RESPONSE TO DFWA INITIAL CONCERNS

In its press release of 28 February 2008, the Defence Force Welfare Association listed its 'initial concerns' about the Report of the Review into Military Superannuation Arrangements. On 3 March 2008, three officers of the Association (Bryan Wilson, Phil Morrall and Richard Griffiths) met with two members of the Review Team (Andrew Podger and David Knox), and members of the secretariat in the Department, to discuss these concerns. Some additional matters were also discussed.

The meeting was constructive and informative. It was agreed that the Review Team's responses should be made available to DFWA members. The DFWA will reflect on this material and the other matters discussed before finalising its submission on the Report to the Government.

The following lists the concerns raised in the press release and the Review Team's responses provided in discussion at the meeting.

1. **DFWA Concern:** The Review Team says that it kept the **total cost** of its work within the costs of the current system. Apart from the fact that that constraint was not in its Terms of Reference, how is it possible to fix problems in the current schemes at the same time as operating a new scheme which has the same total costs/benefits as the current schemes?

Review Team Response:

- Our TORs required us, inter alia, to review current arrangements and their suitability in the light of:
  '(1b) The need to efficiently manage the unfunded liability for military superannuation ...'
  '(1f) The current and future costs associated with providing, managing and administering military superannuation arrangements;'
  And to make recommendations about the future for military superannuation that
  '(4c) Are consistent with broad Government superannuation and budgetary policy;'

- We did not set the current costs as a strict ceiling, but did decide from the beginning that these should be the basic benchmark, and that if we were to make recommendations requiring additional resources those would need to be fully justified particularly in terms of improvements to recruitment and retention.
- Solutions to concerns with the current schemes, and changes necessary to meet developments in the legislative and regulatory framework (TOR 1a), do not necessarily require additional resources. It would have been remiss of the Review Team not to look first at possible solutions that did not increase taxpayer costs.

2. **DFWA Concern:** How does the new defined contributions scheme compensate ADF personnel for their **increased risk** (that is: the superannuation investment risk associated with an accumulation fund) if the new scheme costs the Government no more than the current defined benefits schemes? Note that ADF personnel will bear greater risks than members of most civilian accumulation schemes because not only will their investments be subjected to market variations but they themselves are less able to influence the timing of retirement because of the military's compulsory retirement provisions due to death, invalidity, age and changes to Defence policies.

Review Team Response:

- Figures 5.1 and 5.2 in the Report suggest the likelihood that the vast majority of ADF members would be better off under the proposed scheme than under the MSBS. The reason this does not translate into a higher cost to Government is that there would also be a shift in risks to the members and away from the Government. Thus the proposed scheme does compensate for the increased risk with higher expected benefits for most members.
- The proposed accumulation scheme would reduce, not add to, the risks related to being uncertain about the date of separation from the ADF.
    - Retirement benefits would not be tied to final salary or final average salary
    - There would be no requirement to crystallise the benefits at any particular time, when the market may or may not be favorable, as the accumulated benefit stays in the fund until age 55, and there is a 10 year window from then to purchase an indexed pension for those eligible to do so. Lump sum benefits from the fund (or other fund of the member's choice) can be claimed or switched to an account-based pension at any time after having reached preservation age (which is increasing to age 60 in the future).
    - Those discharged on medical grounds will have access to defined insurance benefits based on their income at time of discharge until aged 60, when they can access their accumulated retirement benefit.
    - Dependants of those who die while in Service will have access to the accumulated retirement benefit, enhanced by the amount that the employer would have contributed over the full years of service to age 60, and can choose to buy an indexed pension if they wish to do so on favorable terms.

3. **DFWA Concern:** How does limiting the **employer contribution** by the Commonwealth to just 16% for ADF personnel during their first 6 years of service recognize "the unique nature of military service"? That is 2% less than the current MSBS and less than 1% more than the Commonwealth currently contributes to its public service superannuation schemes. Higher (or lower) contributions at the beginning of working life have a disproportionate effect on

the final outcome because investment returns compound. It should also be noted that the average length of service in the ADF is only slightly above 8 years at present, so many ADF personnel will never receive significantly greater employer contributions than if they had joined the public service.

Review Team Response:

- The impact of the proposed scheme is almost the reverse of what DFWA implies. As shown in Figures 5.1 and 5.2, the biggest winners are those with shorter periods of service. Why? Because the apparent MSBS 18% contribution rate is no such thing for these ADF members. For them, the employer contribution is locked away for up to 30 years or more when they leave the ADF earning only the CPI. In contrast a 16% contribution in a real fund, with investment earnings all the way to age 60, is worth much more for them than an 18% notional contribution in a defined benefit formula.
- The 16% is also significantly more than the 15.4% in the APS schemes, as the latter includes the costs of insurance for death and disability, while insurance in the proposed military scheme is in addition to the 16%.
- The 9% that most people in the community receive also has to meet the costs of insurance which typically is 1% (around 3.8% for the military), so the proposed 16% is about double the community norm.

4. **DFWA Concern:** Why propose that the **spouse's reversionary pensions** paid on the death of a former ADF member be reduced from the current 67% under the MSBS to 62.5%, noting that the parliamentary scheme reversionary rate is 83%?

Review Team Response:

- The proposed scheme offers those with more than 15 years of service the option of purchasing from their accumulated benefit an indexed pension at a fair price determined by the Actuary. For illustrative purposes, our report uses pensions indexed to the CPI and with a 62.5% reversionary benefit, the latter reflecting more common community arrangements including social security relativities. Eligible members could choose to purchase pensions indexed to earnings, or with more generous reversionary benefits, but at higher prices.

5. **DFWA Concern:** Why has the Review Team proposed a cap on benefits to be paid for **not more than three children** of ADF personnel who have been killed in the line of duty? Won't the relatively small number of Defence families with more than three children *need* more financial support, and won't the added cost be minimal?

Review Team Response:

- The proposed cap mirrors current MSBS rules. They are there to avoid the total pension exceeding the previous salary.
- The widow(er) will in fact receive a lump sum, comprising the member's accumulated benefit plus the benefit that the employer would have contributed had the member stayed in the ADF to age 60. They will have the option then

to retain some or all of the lump sum as they wish, or to convert some or all of it into an indexed pension on a favorable basis. Should they choose the latter, our calculations suggest they could expect a larger pension than under the MSBS (see Table 5.4).

6. **DFWA Concern:** Why did the Review Team instruct the Government Actuary to calculate the costs of the new scheme, and the cost of changing the indexation of pensions paid under the current schemes, on the basis of the more expensive **Average Weekly Ordinary Times Earnings (AWOTE)** rather than on Male Total Average Weekly Earnings (MTAWE)? MTAWE is the indexation method used for the Age pension and the indexation method referred to at Recommendation 14 in the body of the Report.

Review Team Response:

- The assumptions in the expressed concern are not correct. The Actuary was not instructed to use one earnings index or another and, over time, neither is consistently higher or lower than the other (the description of Age pension indexation is not precisely accurate either).
- The Actuary worked on the basis that earnings move on average 1.5% pa faster than prices.

7. **DFWA Concern:** Why does the Report not **identify clearly every aspect of detriment** to members of the new scheme, when compared with the treatment of members of the current schemes?

Review Team's Response:

- The Review Team believes it has presented the impact of its proposals fairly, honestly and openly. It is willing (as evidenced by the discussion on 3 March) to provide explanations and additional information as requested.
- Our TORs (4b) require that our recommendations 'are not detrimental to former and current members of the ADF (that is, the recommendations will not force change to the retirement benefits already established for former and current members of the ADF)'.
- We have complied with this requirement, and indeed gone further than the APS arrangements in recommending that current ADF members, and preserved MSBS members, be offered the opportunity to transfer to the new scheme, an offer the Actuary predicts most would take up.
- The requirement does not mean that the new scheme must offer more generous benefits in every instance than would the MSBS. That would be virtually impossible in any case, without totally undermining the defined contribution nature of the scheme we propose; and it would be prohibitively expensive.

Andrew Podger (Chair, Review Team)
David Knox (Member, Review Team)
6 March 2008