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Warding off longevity risks: Ensuring sustainable income for retirement

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The ageing population is no longer just a demographic problem for developed nations. China, for one, might become the first old, developing nation if current birth and life-expectancy rates are anything to go by.

Terms like "silver tsunami" have been used to describe this growing mass of senior citizens – and its potent implications on society. Existing social norms, infrastructure, country and company finances need to be given a long hard look as issues surrounding longevity risk become an urgent concern to corporations, policymakers, and individuals worldwide.

While the challenges are well recognised generally, the key issue now is how to measure longevity risk more accurately so that survival patterns may be evaluated and analysed dynamically. Another challenge is to develop financial instruments that can help hedge and manage such risks.

Life expectancies have been inching upwards over the last two to three decades. This is a trend that is likely to continue for the next half century. According to pension expert, John Piggott, Director of the ARC Centre od Excellence in Population Ageing Research, people who have been relying on their traditional sources of income to see them through their remaining years may find themselves running out of money sooner than they expect.

Piggott was speaking at the seminar "Longevity: The New Risk Frontier (http://www.smu.edu.sg/institutes/skbife/Emailer/CSS%2020%20Nov%2009.htm)", organised by the Centre for Silver Security (http://www.smu.edu.sg/institutes/skbife/centres/css/index.asp), part of SMU's Sim Kee Boon Institute for Financial Economics (http://www.smu.edu.sg/institutes/skbife/index.asp). The seminar saw a wide range of industry players, regulators, researchers and other stakeholders in the field sharing their views on how the community may mitigate longevity risk, thereby making retirement more secure for the population and sustainable for related stakeholders.

A common circumstance that is playing out all over the world is one where retirees run out of money – they may not have saved enough or their wealth may be tied up in the family home. Social security payments, such as those distributed in the United States, are almost certain to be reduced as governments push the onus of retirement financing and planning back to the individual.

In Asian societies where children are expected to take care of their aged parents, changing societal mores and falling birth rates have changed the demographic pyramid for good, and along the way, weakening the dynamics of the age-old "family annuity". More and more, retirees are expected to plan – and pay – for their golden years.

Already, countries like Australia, Denmark, Hong Kong and Malaysia have instituted a "defined contribution" scheme where employees regularly contribute to a retirement fund when they are in the workforce. Singapore's Central Provident Fund (http://knowledge.smu.edu.sg/article.cfm?articleid=1080) (CPF), the mandatory pension scheme, is such a defined contribution plan, where upon retirement; an employee can tap on the CPF savings he has accumulated over the years, subject to caps.

However, the problem arises when the retiree outlives the minimum sum he has in his CPF Retirement Account (RA), which is calculated on an estimated 20-year draw-down period. "Potentially, this will affect about 50% of CPF members in Singapore," said Tan Hak Leh, Deputy President of Life Insurance Association of Singapore (LIAS).

A possible solution mooted by the industry is in the form of life annuities, where an annuitant invests a capital sum to earn a monthly income that he will receive for the rest of his lifetime; another is reverse mortgage annuities, which unlock the value of the family home, typically already paid for by the retiree. Similar to life annuities, "reverse mortgages allow the retiree to draw a gradual pension on the mortgage," explained Piggott, and upon his death, the home may be sold and the proceeds split between the lender and beneficiaries.

Christina Tang, Head of Regulatory Management for Group Retail at the Association of Banks, thinks it is "good" for the government to mandate a life annuity. "It is like an extension of the CPF minimum sum scheme; such life annuities offer more choices to the individual CPF member, though not to the creditors," she said.

Annuities: a new lease on life

Even though annuities are "one of the best hedges against longevity risk, it is not intuitive for most people," said LIAS' Tan. He cites figures from the finance industry regulator, the Monetary Authority of Singapore, which show that for every year from 2006 to 2008, life annuities accounted for less than 1% of all policies sold by insurance companies in Singapore.

Globally, the trend towards life annuities is also dismal, said Piggott. "Premiums are paid up front, you lose control of your capital, and most of the time, the bequest sees a sudden big drop." On the other hand, premiums on a reverse mortgage annuity are due only at closure, and there is a "gradual reduction in the bequest, which people are more comfortable with," he said.

Piggott suggests that the public sector should kick-start such schemes with "plain vanilla", or basic, easy-to-understand plans, that provide a regular stream of income for retirees. The government-initiated schemes can help people overcome the "nervousness" of investing in an unfamiliar product and pave the way for the private sector to enter the market with "more sophisticated products so people will have more choice".

In 2009, the Singapore government announced that it will mandate the CPF Lifelong Income Scheme for the Elderly (CPF LIFE) from 2013. Coordinated public sector effort, including a public education campaign, helped raise awareness of the life annuity insurance plan and its benefits.

Currently, there are four CPF LIFE plans for Singapore citizens and permanent residents who meet the age requirement and minimum cash savings requirement in their CPF RAs. As of September 2009, people aged 55 years and above can tap on their RA savings to buy one of these plans. Their payouts will commence from their draw down age, which is 62 years in 2012; it will be gradually raised to reach 65 years by 2018.

CPF LIFE is not compulsory for those with less than S$40,000 in their RAs, or citizens and PRs aged 80 and above, although they can opt-in if they wish. The initial two-month opt-in phase received tremendous support. "We had about 30,000 sign-ups, with a commitment of $1.2 billion," said Don Yeo, Deputy Chief Executive for Policy & Corporate Development, CPF Board.

Of these, about half signed up for the LIFE Plus Plan, which distributes high monthly payouts and low bequests; a third picked LIFE Balanced Plan, which gives medium monthly payouts and bequests. The rest, in equal proportions, chose the LIFE Basic Plan, with low monthly payouts and high bequests, and LIFE Income Plan, which gives the highest monthly payouts with no bequests.

The local market for annuities is "in its infancy", so the CPF has deliberately kept the products simple, said Yeo. For example, payouts are not adjusted for inflation or linked to real returns on capital investment; instead, members will be receiving a fixed sum on a monthly basis. "To ensure sustainability, we invest in special government bonds which are stable, without large fluctuations," he said.

Unlocking a fixed asset

Despite offering phased withdrawals and deferred premiums, reverse mortgage annuities are perceived to be complicated as there are tax and legal uncertainties, compounded by the fact that the real estate market is not transparent.

For the lender, the longevity risk is underlined by the mortality of the home annuitant, as the value of the property cannot be realised until his death. For the home owner, a reverse mortgage would deny him the chance to leave a bequest to his beneficiaries. At the same time, both parties face the risk of drastic fluctuations to property prices during this mortgage period.

Piggott suggests that the public sector can play a critical role to "provide access to home equity, curtail barriers like application and tax barriers, provide liquidity for banks to take on reverse mortgages, and provide re-insurance for lenders to jumpstart securitisation".

From March 2009, Singapore's Housing & Development Board (HDB) begun accepting applications for the Lease Buyback Scheme (LBS). The LBS provides an additional option for low-income elderly Singaporeans in three-room and smaller flats to cash out part of the money "locked" in their flats. Under this option, the home owner receives a lifelong stream of payouts to supplement his retirement income.

However, to qualify, this LBS is not a reverse mortgage annuity, said CPF's Yeo. He explained that HDB will use part of the proceeds to purchase an annuity from the CPF Board in order to provide the home owner with a monthly payout. Because LIFE annuities are new to Singapore, Yeo highlighted that it will take time before there can be sufficient data for analysis.

For now, Piggott wants stakeholders to "sharpen risk coverage" and "pool the annuity functions". Most of all, he hopes governments will take the lead in establishing life annuities and reverse mortgage annuities as viable options in retirement planning. Clearly, "mere" market forces from the private sector and individual households are not quite sufficient to address the growing "risk" of longevity, he said.

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