Annuity Values in Defined Contribution Retirement Systems: The Case of Singapore and Australia

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This project is funded partly by the Wharton-SMU Research Center of Singapore Management University
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January 2002

Support for this research was provided by the Australian Research Council, the Pension Research Council at the Wharton School, the National Bureau of Economic Research, the Economic and Social Research Institute of the Government of Japan, and the Wharton-SMU Research Center at Singapore Management University. The authors are grateful to Matthew Williams for research assistance. Helpful comments were provided by Estelle James, Ooi Wai Shyong and Augustine Tan. Opinions remain those of the authors and not of the institutions with whom the authors are affiliated. © 2002 Doyle, Mitchell and Piggott. All rights reserved. Small segments of text may be used with attribution.
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Abstract

Annuities will plan an increasingly important role in countries with national defined contribution retirement systems. In this paper we examines life annuities in two countries, Singapore and Australia, each of which has a national mandatory pension program. Exploiting data on annuity pricing and purchase behaviour, we compare the money’s worth of life annuity products across these two nations. Our results indicate that, after controlling on administrative loadings, there are important differences in measured adverse selection. Part of the explanation may be due to the different structures of the two countries’ retirement systems.

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Throughout much of the developed world, programs have been developed to provide a degree of insurance against old-age risk. For example, public defined benefit (DB) plans in some countries pay retirement benefits that protect the aged against outliving their resources due to longevity risk and/or financial misfortune. Corporate DB plans also are typically configured to pay out a guaranteed retirement income stream linked to worklife earnings and continuing until death (McGill et al. 1996). More recently, a rather different pattern of risk-bearing is taking shape as countries move toward defined contribution (DC) retirement systems. Either publicly-mandated or voluntarily provided, the DC model is accumulation-based, characterized by specifying the contribution that must be made to the plan, usually as a fraction of employee earnings.

The DC model is very popular in Australia as well as in various Asian countries, most notably Singapore, where it offers an accumulation structure with mandatory contributions to individual accounts. DC plans have been proved to be powerful engines for channelling workers’ earnings into retirement saving (Palacios and Pallares-Miralles, 2000). Yet in the rush to establish DC accumulation vehicles, there has been too little attention on how these plans function during the decumulation phase. The specific problem confronting DC participants is that retirement asset accumulations must be managed carefully beyond the retirement date all the way to death, so as to ensure a dependable flow of income in retirement (Bodie 2000).

Economic studies have previously demonstrated that products such as life annuities can play a key role in the decumulation process, working to ensure a degree of consumption smoothing through time.\(^1\) Despite the theoretical attractiveness of annuities, evidence from the US and the UK shows that few people hold annuities in their retirement portfolios and voluntary annuity markets remain thin. Part of the reason may be that life annuity prices appear high relative to population life expectancy and to alternative investment returns, though of late, prices have been dropping steadily (Brown et al. 2000). In other countries little is known about annuity market performance, and this is the subject of our analysis. Specifically we compute and assess the money’s worth of individual annuities offered in Singapore and

\(^1\) See for instance Friedman and Warshawsky (1988, 1990), Warshawsky (1988), and Mitchell et al. (1999).
Australia. Both countries rely on a mandatory DC-type plan as their primary employment-linked compulsory retirement vehicle, but the two countries have sharply contrasting annuity markets and old-age support systems. After we laying out the assumptions and methods used to calculate money’s worth of lifetime annuities, we discuss findings. The paper concludes with a discussion of the potential relevance of our results for other countries.

The Retirement Framework in Singapore and Australia

Singapore and Australia were deliberately chosen for this study because both rely on mandated contributions to national DC systems, rather than on pay-as-you-go taxes to finance an employment-related retirement benefit program. In Singapore, the Central Provident Fund (CPF) operates as a centrally-administered publicly-mandated retirement scheme built around individual accounts. Both employees and employers must contribute a substantial fraction of earnings until the employee attains age 55. The current contribution rate is set at 32 percent, split between employers and employees, though the rate was 40 percent until the Asian crisis.² Fund accumulations are used partly to provide a buffer to cover participant healthcare expenses (6 percent) and they may also be used for the (heavily subsidized) purchase of residential property. They may sometimes be used for small business investment and education. Other than the CPF, the Central Government provides limited financial support for the aged. Fewer than 2 percent of the elderly receive social assistance from the government, and an emphasis is placed on family provision for the elderly. In addition, labour force participation among the elderly is high by developed-economy standards.³

In Australia, by contrast, a relatively generous and means-tested social safety net insulates the elderly from destitution.⁴ By law, the minimum-income safety net is targeted so the monthly indexed pension for life amounts to 26 percent of average male full-time earnings for a single pensioner and 43 percent for a couple. This social insurance payment, along with the owner-occupied housing paid for over workers’ lifetimes, is the major source of retirement finance for most elderly Australians today. The age pension benefit is means-tested against both private income and assets, but the thresholds are set relatively high: over half the aged in

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² It is anticipated that the contribution rate will return to the 40 percent level in the future.
³ For a more detailed discussion on the Singaporean pension system see www.cpf.gov.sg and also Asher (1999), among others.
⁴ For more on the Australian retirement system see Bateman, Kingston and Piggott (2001)
Australia currently receive a full government old-age benefit, and 80 percent receive some payment from this safety net program.

In addition to the safety-net benefit, Australia has mandated a privately-managed defined contribution system termed the “Superannuation Guarantee” system. Under these rules, employers must pay 9 percent of earnings (phased in through 2002-03) to a pension plan, with the plan manager selected by the employer. Participating employees have some freedom over portfolio choice, subject to offerings provided by their plan manager. The retirement accumulation is required to be “preserved” – that is, not used by the worker for virtually any reason – until the age of 55. (This latter age is being increased to 60 over time). Thus far, accumulations have been well-insulated against non-retirement uses (e.g. housing or education).

**Retirement Payouts in Singapore**

The Singaporean CPF design has a mandatory contribution rate of up to 40 percent of payroll, a level that might lead one to conclude that Singaporean workers would reach retirement age having accumulated large holdings in their DC portfolios. This turns out not be the case, however, since the accumulation need not be preserved in the fund to retirement age. In fact, the bulk of the funds is actually used for investment in housing. Consequently retirement accumulations in the CPF financial portfolio are generally low by retirement age (McCarthy et al, 2001).

This outcome prompted a policy change in the early 1990s, when retirees were required to have what is termed a “minimum sum” at retirement – one that must be accumulated by age 55. This minimum sum is a lower-bound financial asset target that by law must now be preserved for a further 7 years until age 62. The minimum sum was set at $Sg 65,000 in the year 2000, rising to $Sg 80,000 by the year 2003. Currently only a minority of retirees has accumulated enough assets to meet the minimum sum requirement by age 55 in financial assets, with most having to “pledge their dwelling equity” to make up the shortfall. The key here is that pension accumulations up to the minimum sum cannot be taken as a lump sum at retirement. Rather, when the funds become accessible at age 62, they must either be left in the CPF to earn interest, be deposited in an approved bank for gradual and regulated drawdown, or be used to purchase a life annuity.

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5 Legislative initiatives are pending to free up this restriction.

6 Throughout, domestic currencies are used for dollar values. As at July 2000, $US 1 = $Aus 1.76; and $US 1 =
The effect of this CPF regulatory evolution has been to boost the size of the annuity market in Singapore substantially. Table 1 indicates the number of annuities sold each year over the last decade. Except for a decline during the Asian crisis, annuity sales have shown a steady increase over this period. In 1999, for instance, about one-sixth of the retiring workforce purchased an annuity, a rather large penetration rate compared to other countries. This represented the sale of 3,200 annuities for an aggregate premium value of $Sg 173 million, out of about 22,000 new retirees that year.

There are several annuity issuers in Singapore offering products that differ in detail but are similar in broad structure. The preservation requirement means that all annuities offered are deferred for 7 years; after that, they typically have a guarantee period or repayment sum, which extends for some other number of years. Some annuities are offered with escalation of 1 or 2 percent a year or with a discretionary profits add-on. One frequently-offered option is to purchase a nominal life annuity with a 7-year deferral period and also a further 15-year guarantee period. This is equivalent to purchasing a 15-year term annuity that is deferred for 7 years, along with a life annuity promising the same monthly payment deferred for 22 years. We have chosen this as our exemplar in the money’s worth calculations reported below.

**Retirement Payouts in Australia**

Payouts from employer-sponsored pension (Superannuation) plans in Australia are relatively lightly regulated. Benefits may be taken as a lump sum up to generous limits, and about 75 percent of payouts are currently in this form. In contrast with Singapore, the Australian retirement income stream market is relatively small, comprising a diverse array of investment and retirement provision products. Available arrangements may be classified into three major product groupings: lifetime annuities, term certain annuities, and phased withdrawals which are called “allocated annuities and pensions.” Both life and term annuities have been available in the Australian market for many years, while the allocated products have only been on offer since late 1992. A snapshot of this market indicates that allocated annuities and pensions attract the largest proportion of income stream capital, representing over 70 percent of total funds under management in July 2000. On the other hand, Figure 1 indicates $Sg 1.8.

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7 These payouts are frequently invested after being withdrawn, but no reliable data exist on their exact disposition.
that the combination of term and life annuities represents only 29 percent of the funds under management in Australia.

*Figure 1 here*

Allocated products have characteristics quite different from other income stream products. First, there is no pooling of longevity risk so there is a chance that the annuitant could run out of money before death. Second, the investment risk of retirement capital is entirely borne by the annuitant, and as such they can choose from an array of investment options. Of the total funds under management in allocated products, 63 percent are with managed funds, 23 percent in capital stable and 14 percent with the money market (Plan for Life Research 2000b). These products can only be purchased with specific retirement saving money, and the annual income drawdowns can vary between an upper and lower threshold. These characteristics have made allocated products very popular with Australian retirees, which is evident by the growth experienced since the early 1990s.\(^8\)

Life and term annuities of course can protect purchasers against rate of return risk. That is, payouts may be fixed in nominal terms, indexed to inflation (the CPI), or escalated at a fixed rate. A guarantee period can be nominated at the time of purchase, where payments continue to be paid for a minimum period even if the annuitant dies during this time. These annuities can be bought with funds from any source. A term annuity may also be specified to pay back a percentage of the original capital on expiry of the contract — a residual capital value (RCV). Many of the short-term annuities specify an income of interest only and 100 percent return of capital at the end of the contract, while many of the longer-term annuities specify an income comprising both interest and capital. Short-term annuities are the most popular form of immediate annuity offered in Australia, relative to genuine longevity and long-term annuities (life and life expectancy products).\(^9\) As seen in Figure 2, the incentive structure implemented in 1998 designed to encourage longevity annuities has not resulted in a large swing towards these types of income stream products.\(^10\)

*Figure 2 here*

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8 Since their introduction, funds under management have increased from around $Aust 3 billion to more than $Aust 25 billion in June 2000 (Plan for Life Research 2000b).

9 Short-term annuities are an attractive and tax-preferred means of preserving superannuation accumulations between preservation age and actual retirement.

10 Longevity annuities meeting certain criteria are income and asset test exempt under eligibility criteria for the Age Pension.
Available market data suggest that very few people in the retiring population buy genuine longevity annuities at retirement. In June 2000, there were 125,849 term and life annuity policies in force in Australia, of which one-quarter were life annuities and three-quarters were term annuities. New sales are also highly skewed toward the term policy: in 1999, of 33,001 immediate annuity policies sold (worth $A 2.75 billion), approximately 3,000 were life annuities and 10,000 term annuities with no RCV. Based on Australian Treasury data, this indicates that only 3 percent of the estimated 100,000 Australians retiring each year purchased a life annuity.  

Turning to allocated annuities, by June 2000 the stock of recipients stood at some 244,000 people receiving allocated annuities/pensions, with sales of over $5.5 billion in the 1999-00 financial year (Plan for Life Research 2000b).

**Calculating Annuity Money’s Worth**

An annuity promise represents a stream of income payments over a future period, with the payout duration a specified term or contingent on a specified event (e.g., an individual’s survival). This latter contract is the simplest form of a life annuity. Annuitants typically pay a lump sum (or single premium) to an annuity provider in return for the promised stream of payments. In a competitive market without commercial costs, the equivalence principle implies that the expected present discounted value (EPDV) of the benefit stream measured over the covered population should equal the original aggregate amount paid for the annuity. Simple equivalence is unlikely to hold in practice, of course, because there are costs that annuity providers have to cover including commissions, administration and marketing costs, reserves, and taxes.

The divergence between the initial premium and the EPDV of an annuity has been termed a “loading” by various authors including Friedman and Warshawsky (1988, 1990) and Mitchell et al. (2000). The EPDV of $1 in premium used to purchase an annuity is the money’s worth of the annuity, and the difference between the initial $1 premium and the EPDV of the annuity represents the proportion of the premium that the annuitant is giving up in order to obtain longevity insurance.

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11 A life annuity can be purchased at any time by a retiree, not just at their initial retirement date. The retiree estimates are based on unpublished Treasury data on workers over 55 withdrawing from the labour force.
When the EPDV is calculated with population mortality tables the loadings can be substantial. Ten years ago, voluntary private annuity markets in the US, for instance, had total loadings on a nominal individual annuity worth almost 20 cents per dollar of premium for a 65 year old male, and 15 cents for a 65 year old female (Mitchell et al., 2000). These loadings have come down substantially in recent years (Brown et al., 2000). Such loadings reflect not only commercial costs but also adverse selection.

Annuity issuers use annuitant mortality tables to factor in the lighter mortality of voluntary annuity purchasers. The loadings on an annuity are smaller when valued using an annuitant mortality table - on this calculation, the loading reflects only commercial costs. The difference between the EPDV of an annuity calculated using population versus annuitant mortality tables reflects the extent of adverse selection. The existence of adverse selection in the US voluntary annuity market is documented by Brown et al., (2000), Mitchell et al., (2000), and Friedman and Warshawsky (1988, 1990). To a limited extent, it is also present in the UK.12 One interesting finding thus far is that in the US, nearly half of the disparity between the expected discounted value of the payouts and the policy premium appears to be due to adverse selection. In the UK, adverse selection also accounts around half of the total loading on voluntary annuities (Finkelstein and Poterba, 1999).

**Defining Annuities Money’s Worth Values**

An annuity’s money’s worth is the ratio of the EPDV of annuity payments to the initial premium paid. The EPDV for a nominal annuity with a guarantee period is calculated according to:

\[
\text{EPDV (nominal)} = \sum_{i=1}^{N} A_{x} \frac{A_{x}}{(1 + r_{t})^{i}} + \sum_{t=1}^{(\omega - x)^{2}} A_{x} \frac{p_{x}}{(1 + r_{t})^{i}}
\]

where \(N\) is the guarantee period, \(x\) is the age at which the annuity is purchased, \(r_{t}\) is the riskless nominal interest rate at month \(t\); \(\omega\) is the maximum life span, \(A_{x}\) is the monthly annuity rate at the age of purchase; \(p_{x}\) is the probability that an individual age \(x\) will be alive after \(t\) months.

The money’s worth is then simply the EPDV divided by \(K\), the premium used to purchase the annuity:

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\[ MW = \frac{EPDV(\text{nominal})}{K} \quad (2) \]

There are three important variable inputs to the EPDV calculation: the annuity market quote, the interest rate used to discount the annual payment, and the mortality table used to determine how quickly to pay out the asset base over time. Data on the annual annuity payments and expected interest rates are drawn from market information, and for the purposes of money’s worth calculations, are fairly straightforward to obtain.

Mortality estimates are more difficult to come by, and our approach requires some elaboration. To calculate the money’s worth of market annuities and the extent of adverse selection, mortality estimates are needed for the general population and for annuitants.\(^{13}\) These must be developed on a cohort basis and appropriately dated to match annuity pricing.\(^{14}\) A cohort mortality table is generally constructed for each birth year representing the actual (or anticipated) mortality experience of that specific birth cohort. For example, if we need to project the expected longevity of a 55-year old Singaporean male in the year 2000, the 1945 birth cohort table would be appropriate. Cohort life tables take into account expected future mortality improvement,\(^ {15}\) and thus they provide the basis for calculating how long an individual might be expected to live.

When the annuitant cohort mortality table relevant to a given market is available, it may be used to compute money’s worth results. In practice, however, many countries have not collected enough data to derive annuitant cohort tables, usually due to insufficient local annuitant experience. In such a circumstance, insurers frequently make use of annuitant cohort tables from other countries having extensive annuity markets, and then transform them to approximate their own national experience. This is the approach adopted in both Singapore and Australia.\(^ {16}\)

\(^{13}\) These mortality assumptions are the cumulative probability of living \( t+x \) for an average person from the annuitant population (based on an annuitant population mortality data) and the cumulative probability of living \( t+x \) for an average person from the general population (derived from a general population mortality data).

\(^{14}\) Thus annuity prices for 2000 should use life tables for that same year, if possible, for money’s worth valuations.

\(^{15}\) Period tables describe the mortality rates of individuals at different ages in a given year. On the other hand, cohort tables describe the mortality experience for a given birth cohort as it reaches different ages. Therefore, to value an annuity purchased in 2000 by a 55-year old, we need a cohort table rather than a period table. For example, the chance that a 55 year old in 2000 will die at age 65, having survived to that age, will depend on the mortality rate of 65-year-olds ten years from now, not on the mortality of current 65-year olds. See also McCarthy and Mitchell (2000).

\(^{16}\) For further discussion on annuitant mortality tables see McCarthy and Mitchell (2000) and Mitchell and McCarthy (2000).
Population cohort tables must almost always be derived from period life tables, which are published from time to time by statistical agencies. As with annuitant tables, these must be adjusted to match the year for which annuity pricing data are available. In addition, the tables must be transformed into cohort tables by incorporating projected mortality improvements. Typically these improvements are extrapolations of past mortality improvements recorded between two previous time periods for which life data have been collected. Where available, age-specific projected mortality improvements can also be incorporated.

Figures 3 and 4 plot cumulative survival probabilities for males and females age 65 in Australia and 55 in Singapore. The salient feature to be drawn from them is the greater prominence of differential annuitant mortality for both males and females in Australia, as compared to Singapore.

Figures 3 and 4 here

**Singaporean Mortality Calculations**

Singapore’s Department of Statistics publishes life tables for the population based on census data approximately every decade. The most recent life tables available were derived from 1990 data, and they are period tables: that is, they provide information about mortality of a cross-section of ages at a point in time and make no allowance for improvements over a cohort’s lifetime. To transform these 1990 Singapore population tables into a form where they may be used to estimate annuity money’s worth, two separate operations must be undertaken: first the 1990 tables must be “aged” to 2000, and then they must be “cohortized”.

To explain the process, aging the Singapore population table involves incorporating mortality improvements for each age and gender combination into the most recent period table. We estimate future mortality improvements by extrapolating past improvements implied by mortality changes between the 1990 and 1980 population tables. Specifically, the mortality improvement over the decade is given by:

\[
\alpha_x(1990 - 1980) = \frac{q_x(1990)}{q_x(1980)}
\]

where \(\alpha_x(1990 - 1980)\) is the mortality improvement rate over the 10 years for each age (represented by \(x\)) and gender combination. These rates are then applied to the 1990 mortality rated to find the 2000 rates:
\[ q_x(2000) = \alpha_x(1990 - 1980) \times q_x(1990) \]  

(4)

where \( q_x(2000) \) is the period mortality probability for an age \( x \) individual in 2000.

The resulting period population table for 2000 then must be “cohortized”. This process relies on the mortality improvement factors given by (3), but it also requires a separate adjustment for each age cohort. For individuals of age \( x \) in the year 2000, the cohort mortality rate \( \hat{q}_x \) is defined as follows:

\[ \hat{q}_x(2000) = q_x(2000) \times \left(1 + \frac{-\alpha_x}{100}\right)^0 \]  

(5)

where \( \alpha_x \) now represents the estimated annual mortality improvement for an individual aged \( x \).

In (5), no change results. But a year later, the expectation of survival will be improved at a rate assumed to be equal to the annual mortality improvement for individuals aged \( x+1 \). This is given by:

\[ q_{x+1}(2001) = q_{x+1}(2000) \times \left(1 + \frac{-\alpha_{x+1}}{100}\right)^1 \]  

(6)

Two years on, the mortality of the cohort is given by

\[ q_{x+2}(2002) = q_{x+2}(2000) \times \left(1 + \frac{-\alpha_{x+2}}{100}\right)^2 \]  

(7)

In general, cohortization of a period table is given by:

\[ \hat{q}_{x+t}(2000 + t) = q_x(2000) \times \left(1 + \frac{-\alpha_{x+t}}{100}\right)^t \]  

(8)

For money’s worth calculations, cumulative survival probabilities are required, given by:

\[ \hat{p}_{x+t} = 1 - \hat{q}_{x+t} \]  

(9)

\[ t \hat{p}_x = \prod_{t=1}^{(\omega-x)} \hat{p}_{x+t} \]  

(10)

17 These have been drawn from Swee-Hock (1981) and Tan (1996). Dr Tan kindly supplied us with annualized 1990 life tables.
where \( \hat{p}_{x+t} \) is the probability of a person aged \( x \) surviving the year to age \( x+1 \), and \( \hat{p}_x \) is the cumulative survival probabilities for a person aged \( x \) surviving \( t \) years. These are calculated for each age and gender on a monthly basis.

Annuitant mortality experience in Singapore is limited, so the standard industry practise is to adopt the annuitant mortality experience of the UK, and adjust it for country specific factors. The a90 mortality tables from the UK reflect individual annuitant experience, which is lagged by 3 years to allow for country differences. These are cohort tables, so no further adjustment is necessary.

**Singapore Annuity Quotes and Interest Rates**

On reaching age 55, Singaporeans have various options for securing their retirement income. As already discussed, one of these options is to purchase a life annuity from an approved insurance company with the minimum sum of $Sg 65,000. Annuities offered in the private market have a deferral period of 7 years until age 62. During this time, benefit payouts are not made so retirees must find alternative sources of income. On reaching the age of 62, annuity payments commence.

To conduct the money’s worth calculation, we base our computations on an annuity design with a guarantee period of 15 years from the first payment. The annuity contract can thus be broken down into three components: a 7-year term deposit (ages 55-62); a 15-year term annuity (ages 62-76); and a life annuity commencing at age 77. This decomposition makes it possible to compare annuities with similar features offered in other countries.

These calculations also rely on the company weighted average monthly payments from the insurance companies for a life annuity financed by the minimum sum, reported in Table 2.\(^{18}\) We note that there is considerable variation between annuity issuers in the first-month payouts. For example, a nominal life annuity purchased for $65,000 by a 55 year-old male pays out between $468 and $600 per month (as of July 2000). Similar dispersion in annuity payouts have been detected in both the US and UK annuity markets (Mitchell *et al.*, 2000, Finkelstein and Poterba 1999). Table 2 also shows that the payouts for men are higher than those for women across the same annuity products. This reflects the fact that women on average live

\(^{18}\) Details are available at [http://www.cpf.gov.sg/cpf_info/home.asp](http://www.cpf.gov.sg/cpf_info/home.asp)
longer than do men, and the insurance company therefore expects to pay the annuity out over a
longer period.

*Table 2 here*

The final piece of information required to calculate a money’s worth is the interest rate
at which to discount the value of income payments made over time to the present value. To do
this we make assumptions about the term structure of future short-term nominal interest rates.
The term structure of yields on Treasury bonds are used to estimate the time series of expected,
future, nominal short term interest rates. The first year rate is derived from the December 2000
1 year T Bill, and the December 2000 2,5,7, and 10 year Treasury bond rates are used
thereafter\(^\text{19}\). The estimated nominal short rate in each alternative period is calculated as the
average of the two adjacent long term bonds.

**Australian Mortality Calculations**

Money’s worth values for Australian annuities are derived using a similar approach to
that used for Singapore (Doyle, 2000). As in Singapore, the Australian annuity market is small,
limiting the data available with which to derive an Australian annuitant table. For this reason,
standard industry practice is to use annuitant tables from the UK and modify them to represent
the Australian population. Currently 60 percent of the Individual Male 1980 and Individual
Female 1980 (IM80/IF80) ultimate tables are used to benchmark annuitant mortalities in
Australia, a standard recommended by the Australian Institute of Actuaries.\(^\text{20}\) This adjustment
captures future mortality improvements, thereby effectively becoming a cohort mortality table.

Population cohort tables are generated from the Australian Life Tables (period tables)
based on census data. These are adjusted by 100-year based mortality improvement factors
provided by the Australian Government Actuary (1998) to generate population cohort tables.\(^\text{21}\)

**Australian Annuity Quotes and Interest Rates**

There are 13 Australian life offices with in-force life annuity business. However, there
are only 9 issuers currently writing new business. The annuity quotes used in the money’s
worth calculation are the average company weighted value of quotes for December 2000. The
annuity type chosen is a nominal individual annuity with a 10-year guarantee feature for 65

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\(^{19}\) Sourced from the Dataroom on the Monetary Authority of Singapore website, found at www.mas.gov.sg.

\(^{20}\) For Solvency standards, 60% of the IM80/IF80 tables are recommended. However, this is viewed as a rather
conservative assumption. Annuity issuers tend to offer annuities on a more competitive basis.

\(^{21}\) Further details are provided in Doyle (2000).
year old annuitants. The money’s worth results are based on the first year monthly payout from
the annuity. The industry average is given in Table 3.

*Table 3 here*

The term structure of yields on Treasury bonds is used to estimate the time series of
expected, future, nominal short term interest rates for Australia. The December 2000 1,2,3,5
and 10-year Treasury bond rates are used (RBA 2001) to estimate the term rates. Again, the
bond rates adjacent to two long bond rates are estimated on an average basis.

**Money’s Worth Results**

Annuity expected present values are computed according to equations 1 and 2, taking
the information on mortality, annuity payments, and interest rates for each country.
Calculations are performed using both population and annuitant mortality (see Table 4).

Turning first to the Singaporean annuity markets, and following the old-age benefit law, we
assume that the retiree purchases a nominal annuity at the age of 55 for the minimum sum of
$Sg 65,000, although payments do not commence until age 62. In the event that the annuitant
dies during this period, the account balance reverts to the retiree’s estate. Our results show that
$1 of premium spent on purchasing a nominal life annuity by a 55-year old male drawn from
the general population in 2000 would generate nearly 108 cents in annuity income (in net
present value terms). This implies that the annuity issuer is charging a negative fee for its
services. Given the term structure and mortality data we have used, an actuarially fair annuity
would deliver a monthly income of $515. The company-average annuity quotes we use
produces a much higher figure, of $555.

*Table 4 here*

One explanation for this finding is that annuity premium quotes have lagged declining
government bond rates in Singapore over the period. Another is that insurance companies
may bear some risk in their investments. In Singapore, for example, available information
suggests that insurance company investments were one-third equities and one-quarter real
estate and loans. Yet an additional point is that when annuities are a relatively new product in a
financial market, insurance companies may price aggressively to build business. As long as the
annuity segment is only a small component of the overall business, companies may be willing
to cover annuity losses from other income. A final explanation is that in Singapore many corporations are government-run, so that corporate bonds can be regarded as relatively safe investments. If the government bond term structure were boosted by one percent to allow for higher corporate rates, the resulting money’s worth ratios would fall to 92.79% for male annuitants, and 94.19% for female annuitants.

The money’s worth values reported for Australia indicate substantially higher loadings than in Singapore. Thus the value is over 11 percent lower for an annuity sold to a 65-year old male drawn from the general population. Our estimates are similar to those reported for the UK by Finkelstein and Poterba (1999), who find loadings of about 14 percent for nominal annuities (using population mortality and the premium for a 65-year old male in 1998). The estimates are somewhat smaller than those reported for the US for 1995: Mitchell et al (2000) report a loading accounts for 18.4 cents out of a $1 premium for a nominal annuity (using population mortality for a 65-year old male). On the other hand these US loadings are falling over time, probably due to increased market competition (Brown et al, 2000).

Table 5 here

It is worth asking whether the observed difference in loadings between Singapore, on the one hand, versus the Western countries, on the other, would shrink if annuitant mortality assumptions are used. The loading for US nominal annuities purchased by 65-year old males using annuitant tables was only 8 percent (Mitchell et al, 2000); in the UK, Finkelstein and Poterba (1999) found a 5 percent loading for the annuitant pool only. The corresponding loading in Australia for annuitants is also 5 percent. In Singapore, the loading is again positive, implying there is no net cost to an annuity; in other words the insurers issuing annuities do not appear to be making money on the annuity business they write (though cross-selling may make them a loss-leader).

Evidence of Adverse Selection

Insurance companies calculate their premiums knowing that annuitants are longer-lived than members of the general population. Given this, it is expected that the EPDV of actuarially fair annuities will be less than unity, based on general population cohort mortality tables. Also the EPDV of annuities based on annuitant cohort mortality tables would be expected to be

22 Money’s worth ratios exceeding unity are also reported for Singapore by James and Vittas (1999), who produce ratios as high as 125% using a July 1999 term structure. With that structure our ratios would fall to 97.6% for male
uniformly higher. The difference between the money’s worth of an annuity based on annuitant mortality and the money’s worth of an annuity based on population mortality is our estimate of the extent of adverse selection in the life annuity market.

Table 6 show very small estimated differences in Singapore: for example, the cost of adverse selection is only 0.69 for men and −1.02 percent for women. That is, adverse selection in the Singapore annuity market accounts for only a minuscule fraction of the total life annuity loading. In fact, for women, it appears that the money’s worth using population mortality is greater than for annuitant mortality; this somewhat perverse result follows from very small mortality differences between the two groups. To an approximation, in Singapore, annuitant tables along with adjustments reflect cohort population mortality. By contrast in Australia the differences are larger, at 6 percentage points for men and 3.6 percentage points for women. 

Table 6 here

The differences across the two countries could be consistent with several explanations. One we favor is that the overall structure of the national old-age system influences the way in which voluntary annuity markets work. Thus in Australia, the government provides a pay-as-you-go minimum welfare benefit sufficient to prevent most elderly from falling into poverty. As a result, few people feel that they need to convert private wealth into an annuity, and consequently annuity penetration is low and adverse selection is high. In Singapore, by contrast, social assistance outside the CPF is rare. Partly due to this, adverse selection in the pool of annuity purchasers appears low and penetration rates are high. It is interesting that this result holds, even though relatively few Singaporeans have sufficient liquid assets to attain the minimum sum threshold at age 55. That is, the group most able to purchase annuities is also more likely to represent the wealthier segment of the population. It is possible that this group may have greater longevity than the population at large, a factor that would only make the money’s worth larger if adjusted for. While there insufficient evidence to prove this hypothesis, it is certainly compatible with the evidence.

Sensitivity to Mortality Patterns

As noted earlier, annuitant mortality tables for Singapore and Australia are derived from UK annuitant tables and modified accordingly for each country. We therefore carried out

annuitants, and 99.5% for female annuitants (with population mortality).
sensitivity analysis to see how variations in mortality might affect our results. To do this, we modified the tables to allow for life expectancy to vary by two years either side of our central case estimates, dated from the year of purchase. For Singapore, the mortality of a 53-year old then represents a –2-year adjustment and the mortality of a 57-year old represents a +2-year adjustment. The same 2-year adjustment is applied to the Australian annuitant mortality table with the base age of 65.

Figure 5 illustrates how this adjustment changes the cumulative survival probability for Singaporean males and estimated results appear in Table 7. The –2-year adjustment exacerbates adverse selection, while the +2 year adjustment reduces adverse selection, relative to the base case results reported in Table 6. In Singapore, the adjustments make more difference to the adverse selection results for males than females. The –2-year adjustment also results in the evidence of adverse selection for both genders. For the Australian case, the –2-year adjustment results in higher adverse selection and lower margins for the issuer on the annuity business.

*Figure 5 and Table 7 here*

**Discussion and Conclusions**

Despite their theoretical attractiveness, lifetime annuities are not terribly popular in US and UK retirement portfolios, and voluntary annuity markets remain thin. Possible explanations come to mind, including the possibility that (a) older people may not convert all their assets to annuities because they plan on bequeathing some of the funds to their heirs; (b) older people may avoid annuities believing they need to hold precautionary balances to cope with uninsurable events; (c) older people may be over-annuitized given publicly-provided social security lifetime benefits. Our research uses money’s worth ratios to value annuities offered in Singapore and Australia, and we show that while administrative loadings are present in both markets, more adverse selection is detected in Australia than in Singapore. We argue that the patterns are consistent with the fact that the generous old-age safety net benefit in Australia curtails the risk of old-age poverty, enabling people to avoid longevity risk. In Singapore, by contrast, no such guarantee is available. In other words, the defined contribution component of

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21 This adverse selection problem is different from the moral hazard described by Smetters (forthcoming) who examines how a minimum benefit guarantee might influence investment portfolio choice in a DC plan.
the two countries’ retirement system is similar, but the extent of annuitization of retirement accumulations appears to respond to the existence of a retirement benefit guarantee. Other explanations are that retirees are not free to dispose of Singaporean CPF accumulations as they wish, and annuities are clearly a better buy in Singapore than many other financial products.
References


### Table 1: Life annuity sales trends in Singapore: 1990 to 1999

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>No. annuities sold</td>
<td>380</td>
<td>720</td>
<td>1350</td>
<td>1510</td>
<td>1690</td>
<td>2340</td>
<td>2550</td>
<td>2030</td>
<td>3200</td>
<td></td>
</tr>
<tr>
<td>% increase</td>
<td>90</td>
<td>85</td>
<td>14</td>
<td>12</td>
<td>17</td>
<td>19</td>
<td>9</td>
<td>-21</td>
<td>58</td>
<td></td>
</tr>
</tbody>
</table>


### Table 2: Monthly nominal life annuity payouts for 55-year old men and women in Singapore: July 2000 (Sg $)

<table>
<thead>
<tr>
<th>Company</th>
<th>Male $ per month</th>
<th>Female $ per month</th>
</tr>
</thead>
<tbody>
<tr>
<td>AIA</td>
<td>$468</td>
<td>$444</td>
</tr>
<tr>
<td>GE life</td>
<td>$585</td>
<td>$555</td>
</tr>
<tr>
<td>ICS</td>
<td>$575</td>
<td>$510</td>
</tr>
<tr>
<td>Keppel</td>
<td>$551</td>
<td>$504</td>
</tr>
<tr>
<td>UOB life</td>
<td>$600</td>
<td>$555</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>$555</strong></td>
<td><strong>$519</strong></td>
</tr>
</tbody>
</table>

Note: Monthly payouts are for a nominal annuity purchased at 55 with payments starting at age 62 and a 15-year guarantee period or similar. The premium is a government set minimum sum of Sg$65,000.

Source: Central Provident Fund (2000).

### Table 3: Monthly nominal life annuity payouts for 65-year old men and women in Australia: June 2000 (A$)

<table>
<thead>
<tr>
<th>Company</th>
<th>Male $ per month</th>
<th>Female $ per month</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMP</td>
<td>$658</td>
<td>$610</td>
</tr>
<tr>
<td>AXA</td>
<td>$682</td>
<td>$636</td>
</tr>
<tr>
<td>Challenger</td>
<td>$722</td>
<td>$669</td>
</tr>
<tr>
<td>Colonial</td>
<td>$648</td>
<td>$601</td>
</tr>
<tr>
<td>ING</td>
<td>$668</td>
<td>$619</td>
</tr>
<tr>
<td>MLC</td>
<td>$697</td>
<td>$651</td>
</tr>
<tr>
<td>National Australia</td>
<td>$697</td>
<td>$651</td>
</tr>
<tr>
<td>Norwich</td>
<td>$586</td>
<td>$537</td>
</tr>
<tr>
<td>Tower</td>
<td>$665</td>
<td>$612</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td><strong>$669</strong></td>
<td><strong>$621</strong></td>
</tr>
</tbody>
</table>

Note: Monthly payouts are for a nominal annuity purchased at 65 with a 10 year guarantee period. Premium is A$100,000.

Source: Rice Kachor (2001)
Table 4: The money’s worth of an nominal life annuity purchased in Singapore at age 55, based on annuitant and population cohort mortality

<table>
<thead>
<tr>
<th></th>
<th>Annuitant mortality basis</th>
<th>Population mortality basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male</td>
<td>108.46%</td>
<td>107.77%</td>
</tr>
<tr>
<td>Female</td>
<td>111.35%</td>
<td>112.37%</td>
</tr>
</tbody>
</table>

Note: Singapore annuitant mortality based on UK a90 annuitant tables and population cohort mortality derived from Singapore period population tables. Discounted at riskless term rates.
Source: Authors’ calculations; see text.

Table 5: The money’s worth of an nominal life annuity purchased in Australia at age 65, based on annuitant and population cohort mortality

<table>
<thead>
<tr>
<th></th>
<th>Annuitant Mortality basis</th>
<th>Population Mortality basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male</td>
<td>95.03%</td>
<td>88.85%</td>
</tr>
<tr>
<td>Female</td>
<td>95.12%</td>
<td>91.50%</td>
</tr>
</tbody>
</table>

Note: Australian annuitant mortality based on UK IM80/IF80 annuitant tables and population cohort mortality derived from Australian period population tables. Discounted at riskless term rates.
Source: Authors’ calculations; see text.

Table 6: Measured adverse selection in life annuity markets of Singapore and Australia

<table>
<thead>
<tr>
<th></th>
<th>Singapore</th>
<th>Australia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male</td>
<td>0.69%</td>
<td>6.18%</td>
</tr>
<tr>
<td>Female</td>
<td>-1.02%</td>
<td>3.62%</td>
</tr>
</tbody>
</table>
### Table 7: Sensitivity results based on different mortality assumptions: Singapore and Australia

<table>
<thead>
<tr>
<th>Country</th>
<th>Lag on annuitant mortality</th>
<th>Gender</th>
<th>Annuitant Mortality basis</th>
<th>Population Mortality basis</th>
<th>Adverse selection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>- 2 yrs</td>
<td>Males</td>
<td>111.91%</td>
<td>107.77%</td>
<td>4.14%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Females</td>
<td>114.82%</td>
<td>112.37%</td>
<td>2.46%</td>
</tr>
<tr>
<td></td>
<td>+ 2 yrs</td>
<td>Males</td>
<td>105.09%</td>
<td>107.77%</td>
<td>-2.68%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Females</td>
<td>107.79%</td>
<td>112.37%</td>
<td>-4.58%</td>
</tr>
<tr>
<td>Australia</td>
<td>- 2 yrs</td>
<td>Males</td>
<td>98.31%</td>
<td>88.85%</td>
<td>9.46%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Females</td>
<td>98.36%</td>
<td>91.50%</td>
<td>6.86%</td>
</tr>
<tr>
<td></td>
<td>+ 2 yrs</td>
<td>Males</td>
<td>91.75%</td>
<td>88.85%</td>
<td>2.90%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Females</td>
<td>91.78%</td>
<td>91.50%</td>
<td>0.28%</td>
</tr>
</tbody>
</table>
Figure 1: Funds Under Management in the Australian Income Stream Market (%)

Source: Plan for Life Research (2000a); (June 2000)

Figure 2: Immediate Annuity Sales in Australia ($A million)

Source: Plan for Life Research (2000a); (July 2000)
**Figure 3a: Cumulative cohort survival probability — general and annuitant populations**

Australian males, 2000

**Figure 3b: Cumulative cohort survival probability — general and annuitant populations**

Australian females, 2000
Figure 4a: Cumulative cohort survival probability — general and annuitant populations
Singaporean males, 2000

Figure 4b: Cumulative cohort survival probability — general and annuitant populations
Singaporean females, 2000
Figure 5: Sensitivity of Singaporean annuitant mortality: Males