Economic Affairs; CPF savings and the elusive dream of high returns, low risk

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The question of how returns on CPF savings should be calculated has resurfaced after an economics don's surprising call for change.

When shopping, many people open their wallets on one simple principle - "cheap and good".

In the world of finance, an equivalent of the maxim would probably be "high and low" - high returns on low risk. The problem is there are almost no investments that can offer a high return on low risk, without a hidden catch. High returns must necessarily come with high risks. That is a universal law of finance.

But last week, a National University of Singapore economics don offered a suggestion that could result in returns on the Central Provident Fund becoming "high and low".

Associate Professor Chia Ngee Choon said at a symposium on pensions that the formula used to tabulate the returns on the CPF Ordinary Account (OA) could be tweaked such that interest rates on the funds can be enhanced while still bearing zero risk for the member.

Currently, the interest rate for OA funds is adjusted quarterly, to either the legislated minimum 2.5 per cent a year or the average three-month rates at the three local banks, whichever is higher.

The CPF Board has said the OA interest rate will be maintained at 2.5 per cent from Jan 1 to March 31, as the computed rate of 0.21 per cent is lower than the legislated minimum interest rate. And the first $20,000 in the OA receives even higher returns of 3.5 per cent.

But Prof Chia believes that returns on the OA should now include the returns of the GIC, a global investment firm that manages the Singapore Government's financial assets for the long term, including CPF funds.

GIC's annualised 20-year rate of return, taking into account inflation, for the year ended March 31, 2014, was an impressive 4.1 per cent. Another way of looking at it is that if you had given $100 to GIC to manage 20 years ago, your $100 would grow to about $223 today, in real terms.

By contrast, $100 left in the CPF Ordinary Account 20 years ago would grow to about $163 today.

By adding part of GIC's returns to the OA funds, members will get higher returns.

But in order to preserve the purchasing power of the OA funds, Prof Chia also proposes that the base interest rate of 2.5 per cent stays.

That would mean CPF members receive all the potential of a possible excess of returns generated by risky investments, but are protected from any risk that these investments could suffer in a negative return.

"We don't want to miss the opportunity of having a higher rate," she said. "We can still keep the 2.5 per cent guarantee. It's a win-win for CPF members."

WIN-WIN?

Prof Chia did not give specific details of how this would work, saying that her next book on the CPF would provide more clarity. But it is worth asking if there should be a direct link between the CPF monies and the investment returns generated by GIC.

This is a longstanding issue which has been debated several times in Parliament, with backbencher MPs comparing CPF returns to those of other pension funds, such as Malaysia's Employees Provident Fund (EPF). The Malaysian fund is like the CPF in that it operates on a fully funded basis, with each worker saving for his own retirement in a personal account.

Under Malaysian law, the EPF provides a base of 2.5 per cent in returns a year to funds it manages. Over the past 40 years, the lowest dividend rate has been 4.25 per cent, in 2002. In 2014, it declared a dividend of 6.75 per cent.

If one had invested RM100 in the EPF in 2005, the initial investment would have risen to RM174.30 over 10 years. In 2014, RM174.30 was worth about S$66.

The Singdollar equivalent of RM100 in 2005 was $45.50. If $45.50 had been invested in Singapore's CPF for 10 years from 2005 to 2014, it would have grown to $58.40, lower than the EPF returns.

A key difference, however, is that EPF members are not shielded from market risk, unlike CPF members.

The Singapore Government has, in recent years, come out to explain how its management of CPF funds differs from that of Malaysia's management of EPF funds. Its position was most recently set out by Deputy Prime Minister Tharman Shanmugaratnam in July 2014, during a debate on the reserves.

Mr Tharman, who at that time also helmed the Finance Ministry, explained that CPF monies are invested by the CPF Board in Special Singapore Government Securities issued and guaranteed by the Singapore Government. As at June last year, CPF net balances were about $275.4 billion.

The proceeds are then pooled together with funds raised from Singapore Government Securities and other government unencumbered assets, such as Budget surpluses from the early years of government.

Together, they are placed with the Monetary Authority of Singapore as deposits,which will eventually be transferred over to the GIC to manage. The GIC takes a long-term investment horizon with a view to generating good returns.

In this way, CPF monies are not unlike deposits in the bank, which pays depositors a fixed interest rate but reinvests the funds it holds in riskier assets, with the aim of generating higher returns.

CPF members receive a minimum of 2.5 per cent interest a year, whether GIC's investments earn or lose money. That means the risk of investment is borne entirely by the Government, which is obligated to pay 2.5 per cent regardless of what happens in the market.

APPROACH WITH CAUTION

One warning about Prof Chia's approach: While it stands to benefit CPF members, it is not a free lunch.

The model can work provided the Government is willing to give subsidies that help top up any potential losses from financial market gyrations.

How big this subsidy may eventually be will depend on the size and duration of market swings. Some downturns can last more than a year, which means that the Government's balance sheet will have to be strong to weather the downturns.

Senior research fellow Christopher Gee of the Institute of Policy Studies (IPS) believes that the CPF currently offers the best risk-free return that few in the private sector can match.

"I'm not sure you can find a better return-risk trade-off out there anywhere in the private markets, and the return is structured to cater to the large majority of CPF members' needs and risk profile; they should satisfy all but the most risk-hungry, most likely top quintile CPF members, for whom their CPF payouts are likely to be a minor component of their overall retirement financial plans," he said.

In an IPS paper published last year, Mr Gee and consultants from Towers Watson found that under certain assumptions, such as rising interest rates, the returns from the CPF Board largely correspond to the typical model portfolio that has invested 60 per cent of its funds in equities, with the rest in bonds.

The model assumes that interest rates will rise to 4 per cent in 10 years, up from nearly zero today. The second assumption is that the 10-year Singapore Government bonds will pay 5.3 per cent a year, up from about 2.2 per cent now.

The study also continues to assume that the CPF will continue to pay an additional percentage point for the first $60,000 of the CPF Ordinary and Special accounts, as it does now.

Under these circumstances, CPF monies could provide about 5.7 per cent a year in returns over 20 years.

With this type of compounded returns, retirement savings will be easily accumulated - $100 today will triple to $303 in 20 years' time.

A final point to consider is that GIC's returns already benefit the population at large. This is how individual Singaporeans, including those too poor to have much or any CPF savings, benefit from GIC's returns currently.

Up to 50 per cent of Net Investment Returns (NIR) of net assets managed by GIC and MAS can be used by the Government for its Budget.

For the current fiscal year, the NIR Contributions account for about $8.9 billion, or 13 per cent of the entire Budget.

Much of the investment returns pay for the increased spending on social welfare, including income support for older folk and needy families.

So the question on GIC returns is really a philosophical one. It is about whether individuals should benefit directly or whether the Government should de cide how best to channel these returns and to whom.

The Government believes it can, through targeted subsidies and support, be more efficient in channelling the surpluses from investment returns to people and families who need more help, rather than to place the returns directly in the hands of CPF members.

As Dr Linda Low, currently a senior research fellow at IPS, noted in a research paper written back in 2004, what the returns should be used for boils down to "a political decision on what role the CPF should play, serving state or members".

In other words, the heart of the debate is not whether CPF interest rates can give a "high and low" type of ideal returns, but how the returns from investing the reserves, government assets and CPF monies should be distributed.

That is a lot harder to answer than building a model to figure out the data and numbers. It is a question that Singaporeans will need to pose and answer collectively.