Inflation-indexing missing in CPF Life

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Those about to retire are likely to be concerned about three aspects of retirement financing: receiving a reasonable level of payout every month; a payout that lasts for the rest of their lives; and a payout that takes account of inflation.

A good baseline retirement product would hence have the following characteristics: its returns are at least that of local inflation; it has negligible risk; and it is easily understandable and investible by the average person saving for retirement.

The best retirement product that meets this need is a well-diversified equity fund, lifecycle fund or other funds offered by the private sector.

Rather, it is an inflation-indexed life annuity. Such a fund converts an individual's accumulated investment capital to lifetime real cash flows that provide for retirement consumption and expenditures.

In 2009, the Central Provident Fund (CPF) took a step in the right direction when it established the lifelong income scheme (CPF Life). It met the first two criteria required by retirees. However, it did not have an inflation-indexing feature. This is due to the fact that Singapore lacks government-backed inflation-indexed bonds.

An inflation-indexed bond is a regular government bond that has a fixed face value and interest rate, except that the former's face value and associated interest payments rise with inflation and fall with deflation.

We often hear claims that certain investments such as equities or commodities, such as gold or housing, will outperform inflation in the long run. But none of these are perfect low-risk hedges. They are therefore not very reliable investments to ensure a safe, dignified retirement for the average person.

The government is the most natural institution to provide inflation-indexed bonds and products. This is because goods, property services and sales tax revenues usually increase as the general price level rises. Government tax receipts are therefore closely linked to inflation.

The government can also exercise some control over interest rates and inflation through the use of fiscal and monetary tools. In the 1970s and 1980s, the Israeli government used price controls to stem runaway inflation successfully.

Inflation-indexed bonds change in value in response to inflation. With inflation, the face value increases; with deflation, the face value decreases.

In the United States, the government goes further, guaranteeing that the adjusted face value will not fall below its original face value in the event of severe deflation. Changes in inflation, as reflected in the consumer price index, affect both the interest paid out annually and the face value of the bond when it matures.

An example would be instructive. Let's assume one buys a 30-year inflation-indexed bond today with a $10,000 original face value and fixed annual interest rate of 3 per cent of face value.

If the inflation rate is 4 per cent the following year, the bond's face value is adjusted upwards to $10,400, which means the actual interest paid out that year is 3 per cent of the adjusted face value of $10,400.

At the bond's maturity, you would receive the final inflation-adjusted face value as well as the associated interest payments.

Until recently, only Japan and Australia offered inflation-protected bonds in Asia that could be used by a local pension fund to produce retirement products.

In July 2011, however, Hong Kong and Thailand issued an initial tranche of such bonds. India and Singapore are considering the possibility. Our rough calculations show that for a 26-year-old professional to receive Singapore's median per capita monthly household income of $1,900 (in real cash flows) upon retirement at age 62, he or she would need to save around $575 per month in total (in real dollars) as of today. In doing our calculation, we used the US Treasury Inflation-Protected Securities (TIPS) real interest curve as a proxy for the Singapore one, given that the latter doesn't currently exist.

What is needed is a life annuity product that can convert the money saved over an individual's lifetime into durable spending power.

What if there isn't sufficient accumulated capital in one's retirement account?

Singapore has the CPF. If that is not enough, consider Hong Kong and Taiwan that offer a reverse mortgage scheme for the elderly. It allows the elderly to receive a monthly stipend by taking some or all equity out of their owner-occupied home, while being guaranteed never to be evicted.

The Hong Kong reverse mortgage programme is privately managed but highly regulated by the Hong Kong Mortgage Corporation. The more recent Taiwan programme for elderly singles (yi tang yang liao) is fully managed by the government.

While the HDB's Lease Buy-back Scheme (LBS) is a step in the right direction, it is overly complicated for the intended audience (that is, the low-income elderly) with its formulaic top-ups and bonus schemes. The LBS also does not provide for lifelong security as it takes into account only the tail-end of the lease of a house. This means someone who lives beyond the 30 years of the LBS technology has no equity left in his house.

Common practice is that the entire equity in the home's remaining lease value is converted into a life annuity, with a guarantee that you can live in your house for as long as you live. The residual housing market value, if there's any appreciation (and less the payouts), accrues to the owner's estate at the point of death.

Products involving long-term savings require a strong public-private partnership, involving a credible government and a well-regulated and trusted private sector.

The objective is to ensure that the average Singaporean is able to maintain a dignified, inflation-indexed standard of living in retirement, by taking advantage of appropriate retirement products purchased at a fair price.

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