Singapore Mandates Annuities

By Editor Test *Thu, Oct 21, 2010*

The government of this tiny Asian nation has confronted its collective longevity risk by requiring the purchase of annuities with defined contribution assets. Wharton pension expert Olivia Mitchell and colleagues have written a new paper about it.

At the ASPPA conference in Washington this week, Treasury Department advisor J. Mark Iwry emphatically assured the pension professionals who filled the vast ballroom at the Gaylord National Resort & Spa that the government isn't plotting to mandate the purchase of annuities.

"We're not talking about a 'Let's force everyone into a one-size-fits-all solution,'" said Iwry, the co-creator of the auto-IRA concept. "We're not trying to force all employees into annuities. We're all about creating more opportunities for people."

Ever since the Departments of Labor and Treasury first solicited public comment last spring on the feasibility of offering optional or default lifetime income solutions in defined contribution plans, conservative bloggers have insisted that the Obama administration intends to force Americans to buy government annuities with their 401(k) and 403(b) savings.

That's arguably a remote possibility in the U.S., except perhaps in the minds of Tea Party activists. But it's not a farfetched idea everywhere. Singapore's government, in a dramatic thrust at the nation's collective longevity risk, will soon begin requiring its 55-year-olds to buy annuities with at least part of their accumulations in the Central Providence Fund (CPF)—the state-run defined contribution plan.

Though mandatory participation in the program, called CFP Life, doesn't start until 2013, it has effectively already begun. A pilot was launched more than a year ago; so far about 30,000 Singaporeans have bought about S$1.5 billion worth of government-issued annuities. And the government itself sells contracts at prices that private insurance companies have given up trying to compete with.

Desperate times call for desperate measures, apparently. Singapore is one of the world's most rapidly aging societies, with a fertility rate of just 1.29 per female and a life expectancy at birth of 80.6 years. After a period when, with little effect, it merely urged people to buy retail annuities, with little effect, the government in early 2008 moved to make annuitization compulsory.

The mandated income product is designed to overcome the usual objections to life annuities by offering payouts that are relatively undiminished by adverse selection, distribution costs or corporate profit margins, and that offer return-of-premium guarantees. (Mandatory participation, in Singapore as in, for instance, the Obama health care plan, helps eliminate adverse selection.)

Here's how the program works, as explained in a recent paper by Olivia Mitchell, director of the Pension Research Council at the University of Pennsylvania's Wharton School of Business, her colleague Joelle H.Y. Fong, and Benedict S.K. Koh of the finance department of Singapore Management University.

At age 55, participants in the CPF must purchase an annuity that begins making level payments for life at age 62. Participants may invest up to the "Minimum Sum," the amount of their accumulated defined contribution savings that Singaporeans must set aside for funding their retirement. (In the past, they had to decumulate that amount in a phased withdrawal over 20 years. Any excess savings could be taken as a lump sum.

"Participants may either purchase a private annuity or select from a menu of government-offered annuity products called the CPF LIFE plans. Initially the intention was to provide a dozen different payout options outlined in 2008, but the menu was later pared back to four plans in 2009 after public feedback suggested that too much choice was confusing," the paper said.

The four plans are known as CPF LIFE Basic, LIFE Balanced, LIFE Plus, and LIFE Income, which differ in the balance they offer between payout rate and bequest potential. Based on an annuity premium of half the estimated Minimum Sum or S$67,000 in 2013, the promised monthly payouts would be between S$524-636 for men and S$500-553 for women. One Singaporean dollar currently equals $0.77.

The government made the annuities attractive by offering better-than-retail payouts and by offering "a guaranteed amount if the death of the insured occurs in a specified time frame," the paper said. "Specifically, when the insured dies, the beneficiary receives the guaranteed amount of the single premium plus accrued interest (if any) less total amount of annuity payouts already made (if positive). The refund, which is a lump-sum payment to the beneficiary, provides an element of capital protection."

Mitchell and her co-authors were interested in finding out if the Singaporean government's entry into the annuity market was a good or bad thing—good because it helped the impact of adverse selection and helped solve the country's longevity risk problem or bad because it preempted the private market competition that stimulates innovation and drives down prices.

They decided that they like what Singapore had done. "We conclude that Singapore's recent move to mandate annuities under the national defined contribution pension system represents a logical step toward national longevity risk management. By establishing the government as an annuity provider, the CPF Board may have taken advantage of scale economies and reduced the pricing impact of adverse selection, given that the latter was found to be quite a substantial proportion of total loadings," they wrote.

"Furthermore, the aggressive annuity pricing is creating public buy-in for the new mandate, while indirectly working to compensate less risk-averse individuals in terms of foregone equity premium," they concluded.

"One offset may be that private insurers have been crowded out, in part because the CPF-designed product pays participants more than what commercial insurance companies had offered. Without competition, it is unclear whether annuity pricing will continue to be attractive and whether product innovation will continue in Singapore. Related questions, as yet unsettled, have to do with whether favoring annuity payments over payments to survivors is politically sustainable, and how long the government will be able to continue subsidizing payouts."