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Subcommittee on Mandatory Provident Fund Schemes (Amendment) Ordinance 2016 (Commencement) Notice

Background Brief

Purpose

This paper provides background information on the Mandatory Provident Fund Schemes (Amendment) Ordinance 2016 (Commencement) Notice (L.N. 156 of 2016) ("Commencement Notice"). This paper also gives a brief account of the relevant views and concerns expressed by members of the Bills Committee on Mandatory Provident Fund Schemes (Amendment) Bill 2015 ("Bills Committee").

Background

The Mandatory Provident Fund System

2. Launched in December 2000, the Mandatory Provident Fund ("MPF") System is a mandatory, privately-managed and fully-funded pension system established under the Mandatory Provident Fund Schemes Ordinance (Cap. 485) ("MPFSO") to offer basic retirement protection to the working population. Employees and self-employed persons are required to join a registered MPF scheme selected by the employers or self-employed persons (as the case may be) and make choice from a range of constituent funds ("CFs") (also generally known as MPF funds) available from the scheme for investment of contributions. All provident fund schemes intended to be operated as MPF schemes must be registered with the Mandatory Provident Fund Schemes Authority ("MPFA") and registered MPF schemes must be operated by MPF trustees approved by MPFA. Major service providers in the MPF System are approved trustees, custodians, scheme administrators and investment managers. Other than investment management, service providers of registered MPF schemes provide a bundle of services which include collecting and allocating contributions, assisting in recovery of outstanding contributions, providing

statutory reporting to regulators, handling transfers between schemes and fund switches within schemes, and administering withdrawals of accrued benefits.

Mandatory Provident Fund Schemes (Amendment) Ordinance 2016

3. The Mandatory Provident Fund Schemes (Amendment) Bill 2015 ("the Bill"), which received its First Reading at the Legislative Council meeting of 25 November 2015, was passed on 26 May 2016 and the enacted Ordinance was published in the Gazette as the Mandatory Provident Fund Schemes (Amendment) Ordinance 2016 (Ord. No. 9 of 2016) ("MPFS(A)O") on 3 June 2016.

4. Under MPFS(A)O, each MPF approved trustee was required to provide a Default Investment Strategy ("DIS") in each MPF scheme. The other main provisions of MPFS(A)O are as follows:

(a) *Fee control mechanism*

The caps on the management fees and recurrent out-of-pocket expenses charged to the two CFs of DIS (i.e. the Core Accumulation Fund and the Age 65 Plus Fund) or imposed on a scheme member investing in the CFs are set at a daily rate equivalent to an annualized rate of 0.75% of the CF's net asset value ("NAV") and 0.2% of the CF's annual NAV respectively.

(b) *De-risking mechanism*

The investment risk exposure of DIS members shall be adjusted in accordance with individual members' age. For the Core Accumulation Fund, 60% of its NAV will be invested in higher risk investments and 40% in lower risk investments; for the Age 65 Plus Fund, 20% of its NAV will be invested in higher risk investments and 80% in lower risk investments. De-risking will commence when a DIS member reaches the age of 50, under which his exposure to investment risk will be reduced automatically as he ages. 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.

(c) *Investment and transitional arrangements*

An approved trustee is required to invest the accrued benefits of a new scheme member who has not given any investment instruction

according to DIS. An existing scheme member may also choose to invest in DIS. The transitional arrangements apply to scheme members who satisfy the prescribed criteria. In general, for an existing scheme member who has not given investment instructions for his/her account, of which the accrued benefits are invested under a pre-existing default investment arrangement of the scheme, the approved trustee is required to issue a specified notice informing such member that he may choose to opt out from DIS. If no reply is received from the member by the trustee within 42 days after the date of the issue of the notice, such benefit will be transferred to and invested in DIS within 14 days after the expiry of the 42-day opt-out period.

(d) *Consequences of non-compliance*

MPFA may request an approved trustee to provide an auditor's investigation report on its compliance with the DIS if the MPFA reasonably believes that the trustee have failed to comply with DIS-related requirements. Sanctions against approved trustee's failure to comply with DIS-related requirements include revocation of its approval as an approved trustee, suspension or termination of its administration of the scheme by MPFA and financial penalties.

Pursuant to section 1(2) of MPFS(A)O, MPFS(A)O comes into operation on a day to be appointed by SFST by notice published in the Gazette.

The Commencement Notice

5. After reviewing the progress of the preparatory work, MPFA proposed to implement all the provisions in MPFS(A)O on 1 April 2017. The Administration gazetted the Commencement Notice on 14 October 2016 that under section 1(2) of MPFS(A)O, SFST has appointed 1 April 2017 as the day on which MPFS(A)O comes into operation.

Views and concerns raised by the Bills Committee

6. The Bills Committee generally supported the policy intent of the Bill to improve the default investment arrangements by mandating statutorily that each approved trustee was to provide, in each scheme, a regulated, highly-standardized and fee-controlled DIS. Some members, however, expressed strong objection to the entire privately-managed MPF System and therefore did not support the DIS proposal.

7. The major views expressed by members of the Bills Committee are summarized in the ensuing paragraphs.

Commencement of the Bill

8. During the course of scrutiny, the Bills Committee raised no objection to the Administration's proposal to move a Committee stage amendment ("CSA") to the Bill to appoint 31 December 2016 as the day on which the Bill comes into operation ("first CSA"). Subsequently, the Administration submitted another CSA to provide that the Bill would come into operation on a day to be appointed by SFST by Gazette notice ("second CSA").

9. At the Council meeting of 26 May 2016 during the Committee stage of the Bill, SFST moved the second CSA and withdrew the first CSA. When moving his second CSA, SFST explained that as Hon TAM Yiu-chung's CSAs to clauses 8 and 11 of the Bill to provide the total amounts of the management fees and "out-of-pocket expenses" must not exceed 0.75% (daily rate) and 0.2% (annual rate) respectively of NAV of a DIS CF per annum were passed¹, the Government and MPFA needed to study how to implement the regulatory requirements as amended, or the time needed to be given to the industry, namely, the trustees, accounting and other professionals concerned, for formulating measures to comply with the new regulatory requirements. SFST's second CSA was passed.

Investment and transitional arrangements for the default investment system

Opt-out approach

10. Members noted the transitional arrangements that within six months after the commencement of DIS, an approved trustee had to give a specified notice to a default scheme member. The specified notice would inform the default scheme member that he could choose not to invest in DIS by specifying his investment instructions. If no reply had been received from the default scheme member, the approved trustee would transfer the accrued benefits to DIS within 14 days after the expiry of the 42-day reply period.

11. While most members and deputations considered that the opt-out approach would serve the interests of disengaged scheme members, some members shared a view of the industry that accrued benefits of default scheme members invested in conservative funds or guaranteed funds would be transferred to the higher risk Core Accumulation Fund without their explicit consent, if those members did not respond to the specified notice. In this

¹ Hon TAM Yiu-chung moved the CSAs in his capacity as the Chairman of the Bills Committee. Please also refer to paragraph 19 in this paper.

connection, members urged the Administration and MPFA to conduct large-scale promotion and educational activities to raise public awareness of the transitional opt-out arrangements for DIS, and to continue engaging the industry relating to the technical issues of the implementation of DIS.

12. The Administration explained that DIS was to protect the interests of disengaged scheme members who had not made their own investment decisions relating to all of their accrued benefits. It was roughly estimated by approved trustees that around one million, out a total of 8.8 million accounts, might be subject to the opt-out transitional arrangements. Existing scheme members who had made specific investment instructions (around 90% of existing accounts) would not be affected by the proposed transitional arrangements, unless they specifically chose to invest in DIS by opting in. The remaining 10% of accounts belonging to disengaged scheme members who had not given investment instructions were the target group of DIS. The Administration assured members that to minimize the scope for unintended outcomes, MPFA would mount large-scale publicity campaigns after the enactment of the Bill to enhance public understanding of DIS including the impact of the transitional arrangements.

Standards of conduct of approved trustees

13. Members had raised concern about how the Administration could prevent the approved trustees from withholding information and not informing their scheme members about DIS, or directing members away from choosing DIS.

14. The Administration pointed out that all approved trustees were statutorily required by the existing relevant provisions in MPFSO to notify all existing scheme members about the introduction of any new CFs because there would be a change to GRs of the scheme. The Administration also pointed out that MPFA had issued guidelines on the standards of conduct expected of MPF intermediaries when conducting sales and marketing activities and giving advice relating to registered schemes.

Accounts of bankrupt default scheme members

15. Some members were concerned about the transitional arrangements applicable to default scheme members who were bankrupt. MPFA advised that the accrued benefits derived from mandatory contributions in respect of a member of an MPF scheme were protected and did not become vested in the approved trustee by virtue of MPFSO. The transitional arrangements applicable to bankrupt default scheme members were the same as to other default scheme members. The approved trustees were required to notify the bankrupt scheme

member in writing about the transitional arrangements. The approved trustees were required to inform the Official Receiver's Office and obtain prior consent from the latter in respect of any payment of accrued benefits to a bankrupt scheme member. Afterwards, the trustee-in-bankruptcy would be able to claim the amount as property of the bankrupt scheme member.

Mandatory Provident Fund Authority's supervision and consequences of non-compliance by approved trustees

16. Members were concerned about MPFA's power of on-going supervision over the DIS CFs for protection of scheme members' benefits. The Administration advised that the DIS CFs would have to comply with the additional specific requirements to facilitate MPFA's assessment of the approved trustee's compliance with the DIS requirements (e.g. investment principles and fee cap). MPFA was empowered under the Bill to request an approved trustee to provide an auditor's investigation report on its compliance with the DIS if MPFA reasonably believed that the approved trustee failed to comply with DIS-related requirements.

De-risking mechanism

17. Members were also concerned about the effectiveness of using the two CFs (i.e. the Core Accumulation Fund and the Age 65 Plus Fund) under DIS. The Administration advised that for the proposed allocation of higher risk assets and lower risk assets in the two DIS CFs, the proposed asset allocation was 60% exposure to higher risk assets until age 50, which would be reduced gradually to 20% by age 65. The proposed approach represented a good balance of empirical analysis and observed practice.

Fee control mechanism

18. Members and some deputations were gravely concerned about the proposed level of the management fee cap and what fee items should be included under the cap. Some members considered that the proposed management fee cap of 0.75% should not exclude those other fees and charges which were primarily out-of-pocket expenses. The Administration and MPFA explained that it would be difficult to cap other fees and expenses that could apply to the DIS CFs since they were primarily out-of-pocket expenses relating to the discharge of approved trustees' duties. Such costs, which were fact specific, were often unpredictable, not known in advance and outside the approved trustees' control.

19. Notwithstanding this, Hon CHUNG Kwok-pan considered it necessary to have a cap on these expenses, and proposed to move CSAs to the effect that a

fee cap level of 0.2% be imposed on out-of-pocket expenses. At the request of Mr CHUNG, the Bills Committee agreed that Hon TAM Yiu-chung, in his capacity as the Chairman of the Bills Committee, would move the CSAs proposed by Mr CHUNG.

Latest development

20. At the House Committee meeting on 28 October 2016, Members agreed to form a subcommittee to examine the Commencement Notice.

Relevant papers

21. A list of relevant papers is set out in **Appendix**.

List of relevant papers

Date	Event	Paper/Minutes of meeting
December 2015 to February 2016	Bills Committee on Mandatory Provident Fund Schemes (Amendment) Bill 2015	Legislative Council Brief File Ref: MPF/2/1/39C(2015) Pt. 2 Legal Service Division Report (LC Paper No. LS12/15-16) Background brief (LC Paper No. CB(1)287/15-16(02))
26 February 2016	House Committee meeting	Report of the Bill Committee to House Committee (LC Paper No. CB(1)595/15-16)
19 May 2016	Council meeting	Report of the Bill Committee to Council (LC Paper No. CB(1)667/15-16)
28 October 2016	House Committee meeting	Legal Service Division Report (LC Paper No. LS3/16-17) Letter dated 14 October 2016 from the Secretary for Financial Services and the Treasury (LC Paper No. CB(2)25/16-17(01))