SUBMISSION

SENATE SELECT COMMITTEE ON SUPERANNUATION AND FINANCIAL SERVICES

INQUIRY INTO COMMONWEALTH PUBLIC SECTOR AND DEFENCE FORCE UNFUNDED SUPERANNUATION FUNDS AND SCHEMES

MILITARY SUPERANNUATION ARRANGEMENTS

Department of Defence
February 2001

Background

There are two superannuation schemes for members of the Australian Defence Force (ADF):

- the Defence Force Retirements and Death Benefits (DFRDB) scheme that was introduced in 1973, replacing the earlier 1948 Defence Forces Retirement Benefits (DFRB) scheme. The DFRDB scheme was closed to new members in 1991; and
- the Military Superannuation and Benefits Scheme (MSBS) replaced the DFRDB scheme in 1991. All new members of the ADF are required to be members of the MSBS.

Both schemes provide benefits for members of the ADF when they retire. They also provide death and disability benefits as well as reversionary benefits that become payable to eligible dependants in the event of the death of the member.

The rules governing the DFRDB scheme are provided for in the *Defence Force Retirement and Death Benefits Act 1973*. The scheme is an unfunded defined benefit scheme that provides a retirement income stream for members of the ADF who have served a minimum 20 years in the ADF. Part of that income stream may be converted to a lump sum. Members of the 1948 scheme (*Defence Forces Retirement Benefits Act 1948)* were compulsorily transferred to the DFRDB scheme when it was introduced in 1973.

The MSBS is governed by the *Military Superannuation and Benefits Act 1991* and the Trust Deed and Rules are created in accordance with the provisions of the Act. The scheme is both an accumulation scheme and a defined benefit scheme. When a member of the scheme leaves the ADF, an entitlement to two benefits arises, a funded member benefit and an employer benefit that is largely unfunded.

Both schemes are superannuation schemes that are subject to the *Superannuation Industry (Supervision) Act 1993* (SIS). The DFRDB scheme is, however, an Exempt Public Sector Scheme listed in Schedule 1AAA of the SIS Act and complies only where it is practical to do so. The MSBS is a fully compliant scheme.

The DFRDB Scheme

Background – The DFRDB scheme came into effect on 1 October 1972 following Government consideration of a Report from the Joint Select Committee on Defence Forces Retirement Benefits Legislation dated May 1972. Mr J.D. Jess C.B.E., M.P., chaired the Committee and the Report is commonly known as the Jess Report. The Minister Assisting the Minister for Defence has portfolio responsibility for the DFRDB Act 1973. The Department of Defence is responsible for policy oversight of the Act, while the Defence Force Retirement and Death Benefits Authority is responsible for the administration of the Act. Day-to-day administration is undertaken by Commonwealth Superannuation Administration (ComSuper).

Benefit – The DFRDB scheme provides a defined benefit, that is retirement pay becomes payable when an eligible member leaves the ADF having served in the ADF for a period of 20 years or 15 years if the member has reached his/her retirement age for rank with out having completed 20 years service. Retirement pay is a percentage of final salary and the percentage varies depending on the member's length of service. For example, after 20 years of service, a member would be entitled to 35 per cent of his/her final salary as retirement pay. Retirement pay is an indexed pension payable during the member's lifetime. The member may elect to convert part of the pension to a lump sum and take a reduced pension. The pension is increased on 1 July each year based on the increase in all groups consumer price index number for the weighted average of the 8 capital cities for the previous March quarter (Part XA of the *DFRDB Act 1973* refers). The increase is the change over the previous March quarter index number. If that change is negative there is no reduction to the pension.

The DFRDB scheme is unfunded. Member contributions are paid into the Consolidated Revenue Fund (CRF) and benefits are paid from an annual appropriation that is administered by the Department of Defence.

Deferred benefits – Generally, a deferred or preserved benefit is not a feature of the DFRDB scheme. There is provision, however, that where a member has not served 20 years, leaves the ADF, commences eligible employment and makes an election within 90 days of leaving the ADF, the DFRDB benefit is preserved. The benefit becomes payable when the member has completed a total of 20 years of service. There is also an option for a transfer value to be paid to certain eligible schemes.

The MSBS

Background – The MSBS came into effect on 1 October 1991. This followed a review of the DFRDB scheme led by Sir William Cole. The Report of that review dated June 1990 had recommended a new superannuation scheme for members of the ADF that would meet the standards of the Occupation Superannuation Standards Act. The OSSA was replaced by the SIS Act in 1993. The Minister Assisting the Minister for Defence has portfolio responsibility for the MSB Act 1991. The Department of Defence is responsible for policy oversight of the Act. In accordance with the MSB Trust Deed, the MSBS is administered by the Military Superannuation and Benefits Board of Trustees No 1. The Rules governing the operation of the Scheme including the benefit entitlements are outlined in a Schedule to the Trust Deed. The Trust Deed may only be amended as provided in section 5 of the MSB Act 1991.

When the MSBS was introduced, DFRDB members were able to make a one-time election to transfer to the MSBS, or remain with the DFRDB scheme. Where an election was not made, the member remained with the DFRDB scheme.

Benefits – The MSBS differs from the DFRDB scheme in that it is intended that benefits that are payable under the Scheme Rules are paid as a lump sum. There are two benefits that a scheme member becomes entitled to when he or she leaves the ADF, a member benefit and an employer benefit.

The member benefit is a lump sum of the member's contributions and interest earned. Members are required to contribute between 5 and 10% of salary to the MSBS and the MSB Board invests those contributions. When a member leaves the ADF the member benefit becomes payable. In line with the SIS preservation standards only those contributions and interest that accrued before 30 June 1999 are payable immediately. Contributions and interest that accrued after 1 July 1999 must be preserved until the member's preservation age, in the MSBS or rolled over to a complying superannuation fund of the member's choice. No part of the member benefit may be converted to a pension.

When the member leaves the ADF, there is also an entitlement to an employer benefit. The benefit is a defined benefit based on a multiple of final average salary. The multiple is based on completed years of service. The benefit is 18% for each of the first 7 years of service, 23% for the next 13 years and 28% thereafter.

The benefit is largely unfunded and is paid from an annual appropriation that is administered by the Department of Defence. The first 3% of the benefit is funded, but is not payable separately to the member because it forms part of the overall defined benefit.

There are restrictions on when the employer benefit entitlement is payable. This depends on whether the member has attained age 55, whether he/she has reached his/her preservation age and whether they have left the workforce. Depending on the circumstances there are lump sum and pension options available to the member. Until the member meets one of the criteria for payment, the benefit must be preserved in the MSBS. This generally means the employer benefit remains preserved to at least age 55.

Preserved benefits – Both the member and employer benefit may be preserved in the MSBS until the member reaches age 65 at which age the benefits must be paid.

A preserved member benefit will continue to accrue interest at the Fund earning rate.

For a preserved employer benefit the funded and unfunded components are treated separately. The funded component, that is the first 3% of the benefit, will accrue interest at the Fund earning rate and this interest is ultimately payable to the member. The unfunded component is indexed so that it maintains its real value. The indexation is measured by change in the all groups consumer price index number for the weighted average of the 8 capital cities.

Indexation

DFRDB – Part XA of the *DFRDB Act 1973* provides for pension increases. Any increase will apply from 1 July each year if the all groups consumer price index number for the weighted average of the 8 capital cities published by the Statistician in respect of the March quarter of the previous year increases. There is no decrease if that index number decreases.

MSBS - Part 6 Division 2 Rule 56 of the MSB Rules provides for increases in pensions and unfunded preserved benefits. The increase is calculated in the same way as an increase in DFRDB pension would be calculated.

The MSB Rule follows the recommendation contained in the Cole Report, which noted:

> "*Indexation*
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> *8.16* *Pensions would be indexed annually in line with the movement in the CPI over the preceding year to the March quarter. This is the same approach as in the DFRDB Scheme and other Commonwealth schemes.*
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> *8.17* *It was noted that social welfare pensions are indexed on a six monthly basis and that low-income MSBS pensioners could experience some financial difficulty in times of high inflation if MSBS pensions were not similarly indexed. Nevertheless, it was considered inappropriate for the MSBS to afford the same treatment to its pensioners as is afforded to welfare recipients. The available MSBS pension would be relatively generous, particularly for those who make the ADF a lifetime career. For those who do not, it could be expected other employment or superannuation would provide an income in addition to the MSBS benefit. Accordingly, and while acknowledging that there would be some exceptions, the financial circumstances of most MSBS recipients would be much more akin to those of recipients of other Commonwealth superannuation pensions than those of welfare recipients.*
>
> ……….
>
> *Resignation Benefits*
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> ……….
>
> *8.27* ……..

> *That part of the lump sum relating to the 3% benefit would be preserved at the fund earning rate. The unfunded balance would be preserved at its real value by indexation in accordance with CPI."*

A brief historic perspective – Professor Pollard of Macquarie University, Sydney undertook a study into superannuation pension updating and reported in March 1973 (Enquiry into Superannuation Pension Updating, Parliamentary Paper No 9, 1973, The Parliament of the Commonwealth of Australia). Prime Minister Whitlam wrote to Professor Pollard in January 1973, noting in respect of the then DFRB scheme (the 1948 scheme for members of the ADF)

> "...You are no doubt aware that my Government has undertaken to adopt without equivocation or delay the recommendations of the Joint Select Committee on D.F.R.B. legislation, including that relating to the annual adjustment of retirement pay and invalid pay. Consequently, that aspect of your present terms of reference will no longer be relevant, but we would wish you to continue your enquiry .....your report would be available to the Government by 31 March next, so that it would be in a position to undertake the review I have mentioned before introducing amending D.F.R.B. legislation ....."

Professor Pollard review is of interest because it notes in referring to superannuation, that "... the aim of employers is not only to give protection but to give peace of mind or to free the employee from the ever present fear that a long retirement might bring severe financial problems in its later years ...". His review looked at a number of indices or methods for adjusting pensions that included:

- gross national product per head of population
- weekly wage rates index
- rate of increase in the value of the pension unit
- a Public Service marker system
- average weekly earnings
- consumer price index plus a supplement
- notional salary method, and
- Commonwealth Service wage rates index.

Professor Pollard's recommendations included that there be an automatic adjustment on I July each year and that the method be based on the Consumer Price Index of the previous March quarter. There were some qualifications and other factors included with the recommendations.

The Jess Report, referred to in Prime Minister Whitlam's letter, addressed automatic adjustment of pensions and made the recommendation that it "should be adjusted annually so that relativity with average weekly earnings is maintained. A possible method of achieving this would be to maintain the relativity of benefits to current pay for the rank held on retirement". In the body of the Report, the argument notes that the average weekly earnings recommendation was "...to some extent this is a compromise between the proportion of salary method of adjustment .... and the proposal that adjustment be related to the consumer price index. ...".

Part XA of the *DFRDB Act 1973* which provides for pension increases was added by *Defence Force (Retirement and Death Benefits Amendments) Act 1977*, No 13 of 1977 which received Assent on 28 February 1977.

Comment

The indexation arrangements recognise a commitment to maintain the purchasing power of the pensions and preserved benefits. They are a measure of change and historically this has been based on the consumer price index.

The commitment to indexation is incorporated into the DFRDB and MSB scheme rules. The same arrangements apply to both changes in DFRDB and MSBS pensions and the unfunded preserved MSBS employer benefit.

To change the existing arrangements would require an amendment to the *DFRDB Act 1973* and a disallowable instrument made in accordance with s5 of the *MSB Act 1991*. It would be expected that a change would only be made where it was beneficial to members of the schemes and this would increase the scheme cost. The cost would be reflected in:

- Defence departmental appropriations. There would be an increase in employee expenses and cash payments made in relation to the employer contributions under accrual based superannuation arrangements; and
- Appropriations administered by the Department of Defence. The cost of pensions would increase, as would the unfunded liability for the schemes. There would also be a notional interest increase.

To assess the impact on cost would require actuarial assessment in the light of any suggestions or recommendations that might be made.

There is occasional criticism, by scheme members, pension recipients and interested lobby groups, of the current indexation arrangements with suggestions being made for change. Such criticism and suggestion is usually single issue focussed without any consideration of the impact on overall scheme design and other benefits provided by the schemes.

Suggestions that have been made include:

- Other indexation factors that could be used as a measure of change in purchasing power and which would give a more favourable result than CPI;
- The use of the higher of CPI or Average Weekly Ordinary Times Earnings (AWOTE);
- Linking pensions to current ADF salaries for the equivalent rank level; and
- In the case of unfunded preserved employer benefits, linking the change to earnings of the MSB Fund.

Arguments could be made either in favour or opposing each of these suggestions depending on the perspective and outcome sought. It is important to note, however, that all these suggestions would increase the cost of the schemes and change could not be implemented without some change in costs. Any increase in cost would either have to be found or other scheme design features changed. If for example, it was decided that if any changes to existing indexation arrangements were to be cost neutral, other benefits would either have to be rationalised or removed to achieve savings equal to the cost.

A far more important consideration in assessing the merits of suggested change to current indexation arrangements is to consider whether the proposal would exceed what could be considered a reasonable measure of change in purchasing power. This is because the current CPI arrangements are considered to be a reasonable measure of change that meets the commitment inherent in the design of the DFRDB scheme and MSBS.

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