Australian Government
Department of Finance and Deregulation

SUBMISSION TO THE

SENATE FINANCE AND PUBLIC ADMINISTRATION COMMITTEE

INQUIRY INTO THE

DEFENCE FORCE RETIREMENT AND DEATH BENEFITS AMENDMENT (FAIR INDEXATION) BILL 2010

April 2011

Introduction

1. The Defence Force Retirement and Death Benefits Amendment (Fair Indexation) Bill 2010 (the Bill) amends the *Defence Force Retirement and Death Benefits Act 1973* (DFRDB Act) and the *Defence Forces Retirement Benefits Act 1948* (DFRB Act).

2. The Bill proposes amendments to enhance the methodology for indexing pensions payable to persons aged 55 years or older under the DFRDB Act and the DFRB Act. The proposed amendments would increase relevant pensions by reference to changes in:

   - the Consumer Price Index (CPI);
   - the Pensioner and Beneficiary Living Cost Index (PBLCI); or
   - Male Total Average Weekly Earnings (MTAWE).

3. The DFRDB Act and the DFRB Act currently provide for indexed pensions to be increased twice yearly in line with increases in the CPI.

Matthews Review

4. An independent *Review of Pension Indexation Arrangements in Australian Government Civilian and Military Superannuation Schemes* (the Matthews Review)[1] was undertaken by an actuary, Mr Trevor Matthews. The terms of reference required Mr Matthews to review the current indexation methodology for pensions paid from the Australian Government's civilian and military superannuation schemes. In doing so, Mr Matthews was asked to consider whether there was a case for a change to the current indexation methodology, having regard to a number of matters.

5. Mr Matthews recommended:

   - That pensions from the Australian Government civilian and military superannuation schemes continue to be indexed against the effects of inflationary price increases.
   - That the same indexation methodology continue to apply to all civilian and military pensions.
   - That pensions from the Australian Government civilian and military superannuation schemes continue to be indexed by the CPI as the most suitable index to protect pensions against inflationary price increases available at this time.
   - That, if a robust index which reflects the price inflation experience of superannuants better than the CPI becomes available in the future, the Australian Government should

[1] A copy of the Report is available at http://www.finance.gov.au/superannuation/pension-indexation-review.html.

consider its use for indexing Australian Government civilian and military superannuation pensions.

6. The Government supported these recommendations[2].

Comments on the Bill

7. The unique nature of military service is already reflected in critical differences between the military and civilian superannuation schemes, particularly through higher employer contribution rates and death and disability arrangements.

8. Unlike similar benefits generally available to the wider community, the Government provides a guaranteed lifetime level of income and indexation to DFRDB pensioners. DFRDB pensions are not affected by downturns in the economy, such as occurred during the global financial crisis.

9. After 20 years service (at any age) a member of the DFRDB is entitled to a guaranteed lifetime indexed pension[3] set at 35% of superannuation salary. After 30 years service the member is entitled to a guaranteed lifetime indexed pension of 51.25% of superannuation salary.

10. The provision of an indexed lifetime pension as part of any remuneration package is available to only a limited number of Australian employees, mainly members of Australian Government and State Government defined benefit superannuation schemes that are now closed. The Matthews Review found that in the few circumstances where employees receive indexed pensions, these are indexed by CPI increases in nearly all cases. Some, very few, schemes index pensions to wage increases.[4]

11. Indexed superannuation pensions are provided as part of a person's terms and conditions as a member of the Australian Defence Force (ADF). Current members of the ADF are either members of the DFRDB scheme or the Military Superannuation and Benefits Scheme (MSBS). As at 30 June 2010 there were around 4,200 contributing members in the DFRDB and around 54,500 in the MSBS.

12. These terms and conditions result in a rate of employer superannuation contribution[5] in respect of the DFRDB that is generous in comparison to the MSBS, the civilian superannuation schemes and the minimum rate of 9% required under the Superannuation Guarantee arrangements.

---

[2] http://www.financeminister.gov.au/archive/media/2009/mr_522009.html

[3] A member can also be entitled to a pension on reaching their statutory retiring age for their rank, on completion of 15 years service.

[4] Matthews Review pg 44.

[5] As the DFRDB, CSS, PSS and MSBS are fully or partially unfunded superannuation schemes the employer contribution rate is expressed as a notional employer contribution rate of superannuation salary.

13. The employer contribution rate for the DFRDB is 33.4% of superannuation salary[6]. This compares to the rate of 27.0% for the MSBS[7]. For the Commonwealth Superannuation Scheme (CSS) and Public Sector Superannuation Scheme, the rates are 21.4% and 16.3%[8] respectively. In the case of the Public Sector Superannuation Accumulation Plan (PSSAP) the employer contribution rate is 15.4%.

14. The DFRDB contribution rate would increase further under the proposed amendments, reflecting a further benefit improvement compared with benefits available for other Commonwealth superannuation scheme members. The Australian Government Actuary (AGA)[9] has estimated the Bill would increase the DFRDB employer contribution rate to 40.6% of superannuation salary.

15. The Bill, would in effect, represent a retrospective upgrade of the terms and conditions of service of the DFRB and DFRDB pensioners, although they are no longer in service. This would impose a cost burden on the Department of Defence without the Department receiving any corresponding benefits, in terms of service by members.

16. In this context, it is not clear to Finance that there is a superannuation policy rationale for changing the 'employer and employee relationship' for one group of Commonwealth scheme members compared with others. Finance notes that the Bill covers military personnel in the DFRDB scheme, not the MSBS scheme that comprises the bulk of current serving members (93% of current ADF members are members of the MSBS). Within the DFRDB scheme, the Bill only benefits those DFRDB retirees aged 55 or over who qualify for a pension.[10] When the DFRDB closed in 1991, less than 5% of Navy personnel were qualifying for a pension.[11] Also, at the time of the *Review into Military Superannuation Arrangements* (the Military Review) more than 80% of those joining the ADF served less than 20 years.[12]

17. Reflecting the proposed differential treatment of a group of beneficiaries and the anomalies that this gives rise to, Finance considers that the passage of the Bill would lead to pressure for these benefits to be extended to other 'employee' groups with increasing financial implications for the Commonwealth budget and increasing the disparity between some Commonwealth superannuation beneficiaries and the broader community. We note that the proposal in the Bill is similar to that previously recommended in the Military

---

[6] 2008 DFRDB and MSBS Long Term Cost Report.
[7] 2008 DFRDB and MSBS Long Term Cost Report.
[8] 2008 CSS and PSS Long Term Cost Report.
[9] Advice dated 13 January 2011 from the Australian Government Actuary to the Department of Defence
[10] DFRDB members who separate from the ADF (other than on invalidity grounds) are entitled to a pension after a completion of 20 years service or, if they have reached the statutory age for their rank, on completion of 15 years service.
[11] Report of the Review into Military Superannuation Arrangements pg 13.
[12] Report of the Review into Military Superannuation Arrangements pg 14.

Review. The Military Review acknowledged that such a recommendation would add pressure for a similar change to be made to the CSS[13].

18. The current pension indexation arrangements for DFRB and DFRDB pensions are the same as applying to pensions payable under the MSBS and the defined benefit civilian superannuation schemes. In addition, all State Governments operate schemes offering indexed defined benefit pensions to some of their employees. All these pensions are indexed by the CPI.

19. The Matthews Review considered whether different indexation arrangements should apply between different military schemes and for the civilian superannuation schemes. He did not consider there was a case for doing so.

20. Mr Matthews also considered whether the unique nature of military service was such as to require the application of different indexation arrangements to military superannuation pensions. He concluded that it would be more appropriate for this to be addressed through specific benefit design features of the military superannuation schemes rather than through indexation.

21. The Bill proposes indexation arrangements for DFRDB pensions broadly similar to those applying to the Age and Service Pensions. However, as reflected in the AGA's advice[14] to the Department of Defence it appears that the Bill would provide for better indexation arrangements than those currently applying to Age and Service Pensions. Unlike the indexation arrangements for the Age Pension, the Bill proposes to provide indexation by the higher of the CPI, the PBLCI, or MTAWE.

22. However, Age Pension and superannuation benefits are provided for different purposes and are not comparable. Military and civilian superannuation pensions are an employment benefit. They are not safety net benefits to ensure Australians receive a minimum level of income in retirement, which is the purpose of the Age and Service Pensions. The military and civilian superannuation pensions are based on different criteria, such as rank and length of service. They are not subject to an income and assets test and are not based on need.

23. This is supported by the Matthews Review, which found that it was not inequitable that Commonwealth military and civilian superannuation pensions are not increased in the same way as Age and Service Pensions and recommended they continue to be indexed by the CPI to protect against inflationary price pressures.

---

[13] Report of the Review into Military Superannuation Arrangements pg 60.

[14] Advice dated 13 January 2011 from the Australian Government Actuary to the Department of Defence.

24. Indexation by reference to MTAWE (a wage based index) would be inconsistent with the findings of the Matthews Review, that the purpose of indexing military superannuation pensions is to index against the effects of inflationary price increases. Mr Matthews found that the purpose of indexation of superannuation pensions is not to provide pensioners with a share of productivity increases which is reflected in the MTAWE[15].

25. The AGA[16] has estimated the Bill would have an immediate increase in the Government's unfunded superannuation liability of $6.2 billion which would worsen the Government's balance sheet. The fiscal impact is $1,667 million and the cash impact is $175 million over the forward estimates. These cash costs would increase significantly in the years beyond the forward estimates. For example, it increases from $33 million in 2012-13, to $235 million in 2020-21 and to $503 million by 2028-29 in nominal terms.

26. The Government has stated that it is committed to fiscal responsibility, including returning the Budget to surplus by 2012-13 and requiring all new proposals to be offset by savings over the forward estimates. Under the Budget Rules, offsetting savings require a decision to reduce expenses below what they would otherwise have been. This would not include second round economic effects, or indirect flow-on effects, because of the difficulties inherent in quantifying such effects. Against these policy settings, a proposal with longer term costs, such as those contained in the Bill, would require structural savings elsewhere in the budget in order to meet the objective of delivering budget surpluses, on average, over the life of the economic cycle.

27. The Government established the Future Fund, a financial asset fund in 2006. Its purpose is to help meet unfunded superannuation liabilities that will become payable during a period when an ageing population is likely to place significant pressure on Commonwealth finances.

28. Withdrawals from the Future Fund to pay superannuation benefits may only occur once the superannuation liability is fully offset or from 1 July 2020, whichever is earlier. For this purpose a target asset level is calculated by a Designated Actuary (currently the Australian Government Actuary) and represents the assets of the Future Fund that would be required to offset the unfunded superannuation liability at the same point in time.

29. The AGA estimated the target asset level for the Future Fund at $103.2 billion for 2010-11. As at 31 December 2010, the Future Fund had assets of approximately $72 billion. The impact of the Bill would be to exacerbate this gap.

[15] Matthews Review pg 46.
[16] Advice dated 13 January 2011 from the Australian Government Actuary to the Department of Defence.