Press Release

LCQ11: Reforming the mandatory provident fund system to allow contributors' direct investment in passive index funds

Wednesday, October 22, 2014

Following is a question by the Hon Paul Tse and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (October 22):

Question:

It was reported last month that the Financial Analysts Journal published a research report on investments of over a 40-year period (the report). The report pointed out that the annual average return rate for passive funds was 6.6%, while that for active funds was only 3.9%. Even if the performances of both active funds and passive investment index funds were the same, part of the returns of the former would still be nibbled away by management fees involved. Moreover, Mr Warren Buffett, who is regarded as the god of stock investments, also has much confidence in passive investments. He has advised his estate trustee to invest 90% of their cash in Standard & Poor's 500 Index funds which have low operating costs as he considers that such funds' long-term returns will out-perform most of the funds managed by professional investors. In this connection, will the Government inform this Council:

(1) whether it will, in the light of the aforesaid report and Mr Buffett's advice, conduct a study on amending Hong Kong's mandatory provident fund (MPF) system to allow contributors to choose whether or not to invest all or part of their contributions directly in passive investment index funds such as the Tracker Fund of Hong Kong without involving any trustee or fund manager, so as to reduce management fees of MPF schemes and to raise investment returns in the longer term; if it will conduct such a study, of the details; if not, the reasons for that;

(2) of the legal basis for the existing compulsory requirement for contributors of MPF schemes to make investments through trustees or fund managers; and

(3) whether it has assessed if the existing compulsory requirement for contributors of MPF schemes, in particular those who do not know how to

select investment funds, to make their investments through trustees or fund managers irrespective of gains or losses is tantamount to unreasonably forcing contributors to ensure the income of fund managers and to allow fund managers to nibble away the returns of contributors, and whether it has assessed if such an arrangement is contradicting MPF's original goal of providing retirement protection for employees?

Reply:

President,

After almost thirty years of deliberation on the design of Hong Kong's retirement protection system, the Mandatory Provident Fund (MPF) System, in the form of mandatory private retirement protection schemes, was eventually introduced. The MPF System aims to assist the working population in saving for retirement by mandating them and their employers to make contributions during employment.

Under this System, MPF schemes are established as trusts and run by professional approved trustees which are responsible for handling the administrative tasks, such as collecting employers and employees' mandatory contributions from employers, recovering default contributions, making regular reports to the Mandatory Provident Fund Schemes Authority (MPFA) and scheme members, appointing investment managers, managing accrued benefits and assisting scheme members in withdrawing accrued benefits, etc. To safeguard scheme members' accrued benefits, approved trustees operating MPF schemes are required to meet requirements on capital adequacy and financial strength and have necessary knowledge and expertise. Furthermore, approved trustees must appoint investment management companies that are registered with the Securities and Futures Commission as investment managers to manage the investments in the schemes.

MPF schemes are composed of constituent funds and designed as pooled (or collective) investment structures, which are efficient for amassing small contributions for investment. As compared to individual scheme members making their own investments, pooled investment structures achieve better economies of scale and have lower investment costs.

The aforementioned design aims to reduce the administrative burden and costs for small and medium-sized enterprises, protect scheme members' interests and achieve economies of scale by consolidating scheme members' contributions under pooled management and investment. If individual scheme members make their own investment instead of joining an MPF scheme through approved trustees and having their accrued benefits managed by qualified investment managers, they would have to take up the aforementioned administrative tasks and investment work which would not be economically efficient.

At present, scheme members may invest their accrued benefits in dedicated MPF constituent funds that track a particular index. To provide scheme members with more diversified fund choices, MPFA has in recent years taken proactive measures to encourage approved trustees to make available index-tracking funds. There are now 27 constituent funds that are index funds, including 12 that invest directly in the Tracker Fund of Hong Kong. As of August 2014, 7.8% of MPF assets (or $44 billion out of the total MPF assets of $564 billion) are invested in such funds. According to information from MPFA, while MPF funds adopting a passive portfolio management strategy charge lower fees than those adopting an active portfolio management strategy, the investment outcomes of the two are very close.

According to the analysis of MPFA, many scheme members do not take an active role in managing their MPF investment, mainly because they find it difficult to make investment choices or do not consider themselves having adequate financial knowledge to make investment decisions. To safeguard the interests of these scheme members, we and MPFA have conducted a consultation on a proposal of introducing a "Core Fund" with fee control as the default fund for MPF schemes. The proposed fee control is 0.75% of assets under management per annum or less and has to be further lowered in the long run. On the whole, we envisage that "Core Fund" will become a benchmark for MPF funds to drive competition and fee reduction so as to further strengthen the role of the MPF System as one of the pillars of retirement protection in Hong Kong.

Ends