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

The Government's Responses
to the Draft Committee Stage Amendments
proposed by the Hon CHUNG Kwok-pan and Hon TANG Ka-piu

Purpose

This paper sets out the responses from the Government and Mandatory Provident Fund Schemes Authority ("MPFA") to the draft Committee Stage Amendments ("CSAs") proposed by the Hon CHUNG Kwok-pan and Hon TANG Ka-piu.

Draft CSAs proposed by the Hon CHUNG Kwok-pan

I. Proposed cap on out-of-pocket expenses

2. As explained at the meeting on 15 February 2016, the proposed CSAs of either including the out-of-pocket expenses in the proposed 0.75% statutory cap for payment of services charged to the two constituent funds ("CFs") under the Default Investment Strategy ("DIS") or introducing a separate 0.2% statutory daily cap on out-of-pocket expenses by modeling on the proposed daily fee cap in the proposed section 34DC poses operational and enforcement difficulties set out in the ensuing paragraphs.

(a) Unavailability of expenses information to approved trustees: Approved trustees relying on investment managers to source appropriate funds at underlying investment fund level for investment, generally have information on the types and aggregated amounts of expenses incurred at the CF level only, but not the types and daily aggregated expenses information at underlying investment fund level. ***There is practical difficulty for the MPFA to enforce the expense cap at underlying investment fund level***.

(b) Infeasibility of applying the net asset value ("NAV")- and daily-based calculation methodology to the proposed expense cap: Even if daily aggregated expenses information were available, there would be methodological issues about (i) how to aggregate a non NAV-based figure in the overall calculation of the fee and expense cap; and (ii) how to identify whether the expense falls within the statutory definition. As a matter of practice, expenses of large funds such as listed exchange traded funds may be disclosed ex post as a single figure in absolute dollar term after the end of financial period, but we are not aware of whether any individual funds disclose the nature of individual expenses and present as a percentage to the NAV. This, and the fact that expenses would be incurred on a dollar basis, does not facilitate calculation of a daily NAV-based cap. ***Imposing an expense cap with so much operational difficulty for compliance may unintentionally limit approved trustees' flexibility to use these funds and consequently increase overall costs of the DIS rather than reducing them.***

(c) Incompatibility of expenses with a daily fee cap: Expenses incurred, even at the CF level, are unpredictable and do not accrue on a daily basis which make calculation and budgeting of items problematic, causing compliance difficulties and exposing approved trustees to the arbitrary risk of non-compliance during the course of managing the DIS CFs. The unpredictability of such expenses is exacerbated at the underlying investment fund level where (even if the availability issues in the previous paragraph could be overcome) an approved trustee may have no way of knowing what expenses are imminent and can have no control over the timing, sequencing or accrual of such expenses.

(d) Conflict of duties and obligations imposed on the approved trustees: A fee cap on expenses will create conflict of duties and obligations. An approved trustee is obliged to pay service providers such as auditors and lawyers, for their services. The expenses incurred are commensurate with the services required and are not generated by the approved trustees for profit making purposes. A conflict of obligation may arise if, on the one hand, approved trustees are contractually obliged to make the payment of expenses and on the other hand, they are subject to a legal sanction if they make a payment exceeding the proposed statutory expense cap. Whilst approved trustees may have some control over the amount of some expenses (e.g. legal or audit expenses), other expenses (e.g. stamp duties, bank charges, printing, posting and publication costs due to unknown frequency of sending publication materials to scheme members) are completely outside the control of approved trustees, both as to amount and timing. Approved trustees would also face conflicts as regards their duties to act in scheme members' best interest. ***Scheme members' interests would be detrimentally affected if approved trustees or investment managers make decisions for the purpose of meeting the proposed statutory expense cap rather than scheme member's broader interests.*** Examples could include an approved trustee not taking steps to defend a spurious legal claim against a fund merely to avoid the legal costs involved or making investment decisions which may not be in the interest of scheme members (e.g. by not investing accrued benefits) merely to avoid the incurring of transaction-based expenses to meet a statutory control on expenses. In contrast, management fees, which are the focus of the proposed section 34DC and are within the control of the approved trustees or specified service providers, do not pose such legal and practical complexities.

3. We would reiterate that the proposed fee cap of 0.75% was the basis of the consultation undertaken and is a reasonable starting position, having regard to the costs of operation, the existing level of fees and international experience. We have also balanced among the need to protect scheme members' interests, the need to ensure operation feasibility in designing the proposed fee control mechanism, the need to introduce the DIS with a fee cap at the earliest opportunity as well as the operational flexibility required for the approved trustees to manage the DIS CFs in the best interest of scheme members. More than half of the consultation respondents supported the introduction of a statutory cap on management fee (63.2%) and the monitoring of expenses through on-going administrative means (60.5%).

4. That said, similar to existing CFs, the MPFA will monitor the Fund Expense Ratio ("FER") levels of DIS CFs regularly and approved trustees will be required to report the FER levels as required in the MPFA

Code on Disclosure. The MPFA will also publish the FER levels of all CFs on its website for comparison by scheme members. Meanwhile, the MPFA will continue to press the industry on measures to drive down the total expense impact, noting that the FER of DIS CFs of most schemes should gradually decline to 1% or below in the medium to long term (i.e. around three to five years).

II. Proposed sunset clause

5. As explained at the meeting on 15 February 2016, we would reiterate that the proposed sunset clause is inconsistent with the Government policy to impose a fee cap for the DIS CFs.

6. First of all, the current drafting of the proposed CSA (especially section 34DCA(1)) will, in effect, stop the operation of the statutory fee cap of 0.75% from 31 December 2021. Under such circumstances, there will no longer be any statutory cap on management fees for DIS CFs and the industry can charge fees at a level that is higher than 0.75%, which would not be in scheme members' interests.

7. Secondly, as explained in our previous paper to the Bills Committee (vide LC Paper No. CB(1)480/15-16(02)) and the Consultation Conclusions (paragraph 38), we will evaluate the operation of the proposed fee cap after the full implementation of the DIS. With the introduction of the DIS by end 2016, and taking into account the timing involved in transitional arrangements and past experiences of setting up of new CFs, we envisage that the DIS will be fully implemented by Q3 2017. At present, without knowing the eventual participation rate of the DIS and in the absence of any experience on its actual operation, we consider it too early to determine the appropriate timing and frequency of such review, not to mention scheduling the review in the law. The proposed section 34DD in clause 8 in the Bill has already provided such mechanism with flexibility, empowering the Secretary for Financial Services and the Treasury to amend the DIS investment requirements in the proposed Schedule 10 to the Mandatory Provident Fund Schemes Ordinance (Cap.485) ("MPFSO") and the level of the fee cap in the proposed Schedule 11 to the MPFSO.

Draft CSAs proposed by the Hon TANG Ka-piu

I. Introduction of a performance obligation

8. Based on the following reasons, we consider this proposed CSA operationally not feasible –

(a) the investment objective of the DIS CFs is set out in the proposed paragraph 2 of Schedule 10. This is set by reference to a preferred asset allocation strategy which the approved trustees would be obliged to implement. This strategy is not designed to match the composite consumer price index over specified periods;

(b) past investment performance illustrated by the generalised return figures published by the MPFA is not indicative of future absolute performance of the DIS CFs; and

(c) investment performance of the DIS CFs (in the form of mixed asset funds) will be driven by the performance of the asset classes set out in proposed paragraph 2 of Schedule 10. The volatility and fluctuation of such asset classes are beyond the control of approved trustees who have been, by the fee control mechanism, encouraged to adopt an index-based approach to investment. It would be entirely inconsistent with such an approach to require the approved trustees to second guess the statutory asset allocation in order to meet some secondary statutory objective related to the composite consumer price index over specified periods.

9. Non-compliance with the proposed performance obligation, due to reasons explained in paragraph 8, cannot be prevented as there are no preventive measures that approved trustees can undertake, as they are obliged to comply with the prescribed asset allocation. Yet, such non-compliance may involve sanctions such as financial penalties, suspension or termination of administration of the scheme by the MPFA. As such, we do not consider the proposed CSA fair and proportionate.

II. Removing the exemption of certain fees charged by custodians from the fee cap

10. Some custodian fees are not calculated based on the NAV of a CF, but are based on the volume or frequency of transactions done. They are treated as expenses which are not necessarily predictable or avoidable as they are driven by the volume and frequency of those activities. Transaction-based custodian fees are only known after those activities have taken place and charged after those transactions have been completed. They cannot and will not be charged based on the NAV of the fund. This approach is different from those fees that are charged on a NAV basis, which are both controllable and predictable in that they are known at the start of the calculation period and therefore can be reasonably controlled under the 0.75% proposed fee cap.

11. Examples of transaction-based custodian fees include those that are –

(a) <u>charged based on the volume and frequency of transactions undertaken to implement an asset allocation strategy for a CF</u>: the higher the number of transactions required and completed, the higher the transaction-based custodian fees. The actual amount will only be known after the completion of the trades. In addition, the numbers of transaction required during a financial period will depend on the investment views and strategy adopted by the fund. This type of fees therefore is not known at the start of the financial period and are not charged based on the NAV of a fund; or

(b) <u>related to corporate activities undertaken on behalf of a CF during any given time period</u>: the higher the volume of corporate activities, the higher the amount of transaction-based custodian fees for processing these corporate actions. Corporate actions are not in any sense under the control of the investor. They are under the control of the entity invested into.

12. In fact, either example would pose practical challenges if such expenses were to be included in the fee cap currently proposed. As explained in paragraph 2 above, in the case of underlying investment funds, an approved trustee would not be in a position to know, on a daily

basis or potentially at any time, what transaction-based fees are incurred in an underlying fund. Even if timing problems could be overcome, we could not be certain that underlying funds (which could, for instance, be a large foreign listed exchange traded index fund) would be willing, or even able, to provide transaction level data to an MPF scheme approved trustee in Hong Kong.

13. Secondly, as explained in paragraph 2 above including transaction-based expenses in a fee control may have unintended behavioural impacts and raise inherent conflicts of duties. It may be very much contrary to the interests of a scheme member if a transaction (e.g. sale of investment in particular shares) was not undertaken merely due to observing the restrictions on transaction-based custodian fee.

III. Introduction of a statutory annual review mechanism

14. Please refer to paragraph 7 above for justification.

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