Executive Summary

REFOCUSING THE CPF SYSTEM

1. The CPF system is fundamentally sound. Since its introduction in 1955, CPF has provided Singaporeans with a framework to save for their own retirement, reflecting our strong emphasis on individual responsibility. The role of CPF has grown over the years – today it addresses both retirement and healthcare needs,and has also enabled the vast majority of Singaporeans to purchase their own homes.

2. Moving ahead, CPF should continue to cater to the three key needs of retirement expenditure, healthcare and home ownership. CPF should endeavour to meet these needs at a basic level. The CPF should focus on the broad majority of the population, between the 10^{th} and 80^{th} percentiles of the income spectrum.

3. As a mandatory scheme, the CPF should be rolled back where it is not necessary, or where it does not meet its intended objectives. Those in the lowest income group (10^{th} percentile and below) cannot rely on CPF alone for their retirement needs. To do so would require higher levels of CPF contributions which would leave them with too little take-home pay for their current consumption needs. Other social support schemes and policies will be required to supplement the CPF framework for this group.

4. At the top end, for households with incomes above the 80^{th} percentile, there is no need to impose on them the same percentage of mandatory savings as for the rest of the population. Those in this group are well able to look after their own financial affairs, and should be encouraged to take greater responsibility for their own financial planning, including planning for their retirement needs. We therefore propose to set the ceiling on CPF contributions at no more than the 80^{th} percentile income level.

5. Changes to the CPF system must be made gradually. CPF members have made long-term commitments based on the current framework, and must be given time to adjust to any policy changes. Our approach in this current review is to mark out the broad path that the CPF should tread in the future and allow these changes to set in steadily, rather than to introduce drastic changes that could shock and destabilise the system.

6. The implementation of many of our recommendations is linked to the restoration of the CPF contribution rate to 40%. When and how quickly this is achieved is beyond the remit of the Sub-Committee. However, we envisage it taking place over the next 2-4 years, depending on the state of the economy. There should thus be ample time for the system to adjust and for Singaporeans to adapt to the changes being proposed.

I. ENHANCING FINANCIAL SECURITY IN RETIREMENT

Challenges of Adequacy

7. Many CPF members today are "asset-rich and cash-poor" at retirement. This imbalance arises mainly because of large withdrawals of CPF money for property purchases.

8. It is rational and sensible for Singaporeans to invest in property. Not only does this provide their families with a roof over their heads, it also gives them a substantial asset that offers added financial security in retirement. CPF members should not be deterred from investing in housing for their retirement, as long as they do so prudently.

9. However, as our society ages, Singaporeans will need more flexibility to convert the homes they own into income to help meet retirement needs, such as through reverse mortgages, subletting their flats, and downgrading. The Sub-Committee recommends that the Government explore ways to make it easier for homeowners to monetise their property. However, even if the mechanisms are available, not all Singaporeans will be in a position to monetise their property. We also need measures to help members increase their CPF cash balances and reach the Minimum Sum.

10. Changes in social and demographic trends in Singapore mean that future retirees cannot rely on their children to the same extent as today's retirees. With longer life expectancies, families with fewer children, and a growing proportion of unmarried retirees, future generations will have to depend more on their own CPF savings for financial security.

Setting Aside More in the Special Account

11. The Government has committed to restore the CPF contribution rate to 40% from the current 36% as soon as economic conditions allow. It has also committed to increase the Special Account (SA) contribution rates from the current 4/6/6 (4% for members 35 years and below, 6% for members above 35 to 45 years, and 6% for members above 45 to 55 years), to 4/6/8 as the total CPF is restored to 40%.

12. However, the SA rates need to be increased beyond 4/6/8 in order to meet future retirement needs. Even at 4/6/8, many members will have difficulty meeting the Minimum Sum, which will be $80,000** *(**Currently up to $40,000 can be in the form of a property pledge)* from July 2003. At SA contribution rates of 4/6/8, the Sub-Committee projects that only about 50% of new members with a full career of CPF contributions would reach at least $80,000 in cash by 55, or $40,000 after half the cash is withdrawn.

13. To boost their SA savings and help more members reach the Minimum Sum, we propose to increase the contribution rate to the Special Account by a further 1%-point to 5/7/9 as we restore the overall CPF contribution rate to 40%, as shown in the table below. This will increase members' SA balances by about 20%, and enable an additional 10% of all members to reach the Minimum Sum by 55.

<u>Table 1: Special Account Contribution Rates</u>

Age of Member	Current Rate (%)	Announced Rate upon CPF Restoration (%)	Recommended Rate upon CPF Restoration (%)
35 years and below	4	4	5
Above 35 and up to 45 years	6	6	7
Above 45 and up to 55 years	6	8	9

Increasing the Minimum Sum to Cater for Higher Living Standards

14. The CPF Minimum Sum cannot remain static. As the economy grows and wages rise, successive cohorts of Singaporeans will have higher expectations of what they consider basic in retirement. Over time the present Minimum Sum will become insufficient for the majority of retirees.

15. We recommend that as wages rise over time, the Minimum Sum should also be increased in step, beyond the $80,000 which will take effect next year. This will have to be phased in gradually, as many members do not have sufficient CPF balances to meet even the existing Minimum Sum today.

Strengthening Provisions for Healthcare Needs

16. Besides retirement income, the CPF also needs to provide more for healthcare needs, the bulk of which is likely to be required during retirement. There are strong upward pressures on healthcare costs. To help Singaporeans better prepare for their healthcare needs in retirement, the Sub-Committee supports the Government's intention to increase the contribution rate to the Medisave Account (MA) by 1%-point when the total CPF contribution rate is restored to 40%, as follows:

Table 2: Medical Account Contribution Rates

Age of Member	Current Rate (%)	Recommended Rate (%)
35 years and below	6	7
Above 35 and up to 45 years	7	8
Above 45 years	8	9

17. We also support the Government's intention to move towards greater risk-pooling through insurance to complement Medisave and improve the efficiency of financing healthcare expenses. Greater risk-pooling through MediShield will improve insurance coverage for Singaporeans. The current framework of co-payments and deductibles should also be retained so as to avoid over-consumption of healthcare and reinforce personal responsibility for healthcare.

18. To generate healthy competition in the provision of health insurance, thereby boosting provider quality and keeping costs down, the Government should consider devolving MediShield and other CPF-based insurance schemes, such as the Home Protection Scheme and Dependants' Protection Scheme, to private insurers to operate and manage. This would be similar to the way in which the Government has allowed private insurers to operate ElderShield.

Encouraging Prudent Withdrawals for Housing

19. The Ordinary Account (OA) should allow members to own a home commensurate with their income, and provide additional savings to supplement the retirement income provided by the SA. As housing absorbs a large part of the OA savings of many members, we need to ensure that withdrawals for housing are not excessive in relation to the property value.

20. When the Residential Properties Scheme for purchases of private property was first introduced in 1981, withdrawals of CPF savings were limited to 80% of the initial purchase price of the property (i.e. a "Valuation Limit" of 80%) to protect members against any drastic fall in property prices. However, this was liberalised over the years. As a result, the current limits on the amount of OA funds that can be withdrawn for purchase of a particular property are very lax. OA funds can be used to repay both the principal and interest on a mortgage loan, even to the extent that OA withdrawals far exceed the value of the property. For example, total OA withdrawals by a homebuyer to pay for both the principal and mortgage interest could reach 160% of the initial

purchase price by the end of a 25-year loan.

21. We propose to cap OA withdrawals for property purchases, so that the amount bears a reasonable relationship to the value of the property. This cap should initially be set at a generous level that will not unsettle or destabilise the property market, and then be gradually tightened. The Sub-Committee therefore proposes to limit CPF withdrawals for housing to 150% of the value of the property, at the time when the member applies to use his CPF funds. We recommend to start with a 150% Valuation Limit this year, and bring it down to 120% in equal steps over 5 years.

22. The Valuation Limit should not apply to those who buy HDB flats on subsidised HDB mortgages, so as to safeguard the basic objective of universal home ownership. It should also not apply to existing loans, because the mortgagors have already made long-term commitments under existing rules.

23. The impact of the Valuation Limit on the property market should be limited. The intention is for prospective homebuyers to take into consideration the revised limits when planning long-term commitments. Despite the Valuation Limit, they can still use their OA savings to pay for the full value of their homes. We estimate that 150% of valuation should be sufficient for principal and interest repayments for the first 24 years of a 25-year loan. Even at 120% of valuation, a CPF member should be able to use CPF funds alone for up to 19 years in a 25-year loan, so that most home buyers will not be affected by this new Valuation Limit.

Enhancing Returns on CPF Balances

24. CPF members also need to invest for higher long-term returns so that they are better able to achieve the Minimum Sum upon retirement. Today, members can invest in unit trusts and investment-linked insurance products under the CPF Investment Scheme (CPFIS). But they face two main challenges in enhancing returns. First, investment costs are high because many of the unit trusts on the market are relatively small and cannot achieve economies of scale. Second, many members are unable to achieve balanced and diversified investment portfolios that can yield lower risks and higher returns over the long term.

25. Members can enjoy higher returns (even after making allowance for the risk involved) if they invest their funds on a long-term basis in well-diversified portfolios. In other countries such as the US, private sector pension providers offer pension plans that make and execute investment decisions on members' behalf, including decisions on strategic asset allocation. Large pension plans are also able to pass to their members some of the cost savings derived from pooling. Pension plan members can thereby enjoy lower institutional costs, instead of the higher retail costs involved if they invested in the market on their own.

26. The Government should facilitate the provision of low-cost privately-managed pension plans to CPF members, as an additional option under the CPFIS framework. Although current CPFIS rules do not explicitly prohibit such pension plans, they pose implicit impediments. For example, SA funds currently cannot be invested in equity funds, which are a key asset class in a diversified investment portfolio offered under most pension plans. Such rules will need to be reviewed. While members may be exposed to some market risk, well-diversified plans will carry less risk than investments in specific products. Members can also limit their downside risk by investing in plans with capital guarantee features.

27. Not every CPF member will be able or ready to participate in such pension plans. We therefore recommend that the CPF should continue the current arrangement of holding members' SA savings, unless they explicitly choose a pension plan or some other approved investment product. We propose that the interest rate paid on SA balances be pegged to a more appropriate long-term interest rate, such as the yield on long-term government bonds. This is a more rational basis than

the current system of pegging the SA interest rate to an arbitrary fixed premium over short-term rates (i.e. Ordinary Account rate + 1.5%-points).

Maintaining Stability of CPF Contribution Rates

28. Given its objectives of ensuring adequacy for retirement income, healthcare, and home ownership, the CPF system should have a long-term orientation. The Sub-Committee is of the view that we should avoid using the CPF as a counter-cyclical, cost-cutting tool, except as a last resort in exceptional economic circumstances. However, should it ever become necessary to reduce CPF rates, this should not be done at the expense of SA contributions. We should instead accelerate ongoing efforts to enhance the flexibility of the wage system.

II. ENHANCING LABOUR MARKET FLEXIBILITY

Reducing Mandatory Contributions for High Income Earners

29. Based on December 2001 CPF data, the current monthly salary ceiling for CPF contribution of $6,000 covers 92% of active CPF members. A monthly salary ceiling of $4,000 would cover about 82% of active CPF members. In line with our proposal to peg the top contribution at no more than the 80th percentile income level, we should lower the current monthly salary ceiling for CPF contributions.

30. However, a one-step reduction from $6,000 to $4,000 would be too drastic. We therefore propose to lower the CPF salary ceiling for both employer and employee contributions from the current $6,000 to $5,000. Over 5 to 6 years, with wage growth and inflation, the 80th percentile income level should reach $5,000.

31. The purpose of this measure is not to cut wages or costs, but rather to enhance wage flexibility by reducing high statutory contributions. We therefore propose that Government phase in the lowering of salary ceilings together with the CPF restoration to 40%. This will give CPF members and the labour market adequate time to adjust. We encourage employers to make appropriate adjustments to salary packages of employees, so as to offset the CPF reduction and to reflect the employees' market value.

Giving Low Income Earners More Take-Home Pay

32. High contributions to the CPF for lower-wage workers also cause rigidities and distortions to the labour market, discouraging these workers from seeking work. Currently, employees do not contribute to CPF for wages up to $200. Employee CPF contribution rates are phased in on a sliding scale from 5% for wages at $200 to the full rate of 20% for wages at $363 and above.

33. We propose to raise these employee CPF wage bands from $200-$363 to $500-$750. This will increase the take-home pay for low-wage and part-time workers, helping them to meet their current needs, and encouraging more to enter the workforce, even if on a part-time basis. We recommend that this measure be implemented immediately. Employer CPF contributions should continue to be paid on wages $50 and above.

Enhancing Wage Flexibility and Employability for Workers Aged 50-55

34. In an increasingly competitive and uncertain business environment, the creation and retention of jobs remains a key priority. This will require greater flexibility in wages, a willingness to accept new jobs, and more frequent upgrading of skills across the workforce.

35. The past two recessions have shown that older workers, once retrenched, face more difficulty in securing re-employment compared to their younger counterparts. While a mismatch in skills is a key challenge to overcome for older workers, skills upgrading alone may not be sufficient.

36. We have to move away from a seniority-based wage system, which is more pronounced in Singapore than in other countries, so that wages are more closely tied to skills and productivity. However, this process will take time and may not be sufficient, because of institutional and labour market rigidities. We must therefore also adjust the statutory CPF component of the wage structure to help mitigate the seniority bias in our current wage structure.

37. Workers above 50 will be the most vulnerable to competitive pressures. They are less well educated than younger workers, less readily retrained and less easily redeployed into new jobs. CPF contribution rates for those above 55 are already much lower than for the rest of the workforce. We have to make similar, but more modest, adjustments for those in the 50-55 age group** *(**50 – 55 refers to those who are aged between 50 years and 1 day and 55 years exactly)*, so as to achieve greater wage flexibility and help preserve jobs for these workers. We propose that the Government keep the employer CPF contribution rate for those in the 50-55 age group at its present level of 16%, even as the rate is restored to 20% for those below 50.

38. We also propose that the Government lower the employee CPF contribution rate for those in the 50-55 age group from the present level of 20% to 16%. This should be phased in together with the restoration of the CPF rate to 40% for the rest of the workforce. This will help mitigate a reduction in take-home pay for older workers seeking re-employment in lower-wage jobs.

39. The effect will be a meaningful reduction in total CPF contribution rate, from 40% (20 + 20) for those below 50, to 32% (16 + 16) for those aged 50-55, to 20% (7.5 + 12.5) for those aged 55-61, after restoration to 40%. This will make it easier for the 50-55 age group to remain employed.

40. Employers are encouraged 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 their wages, e.g. bonuses or the monthly variable component (MVC), depending on the circumstances of each company and the contribution of each worker.

41. Some workers in the 50-55 age group may face mortgage payment shortfalls, especially when the SA and MA rates are increased by a further 3%-points and 1-% point respectively to reach their target levels. When the Government reduced the employer CPF contribution rate in 1999, a set of measures, including allowing the use of SA balances, was implemented to assist members with mortgage shortfalls. The intention was to phase out these measures when the CPF rate is fully restored to 40%. To help affected members adjust, the Government should allow workers aged 50-55 to continue to draw on their SA for a period of time, to meet any shortfalls in their mortgage repayments due to the non-restoration of employer CPF rate.

42. These proposed recommendations to enhance the flexibility of the wage structure for workers in the 50-55 age group can only be part of a larger programme of measures aimed at strengthening the long-term employability of these workers. The non-restoration of the employer CPF rate for this group signals the need to address this long-term issue and must be complemented by other sustained efforts, especially in skills upgrading and re-training.

CONCLUSION

43. Singapore faces significant economic challenges in the years ahead. We are also a rapidly ageing society. We need to refocus the CPF towards enhancing Singaporeans' financial security in retirement. This means we must safeguard a larger proportion of funds in the CPF for retirement

needs, place judicious limits on withdrawals for housing, and introduce enhanced investment options to improve risk-adjusted returns for members.

44. At the same time, the CPF system must support a more flexible labour market, so as to preserve jobs and maximise employment. Taken in totality, our recommendations seek to strike a balance between the competing priorities of enhancing retirement security, providing for home ownership, and increasing economic flexibility.