

Ministerial Statement on Government's Response to the Economic Review Committee Subcommittee Recommendations on the CPF System

CPF AND RELATED CHANGES

Mr Speaker Sir,

Introduction

1. The Economic Review Committee (ERC) unveiled its first major set of recommendations covering taxation in April this year. The Government responded to these measures with a package of tax reforms in the Budget Statement, which will enhance our competitiveness, and help us to attract foreign investment and talent to Singapore, thus creating jobs and generating wealth for Singaporeans.
2. Another major set of proposals from the ERC is on the Central Provident Fund (CPF), which the ERC Subcommittee on Taxation, the CPF system, Wages and Land released on 15 July. The Sub-Committee reviewed the existing CPF framework, and proposed changes to the system to achieve a better balance between retirement security and home ownership, and to make the labour market more flexible, in order to maintain and create more jobs, especially for vulnerable groups such as lower income and older workers.
3. In parallel with the work of the ERC, the Ministry of National Development (MND) has been studying how to inject greater flexibility into the public housing market. In particular, MND has studied devolving to the private sector, those functions of the Housing Development Board (HDB) which extend beyond the government's core responsibility of providing affordable basic housing.
4. Today, I shall present the Government's response to the ERC's CPF recommendations, and outline the changes to CPF rules arising from MND's review of HDB.

Response to the ERC's Recommendations

Key Principles of the CPF System

5. Let me first deal with the ERC recommendations.
6. The Government accepts all the ERC recommendations. The CPF is the cornerstone of our social security system. It is based on individual responsibility and self-funding, and has served us well for many years, helping Singaporeans save for their own retirement. The CPF system remains fundamentally sound. However, our society is changing. Singaporeans are living longer. More are remaining single or having fewer children. Increasingly Singaporeans have to depend more on CPF savings than on their children for their retirement needs. We now must update the CPF framework, to adapt to a different economic and social environment, and to pre-empt future problems.
7. Changes to the CPF system will be based on the following principles adopted by the ERC:
 - a. First, CPF should focus on three key objectives: retirement expenditure, healthcare and home ownership. These form the core elements of financial security
 - b. Second, CPF should aim to meet these three needs at a basic level. Beyond this basic level, individuals should rely on their own private savings and

arrangements. For a compulsory scheme like the CPF to go beyond providing for basic needs would add rigidity to the economy and be onerous to both employers and workers.

- c. Third, CPF should be designed for the broad majority of Singaporeans, between the 10th to the 80th percentiles of the income spectrum. Those below the 10th percentile cannot rely on CPF alone for their retirement needs, and would need the help of other social support schemes. Those above the 80th percentile should be well able to look after their own financial affairs, including planning for their retirement.
- d. Finally, changes to the CPF system should be gradual, because many people have made long term commitments based on the current framework, and need time to adjust to any policy changes.

Minimum Sum

8. Since 1994, the Government has been progressively increasing the Minimum Sum by \$5,000 each year. We will reach the target Minimum Sum of \$80,000, including up to half in a property pledge, by July 2003. This will allow members to draw a monthly income of about \$450 to support a modest standard of living upon retirement.
9. The Government agrees with the ERC that the CPF Minimum Sum should not remain frozen at \$80,000. As the economy grows and wages increase, Singaporeans will have higher expectations of what is adequate for their basic retirement needs. The current Minimum Sum will not be enough and will need to be revised upwards over time. The Government will decide on the next target amount for the Minimum Sum, and the schedule for reaching the new target, after the Minimum Sum has reached \$80,000 next year

Special Account

10. The contribution rates to the Special Account are currently 4% for members aged 35 and below, 6% for those aged between 35-45, and also 6% for those aged between 45-55 (or 4/6/6). The Government has announced that these contribution rates will be increased to 4%, 6% and 8% respectively (or 4/6/8), as we restore the CPF contribution rate to 40%.
11. Even at 4/6/8, however, only half of all CPF members can achieve the Minimum Sum of \$80,000 by age 55. To help more Singaporeans attain the Minimum Sum, the Government has decided to adopt the ERC's proposal to raise the target CPF contribution rates to the Special Account by 1%-point across the various age groups, from 4/6/8 to 5/7/9. This will enable another 10% of CPF members to attain the Minimum Sum of \$80,000 by age 55.
12. This increase in the Special Account contribution rates to 5/7/9 will be effected as we restore the total CPF contribution rate to 40%.

Investment in Private Pension Plans

13. To help CPF members build up more cash savings, the ERC has proposed that the Government facilitate the provision of low-cost, privately managed pension plans to CPF members.
14. The Government agrees that we should encourage Singaporeans to invest in privately-managed pension plans. Experience in other countries such as the US and Australia has shown that over the long term well diversified pension plans offer better returns than keeping the money in cash, earning short term savings or fixed deposit rates of interest.

Such pension plans also offer superior returns, at lower risk and cost, compared to members investing the money themselves in shares or unit trusts.

15. However, private pension plans are not yet available in the local market. This is in part because the current regulatory rules for the CPF Investment Scheme, or CPFIS, are not conducive to such plans. More fundamentally, it will take time for Singaporeans to adopt a mindset of investing their retirement savings with a long term perspective, instead of using CPF funds to trade for short term gains, for example on the stock market. Based on the experience of other countries, the process of changing this public mindset may take a decade or longer. Nevertheless, we should start now.
16. On its part, the Government will facilitate investment in private pension plans, as an additional option under the CPFIS framework. We will review existing CPFIS rules to improve the viability of pension plans, and encourage members to consider pension plans seriously as an investment option. However, CPF members must remember that higher risk accompanies higher returns, and that they are ultimately responsible for their own investment decisions.

Special Account Interest Rate

17. Not all CPF members will be ready to enrol in private pension plans, or take on other investment options already available under the CPFIS. Those who prefer to can continue to leave their savings with the CPF Board. The Special Account interest rate is currently pegged to a premium of 1.5%-points over the Ordinary Account interest rate. The ERC has proposed pegging the Special Account interest rate to a more appropriate long term interest rate, such as the yield on long term government bonds.
18. The Government agrees with this recommendation in principle. It will study the matter further, to determine the appropriate benchmark interest rate to use, and the timing of implementation.

Salary Cap

19. The Government also agrees with the ERC's recommendations to lower the salary ceiling for CPF contributions from a monthly salary of \$6,000 to \$5,000.
20. This is in line with the principle that CPF should focus on catering to basic needs of the population in the 10th to the 80th percentiles of the income spectrum. CPF members who earn more than \$5,000 a month fall well within the top 20th percentile in terms of income. There is no need to require them to set aside the same proportion of their incomes in compulsory CPF savings as others with lower incomes. Lowering the salary ceiling for CPF contributions to \$5,000 will achieve this.
21. The civil service will also rationalise the salary ceiling of the public sector with that of the private sector. The salary ceilings for non-pensionable public officers are currently \$7,000 for employer contributions, and \$6,000 for employee contributions. We will reduce both ceilings to \$5,000.
22. Pensionable public officers currently have higher CPF salary ceilings, at \$9,333 for employer contributions, and \$8,000 for employee contributions. As their CPF contribution rates are lower than for non-pensionable officers, their salary ceilings were set higher so that their maximum contribution in dollar terms would equal that of non-pensionable officers. With the ceilings for non-pensionable officers brought down to \$5,000, we will lower both the employer's and employee's ceilings for pensionable officers to \$6,667.
23. The contribution ceiling to the Supplementary Retirement Scheme (SRS) will be

correspondingly reduced to \$5,000.

24. One reason the CPF salary ceiling had been set at a high level was to effectively lower the personal income tax burden on higher income groups, because compulsory CPF contributions are tax deductible. At a time when top personal income tax rates were high, this was especially relevant for employees, whose incomes tended to be more fully declared than self-employed workers and professionals. However, over the years we have lowered income tax rates significantly. We have now also implemented the SRS scheme, which enables Singaporeans to set aside additional voluntary savings for retirement, in tax sheltered SRS accounts. There is therefore no longer a need for such a high CPF ceiling. Singaporeans who are concerned that the lower CPF contribution will result in them paying more income taxes, and who have not taken full advantage of the SRS scheme, may wish to do so to lower their tax liability.
25. These changes will be implemented as we restore the CPF contribution rate to 40%.

Income Floor

26. Currently, employees who earn less than \$200 a month do not contribute to CPF. Contribution rates are then phased in on a sliding scale from 5% for wages at \$200 to the full rate of 20% for wages at \$363 and above.
27. This income floor of \$200 was set in 1955 when CPF was first introduced. In the half century since then, wages have gone up many fold, but we have not correspondingly adjusted the income floor. The Government therefore agrees with the ERC's proposal to raise the income floor for employee's CPF contribution from \$200-\$363 to \$500-\$750. The vast majority of workers in full-time jobs earn more than \$750 per month* [** \$750 corresponds to the 10th percentile of income*]. This change will therefore benefit especially part-time workers. We hope that it will encourage more people who are presently not working, for example housewives, to take up part time work.
28. This change will take effect for salaries earned from 1 Oct 2002.

Older Workers Aged 50-55

29. Currently, the unemployment rate for older workers aged 50-55 is still low at 4.6%. However, this situation is unlikely to persist. As our economy upgrades and restructures, structural unemployment, especially among older workers, will increasingly become a problem.
30. We had a foretaste of this in the recent economic downturn. Older workers who were retrenched faced much greater difficulty securing re-employment compared to younger workers. A survey of workers who were retrenched in the 4th quarter of 2001 found that as at end Mar 2002, among those aged 50-55, the re-employment rate was 41%, compared to an overall re-employment rate of 50%. Older workers also took longer to find new jobs. The median duration of unemployment for workers aged 50-55 was 21 weeks, compared to 13 weeks for workers across all age groups. On top of this, 73% of workers between 50-55 years accepted pay cuts when they were re-employed, compared to an overall average of 59%. The pay cuts were often substantial.
31. This problem of structural unemployment will not go away. The fundamental reason is that our workers will continue to face strong and increasing competition both from educated workforces in developed countries, and from the lower cost workforces of countries like China. Older workers will be most at risk, because they are on average less well educated than younger ones. This too will be a persistent issue, because although

workers aged 40-44 are better educated than those aged 50-54, workers aged 30-34 are better educated still ** [** The percentage of workers with below secondary education is 49% for the 50-54s, 35% for the 40-44s, and 17% for the 30-34s].* In 10 years' time, when the workers now in the 40's reach their 50's, they will still be less well-educated than workers who are ten years younger, and therefore will be at greater risk of becoming structurally unemployed.

32. Our older workers are also more vulnerable because our seniority-based pay system pushes wages up beyond what their skills and productivity can justify. When older workers lose their jobs, they tend to have higher wage expectations, which makes it more difficult for them to find re-employment. The 40% CPF contribution rate exacerbates these problems, because it discourages employers from taking on older workers, and also discourages older workers from working for lower take-home pay.
33. To address the first problem of older workers being less skilled, we must continue to push for skills upgrading. Last year, the Government introduced a comprehensive set of programmes to upgrade the skills of older workers. These included enhanced support for the Skill Redevelopment Programme (SRP), and the People-for-Job Traineeship Programme (PJTP) which incentivises employers to hire older workers by defraying part of the associated training costs.
34. These programmes were originally intended to last for 12 months, to tide older workers over immediate difficulties in the economic downturn. The Government will now extend the enhanced support to the SRP, as well as the PJTP, for an additional year until November 2003.
35. We will also improve the PJTP for older workers. Under the PJTP, workers receive wage support for 6 months, amounting to 50% of their wages. For workers who are more than 50 years old, we will extend this period of wage support to 9 months, but at a lower support rate of 25% for the additional 3 months.
36. To address the second problem of the seniority-based wage system, we need to inject greater flexibility in the wage system. The effort to promote flexi-wages has yielded results, but it will take many years to complete. We need to complement it by lowering the burden of statutory charges on wages for this vulnerable group of older workers.
37. The Government therefore agrees with the recommendations of the ERC to keep the employer's CPF contribution rate for workers aged 50-55 at the current 16%. We will also progressively lower the employee CPF contribution rate for workers aged 50-55 from 20% to 16%, as we restore the CPF contribution rate. This will increase the take home pay for these workers and help them to meet their financial commitments.
38. With this structural change, the total CPF contribution rate for workers aged 50-55 will be 32% - 16% from employers and 16% from employees. This is a meaningful step-down from the 40% full rate for those aged below 50, to 32% for those aged 50 - 55, to 20% for those aged 55 - 60. It will encourage employers to keep their older workers.
39. I should clarify that the non-restoration only applies to workers aged 50-55, and not to workers aged 55 and above. These workers above 55 will have their CPF contribution rate restored together with workers aged below 50, to their pre-1998 levels.
40. The reduction of the total CPF contribution rate to 32% for workers aged 50-55 addresses a foreseeable future problem. However, for workers already in this age group who currently have jobs, the non-restoration of employer contributions may cause them to lose out, at least relative to other workers whose employer contributions will be restored.

41. Some older workers have also expressed concern that the non-restoration will affect their ability to service their mortgages. Younger workers will have time to adjust, and are unlikely to run into such problems by the time they reach 50-55. But workers now in this age group may face mortgage payment shortfalls.
42. These are valid concerns, although the difficulties are transitional. We can and should take steps to buffer their impact on workers who are currently in this age group, especially as the restructuring of CPF rates for the older workers deals with a medium-term rather than an immediate problem of structural unemployment.
43. To help workers facing mortgage shortfalls due to the non-restoration, the Government will allow these CPF members to continue to draw on their Special Account to pay their mortgages for a longer period of time. We already introduced such a scheme when we cut the CPF rate in 1998. We will extend its duration.
44. As recommended by the ERC, we encourage employers to pass on part of their cost savings to deserving workers in this age group, as the CPF is restored for the others. Employers can do so through the variable component of wages, such as bonuses or other variable payments, depending on the circumstances of each company and the contribution of each worker.
45. The civil service will take the lead and implement a Transitional CPF Top-Up Component (TCTC) for civil servants aged 50-55. Officers who are aged 50-55 on the dates when the CPF is restored for others, will receive, in their TCTC, part of what they would have got had their CPF too been restored. PSD will announce details of this scheme in due course.

Valuation Limits on Bank Mortgages

46. Home ownership for Singaporeans continues to be a fundamental policy objective of the Government. When the Residential Properties Scheme first started in 1981, CPF withdrawals for private property purchases were subject to a Valuation Limit of 80% of the value of the property. Over the years, this Valuation Limit was progressively liberalised. The current limits on the use of CPF funds to purchase properties are very lax.
47. CPF withdrawals for housing can reach imprudent levels if they are not appropriately capped. This is especially so because we allow CPF savings to be withdrawn not just to pay for the property itself, but also to service the interest payments on a mortgage loan, which are in fact not investments, but a form of consumption. Furthermore, the property market goes through cycles. If property prices fall, part of the CPF savings that members have put into the property may be lost.
48. CPF withdrawals for housing are meant as a form of investment. Indeed for most Singaporeans, the house they live in is their single most important investment. The amount of CPF committed to a house should therefore bear an appropriate relation to the value of the property. The Government accepts the ERC recommendation to set a withdrawal limit equivalent to 150% of the valuation of the property. The 150% Valuation Limit will take effect for options to purchase residential properties entered into, on or after 1 Sep 2002 * [*The limit will be applied on top of the Available Housing Withdrawal Limit (AHWL). The AHWL is the lower of 80% of the gross CPF savings in excess of the Minimum Sum or the available Ordinary Account balance after setting aside the Minimum Sum cash component. A CPF member seeking to withdraw more CPF savings than the property's original purchase price would be subject to the Valuation Limit or AHWL,*

whichever is lower.] The limit will be brought down gradually to 120% of the value of the property, over 5 years.

49. At 150%, the Valuation Limit should not have significant impact on most home buyers, or on the property market. Even at 120%, a typical CPF member can still service a 25-year mortgage fully with his CPF for 19 years. There is thus a long lead-time for CPF members to plan their finances properly so that they can continue servicing the mortgage in cash after their CPF withdrawals have reached the Valuation Limit, or factor in some cash co-payment along the way and spread out the usage of their CPF. However, by instituting the Valuation Limit now, we establish the important principle that the amount of CPF used to buy a house must not be excessive in relation to its value.
50. This Valuation Limit will not apply to those who purchase HDB flats using subsidised mortgages. It will also not apply to options to purchase entered into before 1 Sep 2002 and existing mortgage loans, except where these are refinanced.

Other ERC Recommendations

51. The ERC has made other recommendations which I have not covered today. These include exploring ways to help home-owners monetise their assets, strengthening provisions for healthcare needs, and devolving CPF-based insurance schemes to the private sector. The Government agrees with these recommendations in principle. The relevant agencies are further studying them to see how best to implement them.

Banks Origination of Market Rate HDB Loans

Mr Speaker Sir,

52. Let me now explain the changes arising from MND's study to devolve some non-core HDB functions to the private sector. These include transferring future HDB market rate loans to banks, changes to the CPF charge on a private property which is mortgaged, and changes to the cash downpayment requirement on mortgages.
53. The Government has a responsibility to provide affordable basic housing, in the form of subsidised HDB flats, to Singaporeans, and enable as many citizens as possible to own their own homes. It also helps HDB home-owners to upgrade to bigger flats, as their families grow and they accumulate sufficient savings. HDB will continue to provide subsidised mortgage loans for first time flat buyers and second time buyers who are upgrading from smaller flats.
54. However, not all Singaporeans who buy HDB flats fall into these categories. For example, they may be buying an HDB flat for a third time, or they may be making a lateral transfer, from one 4-room flat to another. Some may even own private properties and may be buying HDB flats to live in while they rent out their private properties. Other HDB buyers do not qualify for HDB subsidies at all. For example, they may be permanent residents, or may have high incomes and be buying a flat on the resale market. HDB allows such purchases, but it does not consider them as falling within its core objective of promoting universal home ownership amongst Singaporeans.
55. In recognition of this distinction, HDB makes two types of loans to the two groups of buyers. For the first group, HDB has subsidised loans which are our key instrument to promote home ownership. The interest rate for such loans is pegged at the CPF interest rate plus 0.1%. For the second group, who do not fall within the basic housing safety net, HDB provides market rate loans. The interest rate is pegged to the rate DBS charges former Credit POSB mortgagors. In 2001, about 37% of all loans provided by HDB,

amounting to \$3.2 bil, were market rate loans * [*In Year 2001, 22,000 out of 58,000 loans granted by HDB were market rate loans. The value of market loans granted by HDB in Year 2000 amounted to \$3.0 bil. In Year 2000, 20,000 out of 61,000 loans granted by HDB were market rate loans.*]

56. HDB has been looking into whether certain functions that go beyond its core activities can be better handled by the private sector, so that it can better focus on its basic objective of providing affordable housing for Singaporeans. Arising from this review, the Government has decided that from 1 Jan 2003, HDB will cease to grant market rate loans. Instead banks will be allowed to provide loans to flat buyers at commercial rates and terms. HDB flat buyers will benefit from more choices, and can take advantage of the many competitive housing loan packages offered by the banks.
57. Existing HDB market rate mortgagors can continue their existing mortgages provided by HDB. However, if they wish to refinance their loans with the banks, subject to the new Valuation Limit, they can do so.

CPF Second Charge on Bank Loans

58. Currently, for mortgage loans made by HDB, HDB has first charge, followed by CPF Board, which has second charge. This means that if the buyer defaults on his mortgage, and HDB repossesses his property, then HDB will deduct the amount that the mortgagor owes HDB, before paying any balance back to the mortgagor's CPF account or to the mortgagor himself in cash.
59. There will be no change to this arrangement when banks start selling mortgages for HDB flats, as far as the mortgagors are concerned. The banks will merely step into the shoes of HDB, and have first charge on the mortgage loans.
60. For mortgages on private properties, however, where the banks are the lenders, the arrangement has thus far been the opposite. In the event of a loan default, the CPF Board assumes priority charge over the mortgaged property, ahead of the banks. This means that in the event of borrower default, the banks are unable to make effective use of the mortgaged property to mitigate their losses. This is because proceeds from the liquidation of the property will first have to be used to repay the CPF Board, i.e. to repay the borrower's own CPF account. And as the loan matures and more of it is repaid through CPF withdrawals, the Board's claims increase correspondingly. The banks are entitled to a diminishing residual amount after the money has been returned to the buyers' CPF account. Hence the more a loan is repaid with CPF, the less satisfactory the bank's collateral position becomes. This is not sound for the banking system.
61. So far this has not posed any major problems, because over the past decades, the property market has risen steadily and strongly, especially in the 80's and early 90's when the economy was booming. So long as property values continued to appreciate, and few borrowers defaulted on their mortgages, there was less concern about the value of the collateral, and whether banks or the CPF ranked first in a default.
62. Looking ahead, the property market is unlikely to be as buoyant as in the 80's or early 90's. This sharpens the latent prudential concerns over the existing charge arrangement.
63. A second problem with the current arrangement is that borrowers who run into difficulty will have less incentive to continue servicing their loans, because their own CPF money will be less at risk than their creditor banks' claim on the property. This can also contribute to imprudent investments in properties. CPF members investing in shares or other financial assets have no such buffer available, and take on the full risks of their

investment decisions.

64. It is therefore not prudent to allow the present unsatisfactory arrangements to continue. The Government has thus decided to reverse the charge position of CPF Board and banks for mortgage loans originated by financial institutions regulated by MAS. The banks' principal will now rank ahead of CPF savings withdrawn to purchase the property and to service the loan. On interest due, CPF Board and the banks will rank *pari passu*. This change will align the treatment for private property loans with HDB loans. It will apply to property purchases where the options to purchase were entered into on or after 1 Sep 2002, and all existing loans that are refinanced after this date.
65. This reversal of charge position will also apply to the use of CPF savings for the purchase of non-residential properties under the Non-Residential Properties Scheme.

10% Cash Downpayment on Housing Loans

66. Currently, bank financing for private property is subject to a cap of 80% of the property value. The remaining 20% downpayment must be paid in cash and serves as a buffer for the banks. CPF money cannot be used for this downpayment, because the CPF Board ranks ahead of the bank in its claim, and so, in a default, CPF money does not provide any buffer for the bank.
67. Now that the lending bank will rank ahead of the CPF Board, CPF can be used for part of the downpayment. However, it would not be prudent to do away with the cash requirement altogether, because this could encourage excessive property speculation. We have thus decided to allow 10% of the downpayment for private property purchase to be paid out of CPF savings. The remaining 10% will still have to be paid in cash. The maximum quantum of bank financing will stay at 80% of property value.
68. The new rules will apply to CPF Board applications for private property purchases where the options to purchase were entered into, on or after 1 Sep 2002. Properties for which the options were signed before 1 Sep 2002 will not be affected.
69. HDB loans, whether subsidised or not, currently have no cash downpayment requirement. HDB flat buyers are allowed to use CPF savings to pay the full 20% downpayment, because for HDB loans, CPF's claim rank second to HDB's claim. When market rate HDB loans are transferred to bank origination, we will initially preserve this arrangement. But for the longer term, the rules for these bank-originated mortgages on HDB flats should be aligned with the rules for private property mortgages. We will phase in the 10% cash downpayment requirement for bank mortgages on HDB flats gradually, over 5 years.

No Change to Subsidised HDB Loans

70. I would like to emphasise that HDB subsidised loans will not be affected in any way by these changes. They will be subject neither to the new Valuation Limit for CPF withdrawal, nor the 10% cash downpayment requirement.

Conclusion

71. Sir, implementation of many of these measures is pegged to the restoration of CPF contribution rate to 40%. When and how long this will take depends on the state of our economy, as well as on developments in the region and around the world. It is therefore difficult to commit to a schedule for restoration, though it remains the Government's intention to restore the rate as quickly as conditions permit. Barring unforeseen

circumstances, we can reasonably expect to restore CPF contribution fully to 40% in 2-4 years.

72. I would like to thank Mr Tharman Shanmugaratnam, his ERC Sub-Committee members, and the members of the CPF and Wages Working Groups for their hard work in coming up with the CPF proposals. During their deliberations, they have solicited a wide range of views' from workers, labour unions, employers, and financial institutions. They have produced a balanced package of proposals which preserves the existing strengths of the CPF system, and at the same time, makes the necessary adjustments to improve the financial security of individual Singaporeans, and to enhance labour market flexibility. These changes, together with the changes to the use of CPF for property purchases and the divestment of HDB market rate loans to banks, will pre-empt significant long term problems, and contribute to Singapore's overall economic resilience and competitiveness.