LC Paper No. CB(1)287/15-16(02)

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

Background brief

Purpose

This paper provides background information on the Mandatory Provident Fund Schemes (Amendment) Bill 2015 ("the Bill") which seeks to introduce the Default Investment Strategy ("DIS") for the Mandatory Provident Fund ("MPF") system. It also summarizes the major views and concerns expressed by Members on related issues during discussions at meetings of committees of the Legislative Council ("LegCo") since 2013.

Background

The Administration's initiatives to tackle the level of the Mandatory Provident Fund fees and develop a Default Investment Strategy

2. The MPF system was implemented in December 2000 as a mandatory, privately-managed, defined contribution, employment-based and fully-funded pension system. Since its implementation, there have been public concern about the high level of MPF fees and calls for enhancing investment choices for scheme members. In 2004, the Mandatory Provident Fund Schemes Authority ("MPFA") introduced the fund expense ratio ("FER") to provide a single indicator disclosed for all MPF funds, aggregating fees and other expenses charged to MPF funds and underlying investments.

3. In December 2011, MPFA commissioned an independent consultancy to conduct a detailed study on the costs incurred by trustees in performing different MPF scheme administration functions ("the Cost Study"). The consultancy report released in November 2012 identified a number of factors contributing to the higher administration costs of MPF system compared to

those of selected international pension systems (Australia, Chile, Mexico and the United States). In response to the recommendations put forward in the Cost Study, MPFA adopted a range of short to medium term measures to drive down MPF fees[1]. Furthermore, the Mandatory Provident Fund Schemes (Amendment) Ordinance 2015 was enacted by LegCo on 21 January 2015. The purposes of the Amendment Ordinance, among others, are to enhance the powers of MPFA in approving constituent funds ("CF") and facilitating trustees' compliance with statutory obligations to provide greater scope for MPF fee reduction.

4. As regards investment choices for scheme members, under the existing MPF system, a scheme trustee will invest the contributions of its scheme members who do not give any investment instructions in one or more of the default funds as specified in the relevant scheme rules. According to the Government, different MPF schemes have different default arrangements/default CFs. The investment objectives, risk levels, fee levels and investment returns of existing default investment arrangements vary widely across different schemes. Some existing default CFs may not suit the long term investment objective of retirement savings. In connection with the Cost Study, MPFA has recommended that the Government consider the proposal of requiring all MPF schemes to offer the same type of low-fee investment fund or funds, i.e. the core fund[2]. On 24 June 2014, the Government and MPFA jointly launched a three-month consultation on the DIS proposal. According to the Government, the majority of the respondents agreed with the proposed general direction of the proposals. Having regard to the feedback to the consultation, the Government decided to introduce amendments to the Mandatory Provident Fund Schemes Ordinance (Cap. 485) ("MPFSO") to introduce a DIS under each MPF scheme.

The Bill

5. The Bill was published in the Gazette on 13 November 2015 and received its First Reading at the LegCo meeting of 25 November 2015. The Bill seeks to amend MPFSO and the Mandatory Provident Fund Schemes (General) Regulation (Cap. 485A) ("MPFS(G)R") to:

(a) require approved trustees to provide in the governing rules of registered schemes a DIS and to invest scheme members' accrued benefits according to DIS in certain circumstances;

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[1] The measures include (a) urging trustees to provide various types of low-fee funds for each scheme and to promote these funds; (b) facilitating trustees in further automating and streamlining their administration processes, and merging smaller scale or less efficient schemes/funds; (c) facilitating scheme members in consolidating their personal accounts; and (d) promoting index funds in the constituent fund approval process.

[2] The term Default Investment Strategy is used in the Bill to denote the concept of core fund.

(b) specify the requirements of DIS;

(c) provide for matters concerning the regulation of DIS; and

(d) introduce amendments relating to the operation and daily administration of registered schemes provided in MPFS(G)R.

6. According to the Government, the policy objectives of setting up DIS are to address the problems of high fees and difficulty in making investment choices in MPF system by regulating the default investment arrangements. The major features of DIS are as follows:

(a) Provision of specified CFs
Each trustee will statutorily be required to provide, in each scheme, a regulated, highly standardized DIS containing two CFs, i.e. a higher risk mixed asset fund called Core Accumulation Fund, and a lower risk mixed asset fund called Age 65 Plus Fund[3];

(b) De-risking mechanism
It serves to adjust the investment risk exposure of DIS members in accordance with individual members' age. Under the mechanism, the accrued benefits of a DIS member who is between the age of 18 to 49 will be invested in the Core Accumulation Fund only. From the age of 50 onwards, a DIS member's accrued benefits in the Core Accumulation Fund will be gradually switched to and completely invested in the Age 65 Plus Fund by the time he/she is 65; and

(c) Fee control mechanism
The total payment of fees[4] (not including out-of-pocket expenses) charged to the Core Accumulation Fund, the Age 65 Plus Fund or a DIS member cannot exceed a prescribed maximum rate to be specified in the law, i.e. a daily rate equivalent to an annualized rate of 0.75% of net asset value of CF. The fee cap will be reviewed regularly with a view to adjusting the level downward further.

7. The main provisions of the Bill are explained in paragraph 12 of the LegCo Brief (File Ref: MPF/2/1/39C(2015) Pt.2), and paragraphs 4 to 13 of the

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3 The Core Accumulation Fund is to be a constituent fund which aims to invest its net asset value ("NAV") predominantly (about 55% to 65%) in higher risk assets such as global equities, whereas the Age 65 Plus Fund is to be a constituent fund which aims to invest its NAV predominantly (about 75%-85%) in lower risk assets such as global bonds.

4 The total payments include those asset based fees paid for the services provided by: (a) the trustee; (b) the administrator, investment manager, custodian and their delegates; and (c) the sponsor and promoter of a scheme and the same types of fees chargeable to underlying investment funds.

Legal Service Division Report on the Bill (LC Paper No. LS12/15-16).

Major views and concerns expressed by Members

8. On 7 January 2013, the Government and MPFA briefed the Panel on Financial Affairs ("FA Panel") the results of the Cost Study and MPFA's proposed reform directions to lower MPF fees. FA Panel was consulted on the DIS proposal on 7 July 2014 and 6 July 2015. Issues relating to the DIS proposal were also discussed at meetings of FA Panel on 29 January 2014, and at the special meetings of the Finance Committee on 8 April 2013, 31 March 2014 and 30 March 2015 for the examination of the Estimates of Expenditure 2013-2014, 2014-2015 and 2015-2016 respectively. The major views and concerns expressed by Members at the above meetings are summarized in the ensuing paragraphs.

<u>Effectiveness of the Default Investment Strategy</u>

9. Some Members were concerned that the DIS proposal could not address the problem of continued increase in MPF fees nor offer a genuine additional choice for scheme members. They questioned whether the yield from a basic, low-fee DIS CF could be better than the interest return from fixed deposits placed with banks. In this connection, some Members suggested that the Government should mandate CFs and DIS CFs of MPF schemes to invest in instruments such as iBonds, bonds issued by large corporates (e.g. bonds to be issued the Airport Authority Hong Kong to finance the three-runway system), Exchange Fund-linked investment products, and fixed bank deposits, etc. These Members considered that the above mentioned investment products, which involved relatively lower risks, lower administrative fees, and yielded more stable investment returns, would generate more accrued benefits for scheme members. There was also a suggestion that CFs with guaranteed returns should be introduced.

10. The Government advised that the major purposes of the DIS proposal were to enhance transparency of the operation of MPF schemes to facilitate scheme members in making investment choices suitable for their needs, and highlight to them the importance of making long-term investment instead of pursuing short-term returns under MPF system. The standardized arrangement of DIS CFs would enhance market competition and facilitate fee control.

11. As regards the suggestion of mandating certain investment tools for MPF schemes, the Government advised that a host of factors relating to system features and industry practices had contributed to the relatively high fees under the MPF system of Hong Kong (e.g. large number of trustees and schemes, and complex operation of MPF system). Hence, the focus should be placed on

improving the system in these areas instead of mandating a particular investment tool for MPF schemes. Moreover, it should be for MPF trustees and fund managers to consider the components of CFs and DIS CFs. MPFA pointed out that DIS CFs should not adopt the most conservative investment approach. The optimal approach should have regard to the need to balance long-term risks and returns in a manner appropriate for retirement savings, and operational efficiency compared to other options. As for the issue of requiring trustees to provide CFs with guaranteed returns, the Government advised that it would be difficult if not inappropriate to implement as the MPF schemes were privately-managed schemes.

<u>Fee control for the Default Investment Strategy</u>

12. Members noted that with the launch of DIS, the total management fees of DIS CFs should not be higher than 0.75% of assets under management ("AUM") per annum, and MPFA also envisaged that the fees level would further be reduced in the long run. Some Members considered that the proposed initial fee cap was on the high side, and opined that it should be lowered. There were also suggestions that the Bill should contain provisions for MPFA to review the management fees of DIS CFs on an annual or a bi-annual basis so as to keep the momentum in driving down MPF fees. Some other Members however pointed out that MPF funds with low FERs were already available in the market. The Government should study why scheme members did not choose these low-fee funds before introducing a fee cap for DIS CFs. They also stressed the need for the Government and MPFA to strengthen public education on fee issues relating to MPF system. For instance, it might not be appropriate to make a direct comparison on fees between MPF system of Hong Kong and the more mature pension schemes overseas as the latter enjoyed a greater economy of scale.

13. MPFA advised that the proposed fee ceiling of 0.75% of AUM per annum for a DIS CF was a fair starting point. While it would be difficult to provide a concrete timetable on further fee reduction, MPFA would review the issue having regard to the actual operation of DIS. The Government added that the Bill would include a mechanism for adjusting the ceiling for management fees of DIS CFs.

14. Members considered that the Bill should contain provisions to prevent trustees from employing alternative fee charging practices to circumvent the fee control mechanism, and to state clearly that the total management fees should be inclusive of all fees. The Government advised that there would be provisions in the Bill to prevent trustees from circumventing the fee control mechanism. MPFA pointed out that trustees had to seek the prior approval of MPFA on changes in governing rules including those changes in fees, and MPFA would examine each application carefully.

Operation of the Default Investment Strategy

15. Some Members considered that it might not be necessary for every trustee to operate DIS as various MPF schemes might share the same DIS CFs. The Government should also explore inviting trustees to operate a central DIS CF through tender. On the other hand, some Members suggested that the Government should consider introducing a public trustee (e.g. the Hong Kong Monetary Authority ("HKMA") or a non-profit making organization) to operate DIS. They considered that a DIS CF operated by a public trustee would have benefits such as lower fees and better protection of scheme members' interests. They further noted that collaboration between the public and private sectors in setting up public trustees had been successful in some overseas pension systems. However, some other Members took the view that even if DIS was operated by the Government or a public trustee, administrative costs would still be incurred and the fee level might not necessarily be lower than those charged by private trustees.

16. The Government stressed that similar to other CFs under MPF schemes, DIS CFs should be operated by the market. Operating DIS CFs through a public trustee would require the establishment of a new operating system and replication of the administrative tasks handled by private trustees, and would involve a long period of preparation and development. Besides, the suggestion for HKMA to take up the role of a public trustee might undermine its capability in discharging the statutory functions of maintaining currency stability and integrity of the financial system of Hong Kong. In order to introduce DIS in a timely manner and given that MPF schemes were privately-managed schemes, the Government considered it appropriate for the market to operate DIS CFs.

17. Some Members enquired whether the Government and MPFA had assessed the operation of the proposed de-risking mechanism through modeling techniques, explored the feasibility of using other criteria (like the amount of accrued benefits in MPF schemes) for determining the on-set of the de-risking mechanism, and studied similar mechanisms adopted in the retirement schemes of other jurisdictions. They further enquired whether there would be provisions in the Bill governing the review and adjustment of the de-risking mechanism to cater for the possible changes in Hong Kong's retirement age in future.

18. MPFA advised that it had engaged the Organisation of Economic Co-operation and Development ("OECD") to conduct modeling on the de-risking strategy using both global and local data and concluded that the strategy was effective. While different jurisdictions used different commencement ages for the de-risking mechanism in their retirement schemes, MPFA had decided to adopt the proposed commencement age of 50 based both on the results of OECD modeling and discussion with the industry. While the

proposed de-risking mechanism had been worked out with reference to current parameters, the Bill would contain provisions to cater for changes to the de-risking mechanism.

19. Members enquired about the decisions which scheme members could make under DIS, and factors taken into account by MPFA in deciding the number of CFs for DIS. MPFA advised that after implementation of DIS, the switching rights of MPF scheme members would be preserved and they could switch in and out of DIS CFs and other CFs freely. Scheme members could also decide the proportion of their accrued benefits to be invested in the Core Accumulation Fund and the Age 65 Plus Fund instead of following the proposed allocations specified in the de-risking mechanism. MPFA added that while a scheme member might not be able to allocate part of his/her accrued benefits to DIS and the rest to other CFs of an MPF scheme initially due to system limitations of trustees, MPFA would continue to discuss with the industry on the feasibility of relaxing this restriction. MPFA further explained that two CFs were proposed for implementing DIS as this could achieve the investment principles of balancing long-term risks and returns in a manner appropriate for retirement savings on one hand and keeping the scheme simple on the other.

20. Some Members suggested that the Government and MPFA should consider adopting another name for DIS CFs to better reflect the purpose of the funds which was to address the problem of high management fees of MPF schemes, and facilitate understanding of the public on the benefits of the funds. The Government took note of the suggestion. While the term "DIS" would be used in the relevant Bill, the Government and MPFA would step up public education and publicity on DIS CFs.

Council motions and questions

21. At the LegCo meeting of 1 December 2010, Members passed a motion on "Comprehensively reviewing the Mandatory Provident Fund Scheme" which called on the Government to review MPF scheme covering aspects, including lowering MPF management and administration fees, allowing full portability of MPF benefits, and implementing universal retirement protection. Another motion on "Comprehensively reforming the Mandatory Provident Fund Scheme" was passed at the LegCo meeting of 2 November 2011 urging the Government to conduct a comprehensive review of MPF scheme and examine the feasibility and impact of measures, including to press MPF scheme trustees to lower their fees, enact legislation to specify fee ceilings for different types of investment funds and fee types, require MPF scheme trustees to provide contributors with products resembling bank deposits that charged no management fees, and introduce fund products operated by the Government at low management fees, etc. Members have also raised a number of questions relating to MPF fees and performance of MPF CFs at the LegCo meetings since

2012. Details of these questions and the Government's replies are given in the hyperlinks in the **Appendix**.

Latest development

22. At the House Committee meeting on 27 November 2015, Members agreed to form a Bills Committee to study the Bill.

References

23. A list of relevant papers is in the **Appendix**.

Council Business Division 1
Legislative Council Secretariat
14 December 2015

Appendix

List of relevant papers

Date	Event	Paper/Minutes of meeting
1 December 2010	Council meeting	Motion on "Comprehensively reviewing the Mandatory Provident Fund Scheme" moved by Hon WONG Kwok-kin Hansard (pages 136 – 234) Progress report
2 November 2011	Council meeting	Motion on "Comprehensively reforming the Mandatory Provident Fund Scheme" moved by Hon TAM Yiu-chung Hansard (pages 251 – 319) Progress report
6 June 2012	Council meeting	Written question raised by Hon Paul TSE on "Charging rates of Mandatory Provident Fund Schemes" Hansard (pages 140 – 143)
7 January 2013	Meeting of the Panel on Financial Affairs ("FA Panel")	Administration's paper (LC Paper No. CB(1)358/12-13(03)) MPFA's paper (LC Paper No. CB(1)358/12-13(09)) Minutes (LC Paper No. CB(1)782/12-13) (paragraphs 16 to 45)
8 April 2013	Special meeting of Finance Committee ("FC") for examination of Estimates of Expenditure 2013-2014	Minutes (paragraphs 3.4-3.5)

Date	Event	Paper/Minutes of meeting
6 November 2013	Council meeting	Written question raised by Hon CHAN Kin-por on "Measures to improve MPF Scheme" Hansard (pages 100 – 104)
31 March 2014	Special meeting of FC to examine the Estimates of Expenditure 2014-2015	Written questions raised by Members and Administration's replies for the session on "Financial Services" (Reply serial numbers: FSTB(FS)007, 008, 025, 044, 050, 097 and 118)
9 April 2014	Council meeting	Written question raised by Hon TANG Ka-Piu on "Fees and Charges of MPF Schemes" Hansard (pages 9570 – 9577)
24 June 2014	The Mandatory Provident Fund Authority ("MPFA") launched a public consultation on "Providing Better Investment Solutions for MPF Members"	Press release Consultation paper
7 July 2014	Meeting of the FA Panel	Administration's paper (LC Paper No. CB(1)1668/13-14(06)) Minutes (LC Paper No. CB(1)1998/13-14) (paragraphs 57 to 76)
9 July 2014	Council Meeting	Written question raised by Hon Paul TSE on "Fees and Charges of MPF Schemes and Expenditure of MPF Schemes Authority" Hansard (pages 16131 – 16137)

Date	Event	Paper/Minutes of meeting
22 October 2014	Council Meeting	Written question raised by Hon Paul TSE on "Reforming the mandatory provident fund system to allow contributors' direct investment in passive index funds" Hansard (pages 649 – 651)
21 January 2015	The Legislative Council passed the Mandatory Provident Fund Schemes (Amendment) Bill 2014	Hansard (pages 4894 - 4991) The Bill passed Report of the Bills Committee (LC Paper No. CB(1)444/14-15)
4 February 2015	Council Meeting	Written question raised by Hon CHAN Kin-por on "Mandatory Provident Fund system" Hansard (pages 5695-5698)
12 March 2015	MPFA released the consultation conclusions of the public consultation on "Providing Better Investment Solutions for MPF Members"	Press release Consultation conclusions
30 March 2015	Special meeting of FC for examination of Estimates of Expenditure 2015-2016	Written questions raised by Members and Administration's replies for the session on "Financial Services" (Reply serial numbers: FSTB(FS)019, 040, 084 and 110)
6 July 2015	FA Panel was briefed on the legislative proposals for the Default Investment Strategy	Administration's paper (LC Paper No. CB(1)1034/14-15(02)) Minutes (LC Paper No. CB(1)1258/14-15) (paragraphs 21 to 37)

Date	Event	Paper/Minutes of meeting
18 November 2015	Council Meeting	Written question raised by Hon Paul TSE on "Review of the investment arrangements under the Mandatory Provident Fund schemes"
25 November 2015	The Mandatory Provident Fund Schemes (Amendment) Bill 2015 received its First Reading	The Bill Legislative Council Brief (File Ref: MPF/2/1/39C(2015) Pt.2) Legal Service Division report (LC Paper No. LS12/15-16)