall give notice in writing to his employer not later than 30 days after the employee becomes such an employee advising the employer whether he elects to become a member of the ORSO scheme or the MPF scheme.

8. Based on the aforementioned considerations, a reply period of 42 days is eventually proposed in the Bill. We have taken note of Members' views that a longer reply period would allow default scheme members more time to understand the DIS and make investment choices. However, having balanced all of the abovementioned considerations, we maintain that the proposed 42-day reply period is appropriate.

(c) the estimated number of scheme members whom the contact details (e.g. addresses or telephone numbers) are unknown to approved trustees and the measures to be adopted by the MPFA to ensure the approved trustees to get hold of these scheme members (also the second enquiry raised in the Hon SIN Chung-kai's letter)

(d) a preliminary draft of the guidelines set out in the proposed section 34DI(2) (also the enquiry from the LegCo Assistant Legal Adviser raised at the meeting);

9. According to the estimates made by approved trustees, there are about 404 000 accounts (representing about 4.6% of the total 8.8 million MPF accounts) belonging to scheme members whom cannot be contacted by approved trustees due to lack of valid contact details (i.e. telephone number and address). These accounts, however, include all MPF accounts and not only those default accounts that may be subject to the proposed transitional arrangements. We expect that the approved trustees should have a clearer picture closer to mid-June 2016.

10. To facilitate the serving of a specified notice on default scheme members whose contact details are unknown to approved trustees, we have included a specific provision in the Bill (i.e. the proposed section 34DI) to require approved trustees to locate scheme members in the manner and within the time limit as specified in the guidelines to be issued by the MPFA. Once approved trustees have been able to locate those members, the approved trustees will need to follow the normal transitional arrangements proposed under the Bill, including the serving of a specified notice on the members. An extract of the draft guidelines is at **Annex**.

- (e) **elaboration on the transitional arrangements in relation to the accrued benefits of a default scheme member currently invested in guaranteed funds (also the third enquiry in the Hon SIN Chung-kai’s letter dated 25 January 2016); and**

11. The transitional arrangements as specified in the proposed Division 3 of Part 4AA of the MPFSO in the Bill are intended to apply to all scheme members who satisfy the criteria set out in the proposed section 34DF (i.e. generally “default scheme members” who have not given any investment instructions and have their accrued benefits fully invested in the DIA of the scheme which can be guaranteed funds, MPF conservative funds, etc.).

12. Within six months after the commencement of the DIS, an approved trustee has to give an opt-out specified notice to a default scheme member. The specified notice will include a form, allowing the default scheme member to choose not to invest in the DIS by specifying his investment instructions.

Possible reply given by a default scheme member during the 42-day reply period	Follow-up by the approved trustee
(a) choose to stay in the existing constituent funds (“CFs”)	<ul style="list-style-type: none"> ▪ continue investing the accrued benefits in the existing CFs
(b) make some other selection of CFs by completing the aforementioned form	<ul style="list-style-type: none"> ▪ invest the accrued benefits according to his selection
(c) take no action	<ul style="list-style-type: none"> ▪ transfer the accrued benefits to the DIS within a 14-day period after the expiry of the 42-day reply period if no reply has been received from the default scheme member, unless the member’s benefits are in default funds which are guaranteed funds as explained below.

13. The procedure for transferring the accrued benefits of any scheme members investing in a guaranteed fund where the proposed section 34DF in Division 3 applies starts with the issuance of the specified notice under the proposed section 34DH in Division 3. The only procedural difference between the treatment of existing accrued benefits invested in guaranteed funds and those in other CFs is that, as set out under the proposed section 34DJ(2) in Division 3, an approved trustee must not invest those benefits in guaranteed funds according to the DIS of the scheme if, at the end of the 42-day reply period, the market value of those benefits is less than the value guaranteed by the fund to be paid to the member on that day. This exception is designed to protect scheme members from losing the benefit of a guarantee that has already accrued but is not unconditional.

14. As set out in paragraph 10 of LC Paper No. CB(1)396/15-16(02), there are four approved trustees using guaranteed funds as the DIA for seven MPF schemes-

Name of Approved Trustee	No. of MPF Schemes	No. of Years of Continuous Investment	Latest Fund Expense Ratio (FER) available	NAV (HK\$ million)
Conditional Guarantees				
FWD	2	5 years	2.21% and 2.31%	\$624.30 (30 June 2015)
Mass Mutual	1 ³	The guarantee is provided in the event of occurrence of one of the qualifying events including normal or early retirement, death and total incapacity.	3.75%	\$118.79 (30 October 2015)

³ DIA contributions equally spread among all CFs.

Name of Approved Trustee	No. of MPF Schemes	No. of Years of Continuous Investment	Latest Fund Expense Ratio (FER) available	NAV (HK\$ million)
Unconditional Guarantees				
AIA	3	Not applicable	1.69% and 1.70%	\$7,174.94 (30 September 2015)
Manulife	1	Not applicable	1.79%	\$10,203.70 (30 September 2015)

15. In those cases where the guarantee is unconditional, the market value of the relevant guaranteed fund is the same as its guaranteed value. Accrued benefits of default scheme members in those cases will be transferred to the DIS within the 14-day period following this 42-day period, unless they choose to give specific investment instructions to their approved trustees within that 42-day period.

16. It is therefore only the accrued benefits of those default scheme members investing in the conditional guaranteed funds may not be transferred to the DIS if, on the expiry day of the 42-day reply period, the market value of the fund is less than its guaranteed value. As set out in paragraph 10 of LC Paper No. CB(1)396/15-16(02), the guaranteed funds of FWD and Mass Mutual are subject to long-term conditions. That said, default scheme members can, at any time before or after the transitional process, give specific investment instructions to their approved trustees to invest in the DIS if they do not want to stay in the guaranteed funds. In any event, in terms of net asset value (“NAV”), these conditional guaranteed funds only account for a very small portion (i.e. 4%) of all guaranteed funds under the existing DIA.

17. Regarding the Hon SIN Chung-kai’s enquiry on the potential risks that might arise during the transfer of accrued benefits from a guaranteed fund to the DIS in times of adverse economy, the MPFA will mount large-scale publicity programme to help scheme members understand the potential risks of any DIS transfers.

18. Regarding his enquiry on why there is a difference in the transitional arrangements between conditional and unconditional guaranteed funds, we consider that accrued benefits invested in a guaranteed fund should not be transferred to the DIS if such transfer would cause the loss of a currently accrued guarantee benefit.

(f) the estimated total amount of accrued benefits of scheme members' pre-existing accounts that might be subject to the opt-out transitional process and subsequently be transferred to and invested in the DIS, and the projection of possible further reduction in the fees charged to other MPF CFs managed by the trustees under the MPF system.

Estimated amount of accrued benefits subject to the proposed opt-out transitional arrangements

19. As set out in paragraphs 1 to 3 of LC Paper No. CB(1)396/15-16(02) and paragraph 4 of LC Paper No. CB(1)480/15-16(02), approved trustees have roughly estimated that around one million accounts, out of a total of about 8.8 million accounts, are investing in existing default funds. Based on information available to the MPFA, as of the end of November 2015, assets in CFs comprising existing DIA is roughly estimated to be 11.8% of NAV of the MPF System, or HK\$69.6 billion.

20. It should however be noted that the HK\$69.6 billion includes accounts in which the scheme members have made a decision to select the CFs comprising the DIA. It is also the case that the number of DIA accounts, scheme members and assets involved will vary over time. New members will be joining the MPF System without giving investment instructions, some existing scheme members having a DIA account will give investment instructions, some accounts will be closed and new accounts will be opened. Numbers relevant today might be substantially different from numbers on commencement date which might also be different from the numbers of accounts that are eventually subject to the transitional process as set out in the Bill.

21. It is also expected that only a proportion of the actual amounts of assets in existing default funds and accounts would be transferred to the DIS, given that a proportion of investment in existing default funds are scheme members' conscious choices (not subject to the transitional process) and some that are subject to the transitional process may opt out from the new DIS during the statutory transitional process. Some may also be excluded from the DIS if they have reached the age of 60 before the commencement of the Bill or have their assets in guaranteed funds. Given these uncertainties, it is difficult to precisely estimate the total amount of accrued benefits that will ultimately be transferred to and invested into the DIS. We expect that approved trustees will have a clearer picture closer to mid-2016. That said, in view of the implementation of the DIS, the MPFA will keep the situation in view and collect from approved trustees DIS-related statistical data for assessment.

Projection of possible fee reduction

22. The DIS proposal is intended to not only provide scheme members with a simplified investment option that is consistent with the overall objective of retirement savings, but also addresses the problem of high fees in the MPF System directly. As explained in paragraphs 39 and 50 of the Consultation Paper of Providing Better Investment Solutions for MPF Members, designating a standardised default investment approach and adopting it as the default investment arrangement will facilitate better benchmarking and comparison of investment performance and fees across and within MPF schemes. A standardised DIS will enable scheme members to focus on a single point of primary comparison. Any material differences which are a result of higher fee adversely affecting performance will be readily apparent and should provide greater market discipline for the industry to ensure that their fees and investment structures are optimized to deliver better outcomes for scheme members. Consequently, we expect that the fee cap will have a benchmarking effect, driving fee reduction or consolidation of other MPF CFs in order to make them more attractive as a choice for scheme members.

23. However, any possible further reduction in the fees of other CFs is subject to a range of factors, including the investment behaviour of scheme members (e.g. scheme members' sensitivity to fees when choosing CFs), scheme members' adoption of the DIS, and the business strategy of the industry in response to any shift of investment from other CFs to DIS CFs. Some other general factors may also have a bearing on the future fee levels of CFs, such as changes in their asset sizes and operation costs. Since the information for making a quantitative assessment of these factors is not available, the MPFA is unable to provide any projection on the future level of fee reductions of CFs.

Financial Services and the Treasury Bureau
Mandatory Provident Fund Schemes Authority
February 2016

**DEFAULT INVESTMENT STRATEGY
DRAFT GUIDELINES ON LOCATING SCHEME MEMBERS**

1. Section 34DI(1) of the Mandatory Provident Fund Schemes Ordinance (“Ordinance”) sets out that that section applies if -

- (a) it comes to the knowledge of an approved trustee of a registered scheme that a specified notice given to an existing member under section 34DH(1) of the Ordinance is not taken to have been given under section 206(1A) or (2) of the Mandatory Provident Fund Schemes (General) Regulation (“Regulation”); or
- (b) the trustee does not know any contact details of an existing member that enable(s) the trustee to give the specified notice to the member under section 34DH(1).

2. Section 34DI(2) provides that the trustee must proceed to locate the member in the manner, and within the time limit, specified in the guidelines for the purposes of that section.

Steps to be taken to locate scheme members [As proposed]

3. For the purposes of section 34DI(2) of the Ordinance, the specified manner and the time limits for approved trustees to locate scheme members are set out below.

4. Where an approved trustee has complied with section 34DH(1) and, on or before the expiry day of the reply period, has knowledge that the specified notice was “not taken to have been given under section 206(1A) or (2) of the Regulation”, such that section 34DI(1)(a) of the Ordinance applies, the trustee must proceed to locate the member in the manner set out in paragraph [6] below within the time limit of [30] days after the trustee has knowledge that the specified notice was not taken to have been given under section 206(1A) or (2) of the Regulation.

5. Where an approved trustee is unable to comply with section 34DH(1) because it does not know any contact details of an existing member such that section 34DI(1)(b) applies, the trustee must proceed to locate the member in the manner set out in paragraph [6] below within the time limit of [6] months after the commencement date of the [Mandatory Provident Fund Schemes (Amendment) Ordinance 2015].

6. Within the time limits specified in paragraphs [4] and [5] above, the trustee must attempt to locate a scheme member in the following manner:

- (a) contact the employer concerned, if any, to obtain any contact information of the scheme member unless the member has been located before the trustee contacts the employer;
- (b) if the member is not located after the trustee has complied with paragraph (a) above, the trustee must make a first attempt to contact the member based on the contact information provided by the employer in paragraph (a) above or, if none, any other contact information known to the trustee. Where the trustee has already sent a specified notice under section 34DH(1), the trustee should use contact information which is different from the contact information used by the trustee for sending that notice if such information available;
- (c) if the member cannot be located after the first attempt, the trustee must make a second attempt to contact the member, at a time and date different from those of the first attempt. The trustee should use contact information which is different from the contact information used by the trustee for sending the specified notice under section 34DH(1) (if applicable) and in the first attempt, if such information is available and the trustee is satisfied that the contact information used in the first attempt cannot locate the member;

- (d) if the member cannot be located after the second attempt, the trustee must make a third and final attempt to locate the member, at a time and date different from those of the first and second attempts. The trustee should use contact information which is different from the contact information used by the trustee for sending the specified notice under section 34DH(1) (if applicable) and in the first and second attempts, if such information is available and the trustee is satisfied that the contact information used in the first and second attempts cannot locate the member.

7. If, after section 34DI(2) has been complied with, a member cannot be located before the expiry of the time limit, the trustee must comply with section 34DI(3).

8. If, after 34DI(2) has been complied with, a member is located before the expiry of the time limit, the trustee must comply with section 34DI(4), regardless of whether the member is located as a result of the trustee's attempts to locate the member as set out above.

Mandatory Provident Fund Schemes Authority
January 2016

Providing Better Investment Solutions for MPF Members

Consultation Conclusions



Financial Services and the Treasury Bureau
www.fstb.gov.hk



Mandatory Provident Fund Schemes Authority
www.mpfa.org.hk

March 2015

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I. Introduction

1. The Financial Services and the Treasury Bureau of the Government of the Hong Kong Special Administrative Region (“Government”) and the Mandatory Provident Funds Schemes Authority (“MPFA”) jointly issued the Consultation Paper, “Providing better investment solutions for MPF members” on 24 June 2014. The Consultation Paper proposed strategies and invited comments on issues including the use of a core fund based on standardized default funds; the investment approach of the default fund as a long-term retirement saving product, the level of fees and charges, member accessibility to the core/default fund and related transitional arrangements. Twelve questions were posed in the Consultation Paper to seek views. The consultation period ended on 30 September 2014.

2. The Consultation Paper invited comments on the following questions:

- Q1. the direction of introducing a core fund in the manner set out in paragraph 36 (a) to (d) of the Consultation Paper, namely, (a) the core fund will be based on standardized default fund; (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; (c) the core fund should be good value; and (d) the core fund is available to all MPF scheme members to choose;
- Q2. whether the default fund should be substantially the same in all MPF schemes;
- Q3. whether it is appropriate that the core fund be based on a standardized default fund;
- Q4. whether the appropriate investment approach of the core fund is one that automatically reduces risk over time as the member gets closer to age 65;
- Q5. preliminary views on the technical issues set out in paragraph 48 of the Consultation Paper, 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;
- Q6. whether keeping total fee impact for the core fund at or under 0.75% is a reasonable initial approach;
- Q7. whether keeping total expense impact (i.e. fund expense ratio (“FER”)) for the core fund at or under 1.0% over the medium term is a reasonable approach;
- Q8. whether passive, index-based, investment strategies should be the predominant investment approach in the MPF core fund;
- Q9. particular asset classes which would not appropriately be invested on a passive, index-based approach;

- Q10. whether the name of the core fund should be standardized across schemes and preference, if any;
- Q11. the general principle for dealing with implementation and transitional issues as set out in paragraphs 78 and 79 of the Consultation Paper; and
- Q12. the proposal in paragraph 81 of the Consultation Paper as to how to deal with the transition for existing MPF members of default funds.

3. We received a total of 266 written responses, of which 146 were sent online, 26 by mail, 23 by fax and 71 by email, from members of the public, including employees and employers, approved MPF trustees, investment management companies, insurance companies, industry associations, fund rating agencies, consultants, labour unions and employer associations, political parties, organizations from the social service sector, other market participants and stakeholders. The list of the 12 Questions is attached at Annex A. A list of the respondents is attached at Annex B.

4. During the consultation period, we arranged meetings and fora to gather views from a wide range of interested parties and key stakeholders on the proposed reform strategies as set out in the Consultation Paper. Over 2900 people attended these meetings and fora. Comments made, and views expressed, at those meetings have been considered in developing the proposals set out below.

Summary of views and comments

5. Details of comments received and our responses to specific issues are set out under Part II below. In broad terms, the majority of respondents indicated overall support for the proposals as set out in the Consultation Paper. The majority of respondents supported the proposal that the core/default fund should be substantially the same in all MPF schemes and the proposed fee control. They generally agreed that the core fund would help address concerns about fees and investment performance, and alleviate the difficulties that MPF members faced in making investment choices between a large number of constituent funds (“CFs”). Respondents generally accepted that a core fund based on a standardized default strategy across all MPF schemes would create the potential for attaining economies of scale which could drive down costs, improve returns, remove performance discrepancies between the default funds in different MPF schemes, create competition and provide a benchmark for other MPF funds. There were, however, a diversity of views on some issues, particularly as to the details of how such core funds should be invested, how they should be described and how they could best be structured in order to best achieve operational scale and efficiency.

Conclusions and way forward

6. Responses to individual issues and points raised are included within the detailed summary in Part II. In the light of the comments received, the following

specific directions are proposed:

- a. The default investment strategy in each MPF scheme should be based on the same investment approach;
- b. The default investment strategy should apply to any contributions or accrued benefits in an MPF scheme for which :
 - i. a member does not, or has not, indicated a specific choice of CFs, or
 - ii. a member specifically chooses to invest in that manner;
- c. The default investment strategy should be designed to reduce investment risks as a member approaches age 65;
- d. The default investment strategy will likely reduce investment risks by adjusting a member's accrued benefits and contributions in two or more CFs in each scheme. The main CF used for this purpose may be referred to as the "Core" CF in the scheme and may invest into common underlying investment funds;
- e. Management fees of the default investment strategy should not exceed 0.75% of assets per annum. We will keep in view room for further reduction of this fee level upon the implementation of the fee control mechanism; and
- f. To encourage a standardized approach, trustees should report performance outcomes of CFs used in the default investment strategy in each scheme against an agreed industry benchmark portfolio and facilities will be made available by the MPFA for the public to compare investment performance across schemes and as against the benchmark on a regular basis.

7. The MPFA has started more detailed discussions with the Government and the industry on how to take the proposals forward. The design and structure of the default investment strategy and the resultant core funds will take more time to finalize. However, based on the comments received from the consultation, research from the Organisation of Economic Co-operation and Development ("OECD") commissioned by the MPFA, further benchmarking of practices in Hong Kong and abroad and subsequent discussions with the industry, the general investment / product approach would be as follows:

- a. The default investment strategy should be designed to reduce investment risks as a member approaches age 65 by adjusting allocation between or across a small number of CFs (e.g. a "Core Accumulation Fund" and another lower risk CF) in each scheme;
- b. The investment strategy for the contributions and accrued benefits of members who are under 50 years of age should be targeted at an exposure of around 60% to higher risk assets (predominantly in global equities) ;
- c. The investment strategy for the contributions and accrued benefits of members who are 50 to 65 years of age should be regularly adjusted to

steadily reduce exposure to higher risk assets. The target exposure to higher risk assets, at and after age 65, should be 20%;

- d. To accommodate inevitable market volatility and to allow some small degree of investment discretion, providers would have a buffer of plus or minus 5% from the percentages indicated above; and
- e. While the industry should not be mandated to adopt passive management, the fee cap, the small size of the asset allocation buffers, as well as the application processes, disclosure and benchmarking will likely drive them towards adopting such an approach.

8. The Government targets to introduce any necessary legislative amendments into the Legislative Council within 2015. Subject to completing the necessary legislative process and the preparation work, it is anticipated that the standardized default investment strategy could be introduced by the end of 2016.

9. We appreciate the responses received and would like to thank all who have participated in the discussion and provided their thoughtful comments.

10. This Paper, the individual submissions and the original Consultation Paper can be viewed on the website of the MPFA at www.mpfa.org.hk under “Information Centre”.

II. Summary of comments received and the Government’s and MPFA’s responses

11. A summary of the comments received from the submissions is set out below. Percentage figures relate to the percentage of written responses of those respondents who answered the specific questions referred to (i.e. not including those made at meetings). Such figures should be treated as general indicators only, as in many submissions, the position expressed is a matter of interpretation and in others, the indication of “yes” or “no” is heavily qualified and in some cases self-contradicting.

II.1 General direction (Q1, Q2, Q3)

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

Comments received

12. The majority of respondents (Q1: 81.4%) supported the general direction of the proposals. The majority of respondents (Q2: 74.2%) supported the proposal that the default fund should be substantially the same in all MPF schemes and (Q3: 71.2%) agreed that the core fund should be based on a standardized default fund. They generally agreed that the core fund concept would help address concerns about fees and investment performance and alleviate the difficulties that members faced in making investment choices between a large number of CFs. Respondents generally preferred a standardized default fund across all MPF schemes as it would create the potential for driving down costs, attaining economies of scale, improving returns, removing performance discrepancies between the default funds in different MPF schemes, creating competition and providing a benchmark for other MPF funds.

13. Non-industry respondents were particularly supportive of the direction of the proposals, as reflected in the views from employers, unions and social service organizations. They believed that the proposals would bring potential benefits such as reduced fees and improved performance from economies of scale, and relieve those scheme members who did not want to make an investment choice from the need to do so.

14. Industry respondents widely supported the broad direction of improving the default investment arrangement for MPF members and some alignment of the investment approach. Many industry associations, including the Hong Kong Investment Funds Association, the Hong Kong Trustees' Association, the Hong Kong Retirement Schemes Association, the Hong Kong Federation of Insurers and individual service providers, however, expressed different views on the detailed arrangements, including the need for introducing a "core" fund or the degree of standardization for the default arrangement. Many organizations had reservations about using the name "core fund" (discussed further below under Q10), which they considered might be misleading or create the impression that the core fund was superior to other CFs in the system. A number of them preferred the name "default arrangement" or its derivation.

15. On the extent and scope of standardization, the MPF industry, some investment managers and non-industry players considered that the scope and extent of standardization should be more clearly defined. A few non-industry respondents were concerned with the cost involved in setting up the core fund. Industry associations suggested that, to foster competition among providers, investment managers and other service providers should be given the flexibility to come up with their own default investment arrangements for individual schemes, so long as any guidelines that were not too restrictive were complied with. A number of industry respondents also called for the standardization to be applied only to a few factors, such as the name, the glide path and the headline fees, with diversity allowed in respect of other factors such as administration processes, investment strategies and outcomes. A few submissions

commented that a high degree of homogeneity among default/core funds in all MPF schemes would give rise to “systemic risk” or “concentration risk” (through its impact on the MPF system if all default members were invested into a single fund) and would stifle innovation. Some investment managers, especially those offering a range of passively managed index funds, however, disagreed with the broader industry direction and indicated their support both for the core fund initiative and for a high degree of standardization.

16. Respondents, both for and against the core fund proposal, stressed the need to enhance investor education to MPF members. A few respondents went further to suggest that the core fund and the concept of standardization would have an adverse effect on, or would stand against, the effort to educate the public on their responsibility for investment and retirement planning.

Response

17. There is general support shown in the responses to the consultation for introducing a standardized default investment strategy that is substantially the same in all MPF schemes. We note concerns and questions about the extent to which the default/core funds should be substantially the same in each scheme. We believe that, for the reasons explained in the Consultation Paper¹, it is important that those who have not made investment choices should not be subject to materially different outcomes in different schemes. The default investment strategy in each scheme should therefore adopt the same investment approach, involving broadly the same exposure to higher risk assets although allowing for some degree of flexibility within which investment managers could deviate from the standard approach (see further discussion under Q5 below). We share the view that product providers should have some flexibility as to how they deliver a common investment approach and this issue is discussed further under II.7 below.

18. It is recognized, however, that even within such levels of standardized approach, investment outcomes will not be absolutely identical across schemes; differences will arise due to many factors including different securities selection, timing, cash-flows and cost/scale impacts. It is therefore important that the investment performance of core funds making up the default investment strategy is benchmarked against an agreed industry standard and each other.

19. In relation to comments that members should be responsible for their own decision-making, we would emphasise that nothing in the proposals is intended to prevent, or discourage, members who want to make an investment choice from doing so. We do, however, consider it critical that the many members who do not want to, or do

¹ See paragraphs 37 to 40 of the Consultation Paper

not have the time or skills necessary to make an investment decision, are best protected by the development of better solutions than those existing at the moment.

II.2 Automatic de-risking and technical issues (Q4, Q5)

- 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?

Comments received

20. 70.7% of respondents to Q4 agreed that automatic de-risking would be the right approach for the core fund. Those who were not in favour of de-risking believed that members should be responsible for managing their own investments, some had concerns about fund proliferation if target date funds were used (as new funds would have to be launched from time to time), and some preferred investing in either some conservative investments or the Tracker Fund rather than using the mixed assets investment approach proposed. Underlying investments could include global bonds and global equities, managed actively or passively.

21. The majority of respondents agreed that reducing equity exposure when members approached retirement age would be beneficial to them. Several investment managers provided suggestions on how to better manage the process of de-risking, such as adopting a “central glide path” around which individual service providers would have the flexibility to adjust exposure to equities. The returns from investing into the hypothetical central glide path could also serve as a benchmark for core funds of all MPF schemes. Other respondents advocated using a target volatility glide path where the expected volatility at each “step-down” age would be calculated at that point in time to determine the appropriate mix of equity/bond, and maintaining a significant equity exposure after retirement age. Some respondents suggested de-risking should continue after retirement. An asset consultant proposed that “smart beta” strategies could be considered, because typical passive mandates assume market capitalization was good, which was not always the case. Many others considered that these types of issues should just be left to providers to decide.

22. While it was generally agreed that automatic de-risking was an appropriate approach, many industry participants and non-industry groups cautioned against adopting age as the sole factor for the de-risking process. It was suggested that other criteria and individual circumstances, such as risk tolerance, current balance of accrued

benefits, expected future income, etc., should be factored in as well.

23. A few respondents were of the view that de-risking might not serve the best interests of some people and might not be the right approach for the core fund. For example, if a member incurred losses from an equity position immediately before the de-risking process, the member would lose out on the chance to benefit from a market rebound in respect of the equity position that had been sold off.

24. On the technical issues raised for discussion in Q5, there was some consensus on the number of funds required if a target date approach were to be adopted. Most respondents considered that one fund every five years would be sufficient, though some proposed a period as long as ten years.

25. Whilst numerous industry submissions provided a view on this point, there was no agreement on whether to adopt a target date fund approach or a life cycle approach². Advocates of a target date fund approach claimed that such funds were easier to understand and to compare, and changes could be more quickly implemented in a volatile market. On the other hand, some respondents preferred the life cycle approach because of its cost effectiveness, as fund launches and closures would be kept to a minimum. Non-industry and trustee respondents generally did not have a view on the age at which de-risking should commence. Investment managers generally believed that this should be left to service providers to decide within any prescribed limits.

26. On the issue of the number of providers for the core fund and the degree of discretion afforded to individual product providers, respondents to the public consultation, Legislative Council members, and labour unions generally preferred more government involvement, which is discussed further, under II.8 below.

27. Opinions of the academics and the professionals varied somewhat. Some agreed that de-risking could help members avoid the risk of making wrong asset allocation decisions, while others said factors other than age, including market or general economic factors, might need to be considered. A number of academics and practitioners also suggested that a life cycle investment strategy might lack investment flexibility and might not be able to respond to sudden market changes.

Response

28. We note that there is general support for the proposal that the appropriate

² See Box 2 on page 20 of the Consultation Paper for what is meant by “Target Date” and “Life Style/Life Cycle” in this context.

investment approach of the core fund is a balanced approach that automatically reduces risk over time as the member gets closer to age 65.

29. **Automatic risk reduction:** The vast majority of respondents supported the proposal that the core fund should automatically reduce risk over time. We note that this also, increasingly, reflects industry practice both in Hong Kong and key international retirement savings markets such as the United States (“US”), the United Kingdom and Australia. The OECD Research commissioned by the MPFA also supports this approach as it is best suited to protecting members from extremely adverse investment shocks close to retirement.

30. **Age-based vs other factors:** Some respondents suggested that risk reduction should not be based on age alone and referred to emerging practices of reliance on other additional factors such as risk tolerance, balance of accrued benefits, expected future income, etc. Whilst we agree that such factors may be relevant in better tailoring the investment approach to individual needs, we are concerned that it would be difficult to adopt such approach at this initial phase. Incorporating other factors into asset allocation processes for individual members will require much more information collection and system development. We also note that the appropriate investment strategy arising from such factors is still emerging. We do, however, agree that any new default investment strategies should be developed in a way that is capable of incorporating such development in the future.

31. **Balanced approach vs single asset class:** While most respondents supported a balanced approach that used a combination of equity and fixed interest securities, we note that a few comments suggested substantially different (and, in many cases, contradictory) investment approaches such as investment into cash or the HK Tracker Fund. The OECD Research commissioned by the MPFA supports the preliminary thinking that investment in 100% equities, such as the HK Tracker Fund, would not be optimal as it would expose holders to too much outcome uncertainty³. Reducing outcome uncertainty must be considered to be a key objective of a well-designed default investment strategy that is principally designed to protect the interests of those members who do not, or do not want to, make an investment decision. The contrasting position of investing only in cash is also considered to be sub-optimal. Whilst such an approach would reduce outcome uncertainty, it would do so at a high cost, in that likely returns would be lower across almost all probability distributions⁴.

³ The research indicates that whilst an all Hong Kong equity approach might produce higher median outcomes, at the 10th percentile probability distribution, such an approach would produce only 50.2% of what a balanced (50% equity/50% bond) approach would achieve.

⁴ For example at 10th percentile distribution, an all cash portfolio would return only 73.7% of what a balanced approach (50% equity/50% bond) would likely achieve and at 50th percentile distribution (median), an all cash portfolio would return only 72.3% of what a balanced approach (50% equity/50% bond) would likely achieve.

32. **Target date vs life cycle:** The divergent views and finely balanced pros and cons regarding whether to adopt a target-date or life cycle approach are noted. Whilst we do not have strong views as to which approach is preferable, we are of the view that all schemes should adopt the same approach, otherwise it will be very difficult to make valid comparison and benchmarking analysis across schemes. On balance, subject to further discussion with the industry on implementation issues, we propose that a life cycle approach should be adopted, using as few CFs as possible. Such an approach can be developed without excessive upfront investment, will be able to be based on existing CFs in some cases, will not require the regular addition of new CFs, will be highly comparable across schemes, will be able to produce reasonably consistent outcomes across schemes and will be capable of refinements to investment approach as investment and allocation strategies develop.

33. Based on the findings from the OECD Research, comments received from the consultation and discussion with industry providers, we propose that the default investment strategy should adopt a balanced, mixed asset, globally diversified investment strategy which will automatically reduce risk as a member approaches age 65. Incorporating suggestions received in the consultation, the central glide path should allow for asset allocations to be managed and varied within a designated band around the central agreed value.

34. A number of detailed aspects of design, the frequency of rebalancing when reducing risk and the mechanisms for so doing will be further developed in consultation with the industry.

II.3 Fee controls (Q6, Q7)

- 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. a fund expense ratio (FER)) for the core fund at or under 1.0% over the medium term is a reasonable approach?

Comments received

35. More than half of the respondents (Fee: 63.2%, FER: 60.5%) agreed that a fee level of 0.75% and a fund expense ratio (FER) of 1.0% for the core fund would be a reasonable initial approach. Many non-industry respondents considered that the proposed fee and FER levels to be a marked improvement from current levels, would improve returns and exert pressure on service providers to cut fees on other MPF funds. Some advocated even lower fee levels, and were of the view that there was room for further reduction in existing management fees. Some suggested that fees should be based on investment performance, but noted that fees and performance might not be

positively related.

36. Investment managers and trustees were, however, almost unanimous in their opposition to the proposed fee and FER levels, often citing the 2012 Ernst & Young report in which it was stated that the cost of administration alone was 0.75%. They claimed that the proposed reduction was too much and would have the detrimental effects of lowering incentives to improve services and engage in product innovation. The trustees of the industry schemes mentioned that the extra administration associated with those schemes made it even more difficult to meet the proposed cap. Some respondents pointed out that fee levels at around 0.75% was lower than the average fees of MySuper funds in Australia (which have a relative scale advantage compared to MPF funds). Other respondents considered the proposed fee level higher than the average fee level of target date funds in the US.

Response

37. Non-industry respondents generally welcomed the proposed levels, with some of them expecting even lower levels. The industry opposed the proposal in general and considered it difficult to meet the proposed fee and FER levels.

38. We believe that the fee levels proposed are a reasonable starting point, having regard to the costs of operation of the MPF system, overseas experience and the aspirations of many respondents. We are also mindful of the differences between the MPF system and other retirement savings systems (e.g. contribution rate, asset size, maturity etc), and so would be cautious about making comparisons between the fee levels of different systems. Whilst the proposed levels are ambitious, we do not consider them impossible for the industry to meet. We consider that a challenging target is necessary to help address the concerns and aspirations that the wider community has for the MPF system. Such a target will also help focus providers' attention on producing a highly efficient and simple default fund structure and will reduce the need for excessive regulation on matters such as structure and fund design. In view of the above, we propose to implement the fee control arrangement of keeping total management fee impact for the default arrangement at or under 0.75% of asset value per annum as an initial approach that can be reviewed, and lowered over time as necessary. With the introduction of the fee control, we expect that the FER for the CFs used in the default investment strategy will decrease to at or under 1.0% over the medium term (e.g. three years after implementation). We will monitor the consequential FER levels over the medium term. We are developing the details of how the fee levels should be measured and calculated in consultation with the industry.

II.4 Passive, index-based investment strategies and asset classes that would not be invested on a passive, index-based approach (Q8, Q9)

- 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?

Comments received

39. The majority of respondents to the Consultation Paper (Q8: 66.8%) were in favour of a passive, index-based approach to investment for the core fund. They cited reasons such as lower fees and costs, higher returns and the possibility index funds achieving reduced volatility and better performance. On the other hand, some were critical of this approach as they were concerned that the strategy might not generate adequate returns for members, that returns from index funds might be affected by the weak performance of a few 'heavy-weight' constituents, and that fund innovation might be discouraged. Others believed that actively managed funds would provide more flexibility for fund managers to adjust their portfolio in response to market factors.

40. Many respondents proposed different types of investments as underlying investments for the core fund in response to Q9, as follows:

- a. *Tracker Fund* – A number of respondents suggested this due to its low fee and good performance.
- b. *iBond and inflation-linked return* – Some respondents suggested iBonds to be issued by the Government on a monthly basis to match monthly MPF contributions. Others wanted the returns of the core fund to be inflation-linked, though they did not mention what types of products should be invested in to achieve this. Other products and strategies to hedge against inflation e.g. Treasury Inflation-Protected Securities (TIPS) with returns rising and falling with inflation rates were also suggested.
- c. *Guaranteed return* – Favoured by some respondents.
- d. *Saving deposits* – Some respondents favoured this believing there would be no charges.
- e. *Returns linked to government funds* – One respondent suggested that the return of the core fund should be linked to those of government-run funds, such as the Innovation and Technology Fund. There was no suggestion on the products that should be invested in to achieve this return.
- f. *Managed in a similar way to foreign retirement funds* – One respondent suggested the passive, index-based fund should adopt a strategy similar to those for the sovereign funds and retirement funds of Norway and Canada. The equity-bond ratio should be kept at 60:40, passively replicating a

global index, with rebalancing from time to time to maintain this equity to bond ratio.

41. Some respondents suggested that items such as bonds, treasury bills, index tracking funds, bond index funds, speculative derivatives, currencies and commodities, property and Real Estate Investment Trusts (“REITs”) should not be used as underlying investments. A few respondents mentioned that equity should not be passively invested while one did not want any investments that were not socially responsible, such as casinos, tobacco companies, and companies with poor human and labour rights records.

42. Many industry respondents did not positively identify with a passive, index-based approach as the predominant approach for the core fund. Most trustees believed that while a passive, index-based approach had its place in the core fund, the investment decision on whether to invest actively or passively should be made by investment managers. Many investment managers believed that active management should be used in the core fund as they believed passive management might not outperform active management. Some also pointed out that there might not be enough approved Index-Tracking Collective Investment Schemes to fully meet the needs of the core fund.

43. Investment managers currently providing passive index funds, however, were in favour of a passive, index-based investment approach for the core fund. They maintained that a low-fee passive index fund would help achieve the objectives of fee reduction. They were also confident of achieving the stated fee control levels.

44. A few submissions from groups with specific interests recommended allowing REITs and private equity as underlying investments for the core fund, believing that these investments would enhance diversification and improve returns for the core fund.

Response

45. Whilst there was majority support for using a passive investment approach for the default investment arrangement, some preferred to use, in full or in part, an active approach, or leave the decision to the industry and service providers. Notwithstanding submissions made to the contrary, we are not convinced that passive management will necessarily produce inferior returns. The research referred to in the Consultation Paper⁵ found that actively-managed MPF funds had not delivered better returns than passively-managed ones. Nevertheless, having considered the views received, we do not consider it necessary to mandate that the core funds should only use

⁵ See paragraph 70 of the Consultation Paper

passive management strategies. Given the fee cap proposed, industry members have advised us that generally it will only be possible to meet this through the use of passive investment management. If some managers are able to provide active investment management within that fee level, and they and the product provider are satisfied that they can achieve better returns from so doing (and can produce evidence of such in relevant applications to the MPFA), then they should not be prevented from seeking to do so. It is important, however, that any resultant under-performance is transparent, vigilantly reviewed by scheme trustees and subject to any necessary remedial action by trustees like reverting to passive management.

46. In relation to appropriate underlying investments for the default investment strategy, some comments are already set out above (in paragraph 32) regarding the investment approach of the core fund. The proposed direction is that the default investment approach should adopt a balanced, mixed assets, globally diversified investment strategy which should automatically reduce risk as a member approaches age 65. Whilst not containing any guarantee as to returns, such an approach will minimize the scope for negative outcomes for members. Individual providers should have flexibility as to what underlying investments or pooled funds they can use in meeting the prescribed approach. Some of the asset classes or strategies mentioned in paragraph 40 above may be adopted by some providers; however, we do not consider it necessary to mandate such investment.

II.5 Name of core fund (Q10)

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?

Comments received

47. A majority of respondents (Q10: 80.2%) agreed that the name should be standardized across schemes. This would help facilitate easy communication with members and would ensure transparency and fair marketing practices. Of the five names suggested in the Consultation Paper, most people chose either “MPF Core Fund” (38.5% of those who indicated a preferred name) or “MPF Default Investment Fund” (34.9% of those who indicated a preferred name). Industry submissions were strongly against using the name “Core Fund”. Many industry respondents expressed concern that the name “MPF Core Fund” might create high expectations for the fund or make people believe that it was the best choice, leading them to overlook other fund choices. Some preferred “MPF Default Investment Fund” to emphasize its nature as a fund for members who did not make investment choices. They also made the point that core fund (singular) could not be used as the likely solution will involve multiple CFs.

Response

48. Based on the comments received, we propose that the default investment arrangement for MPF schemes will adopt a standardized name. We note that there was some confusion expressed regarding terminology and names, particularly as regards the terms “core” and “default” fund. As stated in the Consultation Paper, the proposal was that the “core fund will be based on standardized default funds”⁶. Design questions were therefore focused on what an appropriate default investment strategy should be. The term “core fund” was only intended to reflect the importance of the new default investment strategy for the MPF system. The term “core fund” was not intended to suggest that the preferred default investment strategy would be a single fund⁷ as it was always considered likely that the preferred investment strategy would involve multiple funds given that a single fund could not adjust risk for different members.

49. Going forward, we propose to use the term “default investment strategy” in describing the investment approach that will be designed for this purpose. Within the default investment strategy in each scheme, the trustee may use two or more CFs (see paragraphs 6 and 7 above) to reduce risk over time. One or more of those CFs may use the term “core” within its fund name (e.g. the “Core Accumulation Fund”) reflecting its key role within the default investment strategy and the broader MPF system.

50. Accordingly, we will proceed with the proposals on the basis that the standardized approach to investment of contributions and accrued benefits for which no choice of CFs has been made will be referred to, for development purposes, as the “default investment strategy”. Further consideration can be given to how this is described to members once the final form and design of the investment approach are finalized. The names of the CFs used under the default investment strategy will adopt common naming conventions as illustrated in the paragraph above. Properly explained, the above approach should not leave scheme members with any misunderstanding as to the nature of any CF described as “core” funds.

II.6 Implementation and transitional arrangements (Q11, Q12)

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?

⁶ Paragraph 36a of the Consultation Paper

⁷ See footnote 17 of the Consultation Paper

Comments received

51. A majority of respondents (Q11: 74.4%, Q12: 72.5%) agreed with the general principles for implementation and transitional issues (including the method for handling the transitional process if the trustee could not identify which members were invested in the existing fund by default). Some respondents said that these issues should be clearly communicated to members and members should be reminded of the opportunity to switch to the new core fund. Those who disagreed with the proposed approach had a few concerns. Some thought that the automatic transfer of benefits should only apply to contributions of new members, and not to the accrued benefits of existing members, because of the risk involved and the investment gain or loss that would be realized in an automatic transfer. Some suggested the new core fund should apply only to future investments. One was concerned about confusing members and another was concerned about using a huge amount of paper for notices. Another liked to see that a fresh decision could be made by all members so that disputes could be avoided. Numerous industry submissions suggested the need for clear legislative support to deal with trustee powers and liabilities. A few suggested that the MPFA, the Government, or a new provider should handle the implementation and transition.

52. Many industry and non-industry groups who submitted detailed written submissions had reservations about the proposed implementation and transition arrangements, especially those in relation to the treatment of existing accrued benefits. Concerns included the amount of transactions that might be required to be completed in a single day, the potential loss of guarantee if the existing investments were in a guaranteed fund, uncertainty regarding the legal status of a transfer without member consent, and the adverse impact on fund price for members who remained in the existing fund.

Response

53. In view of the comments received during the consultation, we will proceed in the general direction proposed in paragraphs 79 and 81 of the Consultation Paper, as summarized below. Noting concerns about requiring many transfers to be done on a single day, we will allow trustees timing flexibility, within a reasonable period after implementation (e.g. 12-24 months) within which to complete any necessary transitional transfers. We also agree that further thought should be given to whether transitional transfers should occur where the trustee of the relevant scheme believes that the relevant member has not yet satisfied any conditions relating to a guarantee. Subject to further discussion and advice about details and timing, this direction would have the following impacts on different categories of members:

- a. all existing members of all schemes will be advised, in advance of implementation, of the new default investment strategy. They will be invited to consider whether they wish to review their existing choice of CFs and notified that if they are an existing default investor they will subsequently receive a further notice advising them of how their existing

accrued benefits will be affected;

- b. for members who join a scheme after the implementation date, all contributions will be invested in accordance with the new default investment strategy, unless or until, the member makes an alternate choice of CFs;
- c. for existing members of a scheme who have never made a choice of CFs, any contributions made after implementation of the new arrangement will be invested in accordance with the new default investment strategy unless or until the member makes an alternate choice of CFs; and
- d. for existing members of a scheme who have never made a choice of CFs in relation to existing accrued benefits, these benefits will, after adequate notice and opportunity to make a choice of CFs, be invested into the default investment strategy.

54. We will further discuss with the industry issues about whether, and if so how, some investments into guaranteed funds should be exempted from transitional transfer. We will also discuss whether there are other categories of member or investments that should be treated similarly.

55. In relation to concerns about whether trustees need legal protection for making transitional transfers, we will seek advice as to whether this is necessary. If considered necessary, we will propose relevant legislative provisions to give trustees the necessary powers and legal protection for acting in accordance with such requirements.

Other issues raised during the consultation

II.7 Structural options

Comments received

56. Despite not being a topic set out in the Consultation Paper, respondents also expressed different views on the possible structural design of the default investment strategy. There were views, mostly from non-fund-industry commentators that there should be a single core fund, or only a few core funds. Some also expressed a wish for more government involvement, although they did not comment on the detailed structural arrangement. There were also comments that the pooling of assets could help bring down fees and achieve economies of scale. On the other hand, some respondents who supported the establishment of a default investment strategy in individual schemes, considered that a common core fund adopted by all schemes would not be desirable as it would create concentration risks. Respondents from the industry were generally in favour of being given the flexibility to incorporate any new requirements about the default investment strategy into their own existing schemes or managed by existing managers, thereby reducing transitional complexity and costs. An industry organization believed that the Government should adhere to its role as the regulating

body rather than set investment requirements.

Response

57. The existing MPF system is a scheme-based system under which contributions are paid into a scheme (chosen by an employer or self-employed person) and invested into one or more CFs in that scheme⁸. The issue about default investment is what rules should apply about how to invest contributions received into that scheme when no instructions have been received from the relevant member. Each scheme needs, and does already have, rules dealing with this question. The proposal, as set out in paragraphs 6 and 7 above, is that, for the first time, these rules should be standardized across MPF schemes. The concept of a “single” default fund, or series of funds across all schemes, is a quite different concept, suggesting the need to identify default contributions and transfer them (either by employers or trustees) from the scheme into which they were paid, to the “central” default scheme and CF. Such a process would create substantial transactional activity each month and create much complexity around issues such as reporting, fees and transfers on subsequent choice under existing MPF structures. Existing infrastructure could not support such a process and it would take substantial time and cost to build any such infrastructure. The establishment costs will be higher and will not be conducive to fee reduction.

58. Individual respondents and organizations representing labour interests considered that there was an imminent need to introduce reform to the existing system to drive down management fees, such that the accrued benefits of scheme members could be better protected. Many of them considered that an earlier implementation of the proposals would be necessary. In view of the above, it appears that establishing a default investment strategy based on the existing framework of MPF schemes would be a more cost and time-effective solution.

59. Another way of achieving some level of centralization would be for all CFs used as defaults in each scheme to be required to invest into common underlying investment pools. Such an approach may be more closely aligned with the current MPF system but will require more regulatory control and will take substantially longer to implement. We note the concerns expressed by some about concentration of operational risks under such an approach.

60. In any event, given that efficiency will be driven by the fee cap of 0.75%, we do not see the need to mandate the use of particular underlying investment pools at this stage. Providers will, because of the fee cap, be forced to seek out efficient and low cost investment solutions. Some, perhaps many, will find it necessary to invest through common underlying investment pools (including, for instance, readily available

⁸ See paragraphs 13 and 14 of the Consultation Paper for more details about existing MPF structure.

index funds) and the MPFA will facilitate this process to the extent possible. Other providers, who can show that it is in members' interests to do so, may be able to use purpose-built investment pools if they can do so within the constraints of the fee cap.

61. If, in the medium term, having regard to the impact of implementing the proposals in this paper, stakeholders are still enthusiastic about further centralization, consideration can be given as to whether it is cost-efficient to build the necessary supporting infrastructure. At this stage, we are of the view that development and implementation should proceed forthwith and subsequent enhancements may be introduced if considered necessary over time.

II.8 Role of the Government and its involvement

Comments received

62. A number of respondents from the industry and intermediary representatives and bodies considered that existing trustees, which possessed professional knowledge, should operate and manage the core fund in the privately-managed MPF system. Some of these respondents considered that the costs of setting this up should not be funded by the public coffer. On the other hand, a number of individual respondents and representatives of labour unions and from the social service organizations preferred a core fund, or elements of it, operated or managed by the Government, the Hong Kong Monetary Authority ("HKMA"), or by a public trustee. They believed that this suggestion could help drive down fees and introduce more competition among existing MPF funds, on the assumption that trustees might not have incentive to improve fund performance.

Response

63. The Government has reiterated on many occasions that the MPF system is established as a privately-run, second pillar system in accordance with principles of the World Bank. The design of the MPF System is to require the working population and their employers to make mandatory contributions to assist the former to save for their retirement well in advance, such that public resources can be focused on assisting those in need. The HKMA should not be involved in running or investing any element of the MPF system as it has no experience/expertise in running or administering an individual account savings scheme. The investment management of the Exchange Fund, which was mentioned by some, is quite different from managing retirement savings contributions. The Government also maintains the view that the core fund should be operated by the market, instead of a public trustee operated by the Government, a public organization or a non-profit organization.

III. Way forward

64. The MPFA and the Government, will take forward the directions set out in paragraphs 6 and 7 above, and will continue to discuss with the industry and technical groups on detailed aspects of the design of the default investment strategy and related transitional arrangements. The final form of any legislative amendments to the MPF legislation will be subject to the usual legislative process. The Government aims to introduce an amendment bill into the Legislative Council within 2015 with a view to introducing the new default investment strategy in 2016.

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:

Annex B

List of respondents

1. Alfred
2. AllianceBernstein Hong Kong Limited
3. Allianz Global Investors
4. AMP Capital
5. Arris Partners Ltd.
6. Asia Pacific Real Estate Association
7. Audrey Hui
8. Bank Consortium Trust Company Limited and Bank of East Asia (Trustees) Limited
9. Bank of Communications Trustee Limited
10. BCT Group (BCT Financial Ltd / Bank Consortium Trust Co)
11. BOCI-Prudential Trustee Limited
12. Business and Professionals Alliance for Hong Kong
13. Caritas Family Crisis Line and Education Centre
14. Central and Western District Council (Cultural, Leisure & Social Affairs Committee)
15. Chan Kam Chung
16. Chan Kwun
17. Chik Chiu Ming
18. Chin Yue Sang
19. Chinese Academy of Governance (HK) Industrial and Commercial Professionals Alumni Association
20. Chiu Sai Chung Eric
21. Chui Chan Kit
22. Cititrust Limited
23. Citizens for Fair Pensions
24. Computershare Hong Kong Investor Services Limited
25. Consumer Council
26. Democratic Party
27. Dimensional Fund Advisors Pte. Ltd.
28. Employers' Federation of Hong Kong
29. Equal Opportunities Commission
30. Federation of Hong Kong Industries
31. FIL Investment Management (Hong Kong) Limited
32. Fiona
33. First State Investments (Hong Kong) Limited
34. FWD Pension Trust Limited
35. Gain Miles Assurance Consultants Limited
36. GAMAHK
37. Henry Yau, W.K. Yau
38. Ho Yan Wai
39. Hong Kong Catholic Commission For Labour Affairs
40. Hong Kong Confederation of Trade Unions

41. Hong Kong Financial Planner General Union
42. Hong Kong Investment Funds Association
43. Hong Kong Professionals and Senior Executives Association
44. Hong Kong Trustees' Association
45. Hong Kong Women Professionals & Entrepreneurs Association
46. HSBC Provident Fund Trustee (Hong Kong) Limited and HSBC Institutional Trust Services (Asia) Limited
47. ICI Global
48. Icy Cheung
49. Inland Revenue Department
50. Institute of Financial Planners of Hong Kong
51. Invesco Hong Kong Limited
52. Jardine Lloyd Thompson Limited
53. Jason Cheng
54. Jonathan Tang
55. Lam SY
56. Lee Shunwai
57. Life Underwriters Association of Hong Kong Ltd.
58. M Chan
59. Marc
60. Mercer Investments (HK) Limited
61. Michelle Chau
62. Mok Ka-man Harrison
63. Morningstar Investment Management Asia Limited
64. MPF Ratings Limited
65. Mr Au
66. Mr Cheng
67. Mr Ho
68. Mr Kwok
69. Mr Kwok Tat Po
70. MSCI
71. New Century Forum
72. New People's Party
73. Noble Apex Advisors Limited (Submission 1)
74. Noble Apex Advisors Limited (Submission 2)
75. Northern Trust
76. Patrick Leung
77. Peter H.Y. Wong
78. Principal Hong Kong
79. Rizwan khan
80. Sivler Lam
81. State Street Global Advisors Asia Ltd.
82. State Street's Global Services and Markets
83. Stephen Wong
84. Sun Life Asset Management (HK) Limited
85. Sun Life Hong Kong Limited

86. Sun Life Trustee Company Limited
87. SY Ho
88. Tam Tsz Chun
89. Tang Yiu Chung Vincent
90. The Actuarial Society of Hong Kong
91. The Chinese General Chamber of Commerce
92. The Chinese Manufacturers' Association of Hong Kong
93. The Federation of Hong Kong & Kowloon Labour Unions
94. The Hong Kong Association of Banks
95. The Hong Kong Council of Social Service (Submission 1)
96. The Hong Kong Council of Social Service (Submission 2)
97. The Hong Kong Federation of Insurers
98. The Hong Kong Federation of Trade Unions (Kwai Tsing Service Group)
99. The Hong Kong Federation of Trade Unions Rights and Benefits Committee
100. The Hong Kong Retirement Schemes Association
101. The Hong Kong Society of Financial Analysts
102. The Hongkong and Shanghai Banking Corporation Limited
103. The Professional Commons
104. TM
105. Tom Lam
106. Towers Watson Investment Services Hong Kong Limited
107. TTW
108. Vanguard Investments Hong Kong Limited
109. Virgo
110. Yu Chi Leung
111. 小市民
112. 廢除強積金
113. 梁偉生
114. 蔡沛恒
115. 郭賀昀
116. 鍾桂強
117. 黃潔蓮
118. Respondents at Public Affairs Forum of Home Affairs Bureau
119. Anonymous respondents (148)