

## A WORD FROM THE VICE PRESIDENT, RETIREMENT BENEFITS

### THE REPORT ON THE REVIEW OF MILITARY SUPERANNUATION

(The report can be viewed at [www.defence.gov.au/militarysuperreview](http://www.defence.gov.au/militarysuperreview) )

#### INTRODUCTION

1. The Review of Military Superannuation was conducted in accordance with a directive issued by the Minister Assisting the Minister for Defence in February 2007. The Terms of Reference (TOR) for the review defined two interconnected principles to guide the conduct of

the review and form the philosophical context within which the TOR were to be addressed. The two principles were defined as the unique nature of military service and the need to compensate members of the ADF for that uniqueness in their superannuation, invalidity and death benefits.

2. The TOR were reasonably comprehensive and required the Review Team to review current military superannuation arrangements and the suitability of those arrangements in the light of a range of factors including the contemporary legislative and regulatory framework within which superannuation benefits are provided in Australia as well as a number of issues that have been frequently raised by ESOs and individual serving and former members of the ADF.

3. Annex A to the TOR defined the characteristics of the unique nature of military service. The first characteristic was the liability for combat operations which is both compulsory and continuous and includes the very real possibility of being exposed to the risk of physical or mental invalidity or death. No other form of employment has a similar liability. This particular characteristic of the unique nature of military service was acknowledged and recognized in the course of the review especially with regard to the need for generous invalidity and death benefits. There were however seven further characteristics of the unique nature of military service such as the military discipline code, regimented way of life, long and irregular working hours, statutory retiring ages well below community norms, high standards of physical fitness, frequent relocations and separation from family. The Review Team

paid little or no regard to these characteristics especially when considering reform of the current DFRDB and MSBS schemes.

4. The TOR required the Review Team to review current arrangements in light of “the current and future costs associated with providing, managing and administering military superannuation arrangements.” The TOR did not stipulate that the Review Team should not make recommendations that would result in expenditure outside of the current defence superannuation budget. The Review Team took it upon itself to apply such a restriction and as a consequence much needed and overdue reforms to the current schemes were either ignored or given very weak support. It is hard to escape the conclusion that so far as reform of the current schemes and costs, the Review Team was working to a different and unpublished agenda.

#### Desirable Characteristics of Military Superannuation in Australia Today

5. In the Executive Summary at page viii of the report the Review Team has defined a set of Guiding Principles for any new arrangement. These principles seem to have been well thought out and are supported. Against the principle of ‘Adequacy’ the definition states that military superannuation for all members of the ADF, both short term and long term *should facilitate the maintenance of living standards both on and through retirement.*

6. The abovementioned adequacy principle is fundamental to the welfare of retirees. The operative words are ‘**maintenance of living standards**’ which can only be achieved by linking pensions to wages. The failure of the Review Team to be consistent with regard to this principle is one of the major weaknesses in the report.

#### Assessment of Current Schemes

7. The Review Team compared the current schemes against their desirable principles and

found that the MSBS compares reasonably well but still falls well short of best practice contemporary superannuation and does not contribute significantly towards recruitment and retention. The review team concluded that the DFRDB Scheme is rated well below the MSBS. It is therefore surprising and disappointing that given this assessment and the opportunity to recommend reforms that would improve the existing schemes, the review team was generally negative.

### The Proposed New Scheme

8. Against the TOR it was not surprising that the Review Team has recommended the replacement of the current superannuation schemes with a contemporary defined contribution scheme that would have the effect of eventually eliminating government unfunded liability whilst transferring risk from the government to the individual member of the ADF. This is not necessarily an undesirable development provided the scheme rewards both the unique nature of military service and the increased risk assumed by members and also the scheme offers adequate flexibility. Some will argue that the new scheme does away with the long-standing paternalism for young and economically unsophisticated ADF entrants that was inherent in the existing defined benefit schemes. It is considered that those arguments can be set aside provided the new scheme is based on sound assumptions and provided the ADF introduces a serious education programme to enlighten its members.

9. The proposed new scheme will be a defined contribution accumulation fund in which each member will have his own fund account into which the employer (Defence) will make a contribution each fortnight. The contribution rates proposed are 16% of military salary for the first six years of service, 23% for the next nine years of service and 28% for the remaining years of service. The increasing rates of contribution are designed to, and should, provide a powerful retention incentive. On reaching preservation age the member will be able to take the whole of his accumulated fund as a lump sum or convert all or part of the fund to an indexed pension. Different conversion factors will apply depending on the method of indexation chosen by the member. Contributions to the fund will be taxed but, in line with the Better Super rules introduced in 2007,

pension payments made to members over age 60 will be tax free. The scheme has many good characteristics such as:

- The option for the member to elect his level of member contribution from nothing if he wishes to whatever rate of salary sacrifice he can afford.
- The option for the member's spouse and children to contribute to the fund.
- The option for the member to elect to have his personal account in either a growth fund, a balanced fund or a cash fund with commensurate levels of risk and return.
- The option for the member to have his employer contributions paid into an outside commercial superannuation fund.
- If the member leaves the ADF before reaching preservation age he can roll his fund into an outside fund (portability) or leave it in the military fund to continue growing until he reaches preservation age. He can also continue contributing to the fund from his civilian employment, as can his spouse.
- On reaching preservation age the member can elect to receive a lump sum or pension or a combination. The conversions for different levels of indexed pension will be calculated by a Government appointed actuary so as to make the fund fiscally self supporting. The anticipated conversion factor for a CPI indexed pension is \$1 of annual pension for every \$20 in the fund. This does not appear as beneficial as the MSBS conversion factor for the same CPI indexed pension, namely \$1 of annual pension for every \$12 in the MSBS fund. This means the fund would need to be 66% more than an MSBS fund size to achieve the same level of pension. This should be achieved comfortably if the accumulation fund is invested to earn 6.5% per annum. There will be other conversion factors (more expensive) for wage based indexation (MTAWE or AWOTE)

## Perceived Problems with the Proposed New Military Superannuation Scheme

10. There are a number of aspects of the proposed new scheme that appear to be unsatisfactory:

- The employer contribution for the first six years of service is 16% of military salary per year. This is a mere 0.6% more than is provided in the Public Service Accumulation Scheme, and 2% less than is provided in the first 7 years in the MSBS. A 16% employer contribution for the first six years of service does not reward the unique nature of military service or compensate for the risk assumed by the members in the new scheme.
- There would appear to be grounds for doubting the accuracy of some of the examples provided in the report. DFWA will be seeking the opportunity to question the assumptions made and methodology used in those calculations with a view to verifying the claims that have been made.
- It will be necessary to verify the validity of the 'conversion factors' suggested for converting the accumulated lump sum to an indexed pension at age 55.
- Doubt has been expressed regarding the relative benefit paid by the new scheme compared with the MSBS in the case of death in service. DFWA will look closely at this condition to ensure that the new scheme is at least as beneficial as the MSBS.

### *Additional Technical Issues*

#### 11. **MSBS Maximum Benefit Limit (MBL)**

The Review Team has recommended that MSBS MBL be abolished. This reform is supported.

12. **Indexation Arrangements.** The Review Team considers that there is an 'in principle' case for changing the indexation arrangements for DFRDB pensions to an earnings basis, similar to the indexation method used for the age and service pensions. (the higher of CPI and MTAW) The Review Team said it recognizes that this change would be expensive and given the government policy on preservation arrangements, the Review Team considers there is no case to increase the benefits payable prior to age 55 but there is a case

for older DFRDB pensioners. The Review Team applies a caveat to this recommendation namely 'if the Government is willing to go beyond the envelope of current costs'.

13. My reactions to this timid recommendation are:

- a. There was no stipulation in the TOR that expenditure be kept within the existing budget. In 1997, when the government changed the indexation of the age and service pensions from CPI to CPI/MTAWE there was a ready acceptance that it would involve increased expenditure. There should be similar acceptance now to bring the indexation of military superannuation into line with welfare pensions.
- b. The guiding principles for superannuation spelled out by the Review Team include the need for superannuation benefits to facilitate the maintenance of living standards both on and through retirement. CPI indexation does not achieve this requirement.
- c. Notwithstanding that MSBS pensions are generally more than DFRDB pensions for equivalent years of service and rank, the fact remains that living standards will only be maintained if wage based indexation is adopted.
- d. In light of the current preservation age that applies to all other Australians including MSBS members, it may be hard to argue with the proposal that indexation of DFRDB pensions be changed only for those over 55 years. DFWA will seek to determine the number of DFRDB recipients who are under 55 before agreeing with this recommendation.
- e. The Review Report has mis-represented the cost of changing indexation of DFRDB pensions for over 55s. At Annex H the Government Actuary has produced an estimated cost based on AWOTE indexation. This indexation has never been sought, is not used for the age and service pension and is significantly greater than the higher of CPI and MTAW.

14. **Life Expectancy Factors.** The Review Team has failed to recognize the unfairness of the DFRDB Life Factor issue and has ruled it out on the basis of spurious logic. The report states *'The fact is that the conversion factor based on a 1960s life expectancy is substantially more generous than a cost neutral conversion factor that takes into account opportunities to earn interest on the commuted lump sum. A conversion factor based on current life expectancy would be even more excessively generous'*. The problem I have with this statement is that the Review Team has invented the idea of a cost neutral conversion factor. There is no mention of a conversion factor or opportunity to earn interest on the lump sum in either the Jess Report or the DFRDB Act 1973. The option to commute a lump sum was an early manifestation of the need to provide a facility to reward the unique nature of military service. The Jess Report refers to military personnel being compulsorily retired at relatively early ages having been frequently moved and having not had the opportunity to establish a home. The need for a lump sum payment being a pre payment of future entitlement is justified against this background. It was not expected that retiring members would be able to invest the lump sum to provide an income stream and there was never any mention of a conversion factor. Furthermore in all other Commonwealth funded superannuation schemes (except for the old Parliamentary Scheme) a lump sum is provided without any repayment or conversion factor. It is likely that the failure of the DFRDB Act 1973 to provide for the periodic updating of the life expectancy table was an oversight. Any other explanation requires us to believe that the parliament intended the repayment of the lump sum should become progressively more disadvantageous to military retirees as time passed and life expectancy increased.

15. In its description of the DFRDB Scheme at Appendix E to the report the Review has omitted to mention a most important factor that is relevant to the life expectancy issue. If a retiree elects to not commute a lump sum, that part of his/her

pension that would have been deducted had he/she commuted, is not indexed at all. This grossly unfair provision was introduced by Amendment No 13 /77 and is contained at appendix Section 98B of the DFRDB Act. The effect of this provision is to force members to commute, even though they may prefer to not do so. If a member lives to his actual life expectancy or beyond he will repay far more than the lump sum received. The only other superannuation scheme that is remotely similar is the old Parliamentary Super Scheme where pension is reduced so that the lump sum entitlement is repaid over 20 years and then deductions continue. The big difference is the retiring parliamentarian need not take the lump sum in which case his/her full pension is fully indexed for life. Alternatively if a member of the parliamentary super scheme is over age 65 at retirement his pension is reduced so that the lump sum is repaid by age 85. If DFRDB pensions were calculated on a life expectancy of 85 years, retirees would all be receiving a lot more retirement pay.

16. The Review established that the DFRDB Scheme is very inferior compared with the MSBS and the proposed new scheme. The life factor anomaly provided an opportunity to partly rectify that relative disadvantage. When presented with this opportunity the Review Team failed.

17. **The Way Ahead.** DFWA is cooperating with RSL and other ESOs to formulate an agreed response to the report. We hope that this process will allow us to exert some influence on the Government's consideration of the recommendations contained in the report. We are seeking an early opportunity to discuss the report in detail so that some of the more obscure and complex aspects of the proposed new military superannuation scheme can be **clarified**.

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