NUS National University of Singapore

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CPF reform: Nudge people to make optimal choices

By SUMIT AGARWAL
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IT IS a simple fact of life that we're all getting older. Not just older as individuals, but also as a nation.

With more of us living longer, pressure is building to make sure that we can look after ourselves in what is (rather tweely) referred to as our golden years.

The challenge is deciding where the boundaries of responsibility lie. How much is down to the individual, and where – and how – should the Government step in?

Here in Singapore, the government advisory panel reviewing the Central Provident Fund (CPF) system has touched on some inevitably sensitive issues. A particularly thorny one is regulation of lump sum withdrawals and the Minimum Sum scheme.

How then should the Government approach this?

As an economist, I'm inclined to oppose restrictions, or at least be in favour of minimising their application. Restrictions create market distortions and inevitably invite pushback as individuals seek ways to get around them. But giving people options also requires the Government to devise mechanisms to "nudge" people into choices that are optimal for them and for society.

In other words, rather than increasing regulations saying to savers more and more about what you cannot do, say instead what you can do, explain what makes it the better option, and thus nudge and guide them towards doing so.

However, the Government does, to a degree, need to take a paternalistic stance – particularly towards older adults who, my own research has shown, have a greater tendency to make more suboptimal financial decisions. Looking at the issue of lump sum withdrawals, for example, there is certainly a risk that more seniors will take out large sums from their funds, leaving little left to provide a liveable monthly income.

The question then is not whether the Government should intervene, but rather which mechanisms of intervention it should use. I would argue that efforts should be focused on improving the general financial literacy of individual savers, and reminding them of the negative costs associated with withdrawing lump sums.

This, in turn, should be supported by risk-free incentives for them to keep their money invested, with outcomes explained in simple terms, thus empowering individuals to make the best choices for their own futures.

It is important also to introduce more heterogeneity into the system. One-size-fits-all options rarely end up fitting anyone particularly well and almost inevitably deliver suboptimal outcomes for the majority.

We are all different and the recommendations from the CPF panel acknowledge that the question "How much do I need to retire?" does not have a uniform answer.

The panel has recommended that there be three brackets of Minimum Sum, and an option to withdraw up to 20 per cent of savings at age 65.

But tempting as they may be, lump sums are of course more than just cash bonanzas to be spent on a new car or a cruise. Used wisely and reinvested, they have the capacity to deliver further returns above and beyond the monthly payments from the CPF. Building awareness, understanding and incentives towards these options should be given priority.

The challenge here is that governments are notoriously bad at communicating and explaining to those they govern what policies mean and how they will affect them.

Furthermore, those whose job it is to manage financial products too often converse in an impenetrable jargon that they feel justifies their salaries but does little to help guide savers towards making optimal decisions.

And on top of that, there is also the "important-but-boring" factor to overcome. After all, financial planning for a regular income in retirement has much less glamour to it than the tempting prospect of getting your hands on a large sum of cash. Presented with a choice, it is not hard to see which has more appeal.

All this does not mean that better communication on the part of the Government is impossible. With a wealth of digital and interactive tools available, creativity and imagination can be deployed to convey the benefits of financial planning and individual responsibility.

What is needed is a simple and clear set of options, with incentives to encourage more savings. This, coupled with a broader national effort to ensure that everyone – not just those nearing retirement age – has a degree of financial literacy to make the best decisions for their future. Such an effort would have widespread benefits.

By raising the level of financial education, we increase understanding of planning and investment options – how best to make use of that lump sum, for example – and improve understanding of risk. Being better informed is, after all, the foundation for making better decisions.

Financial literacy does not mean everyone acquiring an MBA-level understanding of the inner workings of the derivatives market. But it does mean ensuring that we live in a society where individuals are better able to distinguish between the temptations of personal short-term gratification and optimising their returns for all of our long-term interests.

stopinion@sph.com.sg

The writer is Low Tuck Kwong Professor of Finance and Research Director of the Centre for Asset Management Research and Investments at NUS Business School.