INQUIRY INTO THE BENEFIT DESIGN OF COMMONWEALTH PUBLIC SECTOR AND DEFENCE FORCE UNFUNDED SUPERANNUATION FUNDS AND SCHEMES

Presentation by Victorian Department Treasury & Finance

Victoria's largest public sector defined benefit scheme is the State Superannuation Fund (SSF).

The Government Superannuation Office administers the SSF.

The SSF has been closed to new members since 31 December 1993. The Revised scheme of the SSF, which is the main pension scheme, was closed on 30 June 1988.

The governing legislation for the Fund is the *State Superannuation Act 1988 (SSA).*

As at 30 June 2000 the SSF comprised:

- 73,000 active members
- 54,000 pensioners
- 50,000 deferred beneficiaries

Indexation Arrangements for Pensioners

Section 91 of the *SSA* requires that SSF pensions be indexed to movements in the All Capital Cities CPI on a bi-annual basis.

It requires that any increase in the CPI for the December half-year be applied to pension payments from the first pension payment in the following June.

Increases in the CPI for the June half-year are applied to pension payments from the first pension payment in the following December.

The bi-annual indexation of pensions was introduced in 1980. Prior to this CPI adjustments only occurred once a year. A minor amendment to the indexation provisions occurred in 1992 when the basis for indexation was changed from the Melbourne CPI to the All Capitals CPI. This change reflects the fact that approximately 25 per cent of all Victorian pensioners live outside metropolitan Melbourne.

The indexation provisions contained in the *SSA* compare favourably with the indexation provisions that apply to public sector pensions in other jurisdictions. For example, superannuation pensions paid by the Commonwealth, NSW, Queensland, and South Australian public-sector superannuation schemes are only indexed on an annual basis. Off-setting this, to some degree, is the fact that in most jurisdictions, there is a delay of only 3 months in applying CPI increases to pension payments.

The contributions paid by Victorian State pensioners over their working careers were based upon receiving a pension that is indexed in accordance with current indexation provisions.

Any change to Fund rules to introduce earlier payment of CPI increases or a change in indexation arrangements that results in indexation greater than that provided by CPI would increase the value of the SSF's accrued benefit liabilities and this increase would ultimately have to be met by Victorian taxpayers.

It is the strong view in Victoria that the current indexation by the All Capital Cities CPI on a bi-annual basis provides an appropriate set of arrangements for pensioners and achieves the aim of protecting the purchasing power of their pensions.

Deferred Beneficiaries

Deferred Beneficiaries are members who have left the public sector (usually through resignation) prior to reaching minimum retirement age. Upon exit, a portion of the accrued retirement benefit is deferred until retirement from the workforce. The member becomes entitled to this benefit at minimum retirement age. It is the benefit payable at minimum retirement age that is indexed by CPI to ensure its purchasing power is maintained.

Under the Victorian Government's recently announced Beneficiary Choice Program (BCP), existing and future deferred benefit members of the State Superannuation Fund will be provided with the opportunity to convert their deferred benefit entitlement to a lump sum to be rolled over into a complying fund of their choice. As it is the indexed-benefit payable at 55 that is being accessed at an earlier time, it is appropriate to apply a discount rate. The discount rate to be applied under the BCP is 4% per annum. The Victorian Minister for Finance determined this rate on the advice of the SSF's actuary.

A discount rate is appropriate because future increases in CPI are expected to be lower than long-term future investment returns. A deferred beneficiary who elects to take an immediate lump sum could invest the lump sum and in future receive investment returns rather than CPI. The impact of the discount is larger for younger beneficiaries than for those that are close to minimum retirement age.

Each year the Fund's actuary calculates the Fund's accrued benefit liabilities as part of an annual review of the unfunded liability. In these calculations the long-term investment return and inflation assumptions used are 7% p.a. and 3% p.a. respectively, resulting in a 4% real rate of return and correspondingly a 4% real discount rate. The lump sum schemes within the SSF include CPI indexed deferred lump sum benefits for which the accrued benefit liability is calculated by discounting the amount of the deferred lump sum benefit by 4% p.a. Hence, a 4% discount rate is natural to use. The alternatives are to use either a:

- higher discount rate than 4% p.a., which would result in a reduction to the unfunded liability each time a member elects an immediate lump sum; or

- lower discount rate than 4% p.a. for the BCP would result in an increase to the unfunded liability each time a member elects an immediate lump sum.

Whether a member will benefit from electing an immediate lump sum rather than a deferred benefit will depend on the member's individual circumstances. For example, if a member can invest the immediate lump sum in a complying superannuation fund and receive an after tax investment return of more than 4% p.a. above CPI they will be better off. Over the last

decade real investment returns have been well in excess of 4% p.a. and over much longer historical periods a real return of this order is not unrealistic.

It should be noted that the rollover of a discounted lump sum to a complying fund will be undertaken in a manner that is fully consistent with Commonwealth preservation laws.

Superannuation Policy Unit
Victorian Department of Treasury and Finance
15 February 2001