Report of the Review into Military Superannuation Arrangements

REVIEW OF MILITARY SUPERANNUATION

The Hon Bruce Billson MP
Minister Assisting the Minister for Defence
Parliament House
CANBERRA ACT 2600

Dear Minister

Final Report of the Military Superannuation Review

We have pleasure in attaching the Final Report of the Military Superannuation Review.

We believe we have developed an attractive and innovative package of proposals that would increase the value-for-money of military superannuation to ADF members as well as to Defence and the Government in terms of recruitment and retention. They reflect best practice contemporary superannuation, while recognising the unique nature of military service.

The central recommendations form an integrated package which should prove attractive to ADF members and their families, and we would strongly caution against a more incremental approach to reform through selective or partial acceptance of our recommendations.

We have received excellent support from the Review Secretariat, ably led by Mr Brian Paule, and the Australian Government Actuary, through Mr Michael Burt. We were also assisted by the many submissions received and the consultations with current and former ADF members. Senior ADF members across all three Services have been particularly cooperative, as have been the Reference Group members from Defence and the Central Agencies, and the key support agencies (ComSuper, the MSBS Board and the Department of Veterans' Affairs).

As an independent Review Team we take full responsibility for the Report and the recommendations.

Yours Sincerely

Andrew Podger
Chair

Dr David Knox

Air Commodore Lee Roberts

31 July 2007

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Attachment: Letter from Minister Assisting the Minister for Defence

Terms of Reference

In announcing the Review of Military Superannuation on 27 February 2007, the Minister Assisting the Minister for Defence released the following Terms of Reference and related guidance.

Principles

Two interconnected principles should guide the conduct of the Review of Military Superannuation Arrangements and form the philosophical context within which the Terms of Reference are addressed. These are the 'unique nature of military service' and the need to compensate members of the Australian Defence Force (ADF) for that uniqueness in their superannuation, invalidity and death benefits, as with other conditions of service, thereby ensuring that joining and staying in the ADF remain attractive propositions.

Terms of Reference

Having regard to the unique nature of military service and the importance of superannuation, invalidity and death benefits provided by the military superannuation schemes:

1. Review the current military superannuation arrangements and the suitability of those arrangements in light of:

    a. The contemporary legislative and regulatory framework within which superannuation benefits are provided in Australia;

    b. The need to efficiently manage the unfunded liability for military superannuation and associated emerging and extant Government policy related to Commonwealth superannuation schemes;

    c. The current and likely future demographic profile of the ADF;

    d. The changing demographics of current members of the military superannuation schemes;

    e. Wider remuneration for permanent and reserve members of the ADF;

    f. The current and future costs associated with providing, managing and administering military superannuation arrangements;

    g. State, national and international best practice in the provision and funding of occupational superannuation, invalidity and death benefits in comparable military and civilian public and private sector organisations whose members are subject to relatively early retirement;

    h. Rehabilitation and compensation arrangements provided under the *Military Rehabilitation and Compensation Act 2004;*

    i. The appropriateness of the Defence Force Retirement and Death Benefits Authority's current constitution and governance structure;

    j. Possible future changes in the governance and administration of Commonwealth superannuation;

    k. The appropriateness of, and potential for, the MSB Fund to be accorded public offer status[1]; and

    l. The Review Team's evidence based assessment of the links between military superannuation and ADF recruitment and retention rates.

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[1] This relates solely to considering the appropriateness of according public access to the MSB Fund and its investment options, to grow the size of the fund with the potential to provide a better scale of investment opportunities. It does not relate to extending membership of the MSBS and associated employer-funded retirement, invalidity and death benefits to members of the public.

2. Having regard to the above, analyse the following specific issues which have been highlighted by emerging and extant Government policy and member feedback:
    - The operation of the Maximum Benefit Limits;
    - Recognition of interdependent relationships;
    - Indexation of military superannuation pensions;
    - The operation of life expectancy factors;
    - Transition to retirement provisions;
    - Preservation arrangements;
    - Portability arrangements;
    - Superannuation splitting;
    - The calculation of final salary for retirement, invalidity and death benefits;
    - The implications of the complexity of the military superannuation schemes for members and the administrator;
    - The impact of the Compulsory Retirement Age given the role of preservation ages and the 2006-07 Budget superannuation proposals;
    - The appropriateness of the three-tiered invalidity classification system.
3. Consult widely within Government and the financial services industry as well as the Defence Force Retirement and Death Benefits Authority, the Military Superannuation and Benefits Board, representative Ex Service Organisations, advocacy groups and members of the ADF.
4. Make recommendations about the future for military superannuation in light of all the considerations above, including potential alternative arrangements, that:
    a. Are consistent with the spirit and requirements of the regulatory environment for superannuation;
    b. 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);
    c. Are consistent with broad Government superannuation and budgetary policy;
    d. Are fully costed with detailed implementation and transition plans;
    e. Are sufficiently flexible to account for potential changes in the ADF workforce associated with the ageing of the population;
    f. Account for permanent and reserve members of the ADF;
    g. Account for contributors, pensioners and those with preserved benefits in open and closed schemes;
    h. Account for defined invalidity and death benefits either in their existing superannuation framework or an alternative framework; and
    i. Account for any accepted recommendations of the Review of the Corporate Governance of Statutory Authorities and Office Holders and the Review of the Government's Role in the Administration of Superannuation for Commonwealth Employees.
5. Present those recommendations to the Minister Assisting the Minister for Defence in writing within six months of announcement. The Review Team is also authorised to make recommendations to the Defence Ministers and the Chief of the Defence Force on issues which are sufficiently distinct and reasonable to address in isolation prior to final reporting.

6. The Review Team is required to furnish the Defence Ministers and Chief of the Defence Force with information about the progress of the Review on a regular basis and to support the ADF in the provision of policy advice to Government. A reference committee comprised of, but not limited to, representatives of Defence, the Treasury, the Department of Prime Minister and Cabinet and the Department of Finance and Administration will provide the Review team with guidance as needed.

The unique nature of military service

1. The Terms of Reference, among other matters, require the Review Team to have regard to the unique nature of military service. In view of this requirement, the following paragraphs outline the characteristics of military service which, when taken collectively, distinguish it sharply from employment in broader society.

2. The main characteristics of military service are:
   - liability for combat operations;
   - a military discipline code;
   - a regimented way of life;
   - long and irregular working hours;
   - statutory retiring ages well below the community norms;
   - high standards of physical fitness;
   - frequent relocation; and
   - separation from family.

3. The principal distinguishing feature of military service is the liability for combat operations. This liability 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. Other special features flow from this liability.

4. ADF personnel are subject to both the civil legal code and a separate Defence Force disciplinary code. The disciplinary code supports the command structures necessary for effective conduct of combat operations and training. The Defence Force disciplinary code imposes restrictions on personal conduct; it demands different standards from those generally acceptable within the community; and it impinges on the individual's family life and leisure time.

5. The discipline code also impacts on the ADF collectively. For example, ADF members are precluded from engaging in industrial action. The creation of the Defence Force Remuneration Tribunal to determine pay and allowances for the ADF is recognition of the ADF's unusual industrial situation.

6. Another industrial aspect of ADF service is the liability to work long and irregular hours. Operational tasks, assistance to the civil community and training activities cannot be tied to set hours. The requirement to work extra hours is unpredictable and often arises at short notice. More importantly, ADF members are obliged to work whatever hours are demanded to complete an assigned task. No overtime is payable but some allowances, particularly Service Allowance, recognise the disability and provide some compensation.

7. Allied to the long working hours is separation from families. The periods of separation can be considerable, particularly for members in operational units. Separation causes stress to both members and families.

8. Another major cause of stress is the necessity to post members at irregular intervals to meet ADF manning requirements. Not only do postings involve geographical relocations, sometimes to relatively unattractive places, but also employment in positions demanding acquisition and utilisation of new or different skills. The limited capacity to laterally recruit exacerbates the posting frequency and employment in unfamiliar environments. Family life in particular can be adversely affected. Spouse

employment opportunities and the quality and continuity of children’s education can be adversely affected.

9. Operational tasks and training for combat are demanding activities. Technology in many cases reduces physical effort but ADF service requires that members maintain a high standard of physical and mental fitness. The consequence of failure to satisfy the ADF standard is severe. A member is discharged from military service where any medical condition precludes effective ADF employment.

10. The demands of ADF service also lead to statutory retiring ages which are considerably lower than the community norm. Most ADF personnel can serve to age 55. However, most ADF members resign prior to attaining statutory retirement age as vocational options are perceived to diminish with age. This suits current ADF personnel management practices.

11. Of the major characteristics of military service the liability for combat and the military discipline code are, of course, peculiar to the Defence Force. Other characteristics of miliary service are derived from or related to these characteristics. Some of these characteristics do also occur in other occupations but only individually. It is the cumulative impact of all the features which constitutes the special nature of the ADF and which distinguishes it from other occupations.

12. The special nature of military service makes it necessary for the ADF to design conditions of service that will continue to attract and retain personnel despite the hazards and hardships of military life.

The need to compensate members of the ADF for the unique nature of military service through their superannuation, invalidity and death benefits as with their other conditions of service

13. The unique nature of military service poses challenges for the ADF when recruiting and retaining personnel beyond those encountered by other employers in the economy. The ADF has structured its conditions of service accordingly and those conditions, including the retirement, invalidity and death benefits, are generous relative to normal workforce standards.

14. It is important to maintain that relative distinction so that people considering joining the ADF and those already serving can recognise the adequacy of their conditions, given the additional hardships and risks inherent in ADF service. A diminution in the relative value of these benefits could have adverse effects on the ADF’s ability to recruit and retain the personnel it needs to fulfil its functions. This could affect the viability of the ADF workforce as a whole which would have significant implications for the Government’s ability to maintain its national security policies.

Additional matter to be considered

During the course of the Review, the Minister Assisting the Minister for Defence wrote to the secretariat of the Review requesting the Review Team to consider an additional matter concerning the payment of superannuation benefits to individuals remanded in custody. The letter is included as an Attachment.

Executive Summary

Introduction

The Terms of Reference (TORs) identify two principles that provide the philosophical context for the Review. Firstly, the 'unique nature of military service' requires careful consideration of the design features in military superannuation schemes. Secondly, superannuation benefits are a key component of ADF conditions of service and have the potential to contribute to recruitment and retention in the ADF.

In summary, the TORs require:

- A review of the current schemes against the two principles and in light of the contemporary superannuation framework in Australia and best practice superannuation, as well as developments in the ADF and elsewhere relevant to military superannuation arrangements.
- Analysis of a list of specific technical design issues concerning the current schemes of enduring interest to stakeholders. This list was supplemented by the Minister's letter to the Review Team requesting a review of the payment of superannuation benefits to individuals remanded in custody.

Occupational superannuation in Australia has changed enormously over the last 25 years. Following the superannuation reforms of the 1980s, the Defence Force Retirement and Death Benefits (DFRDB) Scheme was closed and the Military Superannuation and Benefits Scheme (MSBS) was introduced. In particular, this widened vesting so all ADF members would benefit, and preserved benefits to age 55 in line with the new community standard. Since the MSBS was introduced in 1991, the contemporary superannuation environment has further changed. Changes that most clearly present challenges for the MSBS include the increased emphasis on flexibility and portability, increasing individual responsibility, a greater emphasis on transparency and funding, and the new 2007 tax arrangements.

Changing employment patterns in the Australian workforce generally, and recent low levels of unemployment, have been reflected in increasing challenges to recruit and retain ADF members. These add to the case for reviewing current military superannuation arrangements.

The unique nature of military service involves the significant risk of death and disability, and the likelihood that career ADF members will retire earlier than is standard practice in the Australian workforce. These characteristics have been, and should continue to be, reflected in military superannuation through the provision of generous death and disability benefits and through access to retirement pensions from age 55.

In conducting the Review, the Team consulted widely and systematically despite its tight time deadlines. The Review Team also approached the task on the basis of working within the broad envelope of the current costs of the existing schemes, while identifying options that might be supported if additional funding were available. It did not approach the task as an opportunity for financial savings (particularly given the stated principles relating to the unique nature of military service and the potential to support recruitment and retention), but it was also conscious of the need to be financially responsible as implied by the several references to costs in the TORs.

Desirable Characteristics of Military Superannuation in Australia today

Drawing together the desirable characteristics of military superannuation from best practice contemporary superannuation, the potential impact on recruitment and retention and the unique nature of military service, the Review Team has applied the following Guiding Principles for any new arrangements for military superannuation:

- **Flexibility**, to meet individual member preferences regarding both contribution arrangements and the form of benefits and to respond to future changes to the broader superannuation or ADF environments.
- **Simplicity**, to enable ADF members to clearly understand and measure the value of their current employer contributions to superannuation and the potential future benefits.

- **Adequacy**, for all members of the ADF, both short-term and long-term, with a level of benefit that facilitates the maintenance of living standards, both on and through retirement.
- **Tailored**, to address the unique nature of military service by providing generous life-time support for dependants in the event of death or disability and rewarding long and arduous military service.
- **Visibly attractive**, forming an integral part of the remuneration package, enhancing the ADF conditions of service package and, in particular, supporting retention at critical points for the ADF and attracting former ADF members to re-enlist.
- **Financially sustainable**, with stable employer contributions over time and no increasing unfunded liability.

Assessment of current schemes

The Review Team determined that, while the MSBS compares reasonably well with most overseas military schemes and with other Australian schemes for 'uniformed bodies', it still falls well short of best practice contemporary superannuation and does not contribute significantly towards recruitment and retention. The DFRDB is rated well below the MSBS.

In conclusion, the Review Team believes that a new scheme should be introduced that fully satisfies the Guiding Principles.

A New Military Superannuation Scheme

To meet the Guiding Principles, the new scheme should have a contemporary approach to providing for retirement income by being a taxed, funded, defined contribution scheme. Unlike many contemporary schemes, however, it should offer a range of retirement benefit options including indexed pensions. In view of the unique nature of military service, it must also retain generous defined benefits for death and disability.

In broad terms, the proposed new scheme will comprise:

- **an accumulation retirement plan**, with individual accumulation accounts built on generous employer contributions increasing with length of service (at 16, 23 and 28 per cent of superannuable salary) and voluntary personal contributions. Members will be able to access their accumulated benefits in the form of a lump sum or an account-based pension on reaching preservation age. Members with 15 or more years of service will have the additional option of converting their lump sum into an indexed pension or an account-based pension from age 55.
- **death and disability benefits** which complement the accumulation retirement plan. For members discharged on medical grounds, disability income benefits will be paid in the form of rehabilitation-focussed salary maintenance payments until age 60. In addition, Defence will continue to make employer contributions to the accumulation plan building funds for retirement at age 60. Death benefits will supplement the funds accumulated in the retirement plan taking into account the members' prospective service to age 60. This total lump sum can be converted into an indexed spouse pension with additional payments for dependent children, similar to current pension arrangements.

The death and disability benefits will also be better integrated with the *Military Rehabilitation and Compensation Act 2004* (MRCA) arrangements.

The proposed new scheme will allow membership beyond ADF members. Membership, without administrative fees, will be available to the spouse and dependent children of a serving ADF member. Membership will also be open to all Reservists, without administrative fees. Members from these groups will have their own individual accumulation accounts. Members who leave the ADF but retain funds in the scheme can also choose to have contributions from future employers directed into their accounts, though they will have to pay an administrative fee.

The Review Team considers that it is important for retention purposes to offer all current ADF members the option of transferring to the new scheme from their current scheme (MSBS or

DFRDB). The Review Team also considers that preserved MSBS members should be allowed to transfer to the new scheme.

The impact on the ADF and ADF members

The proposed new scheme will meet the Guiding Principles far more closely than the existing schemes, though members will bear more of the risks.

Members separating with under 20 years of service are likely to gain, and longer serving members are likely to receive broadly comparable retirement benefits to those under the MSBS.

Disability benefits for compensable injuries are generally unchanged, and benefits for non-compensable injuries are, if anything, improved particularly by more generous indexation arrangements. There is also the likelihood of improved benefits at age 60, with access to a substantial accumulated lump sum that can be converted into an indexed pension. Disability payments would be reduced, of course, if the individual is successfully rehabilitated into employment.

Death benefits are also likely to be more generous than under the MSBS.

The apparent inconsistency of many ‘winners’ and few ‘losers’ but with the same long term cost to Government is explained by the transfer of risks from Government to members.

The Review Team considers that the new scheme will have a positive impact on retention, in particular, by making transparent the value of the employer contribution as a component of the remuneration package, demonstrating its generosity compared to the level of employer superannuation contributions elsewhere. In so doing, it should take pressure off demands for increases in ADF pay and hence give better value for money to Defence from its total remuneration package.

While superannuation does not have a major impact on recruitment of young people, the increased transparency of the value of the employer-financed benefit under the new scheme, and its enhancement of the remuneration package, should have a positive effect. There is likely to be a significant advantage for attracting older and more experienced recruits. Effective marketing will enhance these positive effects.

The Review Team does not recommend that Reservists, other than those on continuous full-time service, be eligible for employer-financed contributions to the new scheme. It believes more careful consideration of the role and nature of Reservists is required, and that this should flow through to consideration of the appropriate remuneration package including the applicability and level of superannuation.

Governance arrangements

A new board would assume all responsibilities for management of the DFRDB, MSBS and the proposed new scheme. In line with the Uhrig Report ‘best practice principles’, the board should comprise seven trustees, one of whom would be an independent chairperson.

Implementation and transition

Given the lead times that will be necessary, the Review Team believes the proposed new scheme should commence in the first half of calendar year 2009, allowing the initial budgeting impact to be spread over two financial years (2008-09 and 2009-10). This timing assumes Government agreement to the major recommendations soon after the Review Team reports at the end of July 2007.

A detailed implementation plan will need to be developed once the Government’s responses to the Review Team’s recommendations are known. The main issues to be addressed in such a plan are identified in the report. The Review Team has suggested the Government could agree to the early implementation of some recommendations.

Education and awareness

The proposed new scheme will require substantial effort to educate members not only during the transition but also on an ongoing basis.

Some details of the components of the transition education and awareness campaign are set out in the report.

The new scheme will require a very different approach by ADF members towards their superannuation. It will involve a shift from the paternalism of the past to much greater responsibility being shouldered by members for the management of their superannuation savings. It will also offer Defence the opportunity to 'sell' its employer contributions as a generous element of the remuneration package, and to enhance its other recruitment and retention strategies. In both respects, this will require ongoing education and awareness of superannuation.

Additional technical issues

The TORs require the Review Team to analyse a list of specific issues which have been highlighted by emerging and extant Government policy and member feedback.

MSBS Maximum Benefit Limits. To address retention concerns, as well as fairness, the Review Team recommends that MSBS Maximum Benefit Limits be fully abolished for all currently serving MSBS members at the date of that change. Consideration could be given to abolishing the MSBS MBLs before the implementation date of the new scheme.

Interdependent Relationships. The Review Team believes the proposed new scheme should reflect contemporary practice and recognise interdependent relationships. It does not consider that the unique nature of military service would justify an exception. In principle, there is a strong case also for recognising interdependent relationships in the existing schemes. The Review Team suggests, however, that any change to the MSBS and DFRDB be made in conjunction with any such changes to the other Commonwealth defined benefit schemes.

Indexation arrangements. The Review Team considers that there is an in-principle case for changing the indexation arrangement for DFRDB pensions to an earnings basis, but recognises that this would be expensive. Given Government policy on preservation arrangements, the Review Team considers there is no case to increase the generosity of benefits payable prior to age 55, but there is a case for older DFRDB pensioners. Accordingly, it is recommended that, only if the Government is willing to go beyond the envelope of current costs, it should consider indexing DFRDB pensions on a similar basis to that applying to age pensions. Any such improvement should be limited to pensions paid from age 55 or, at a lower cost, from age 65.

The MSBS has very generous arrangements for converting lump sums into indexed pensions, and it would be difficult to justify an even higher subsidy for pensions by indexing them on the basis of earnings rather than prices. Accordingly, the Review Team does not recommend a change in indexation arrangements for MSBS pensions.

Life Expectancy Factors. The Review Team acknowledges the significant improvement in life expectancy since the 1960s, but is not persuaded by the claim for a more generous treatment of commutation arrangements under the DFRDB which still applies those life expectancy factors. 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 solely on current life expectancy figures would be even more excessively generous.

Calculation of Final Salary. While there are valid reasons for using Final Average Salary (FAS) as the basis for setting retirement benefits in the MSBS, these do not apply in the case of death and disability since the benefit is based on prospective service rather than past, and the member cannot choose the date of death, injury or separation. Accordingly, death and disability entitlements under the proposed new military superannuation accumulation scheme are more aligned towards the MRCA benefit regime and will be based on final salary (not FAS). The Review Team considers a similar approach should be adopted for MSBS death and invalidity benefit calculations; this could be implemented quickly.

Individuals remanded in custody. During the course of the Review, the Minister Assisting the Minister for Defence raised with the Review Team the applicability to military superannuation of provisions elsewhere to suspend pensions for individuals remanded in custody by Federal or State Authorities. Current arrangements are complex and not particularly coherent, with some Government payments suspended and others not suspended. Apart from the existing provisions for corruption, the Review Team is inclined to an approach along the following lines:

- Safety net payments such as service pensions should be suspended while Government covers living expenses directly while the person is imprisoned.
- Compensation payments for loss of earnings and impairment should not be suspended.
- Superannuation payments either from accumulated funds or via defined benefit disability payments should not be suspended.
- In the last two cases State authorities could, should they choose to, pursue recovery of costs to offset accommodation and living expenses associated with imprisonment, or to contribute to victim compensation.

Financial Implications

The financial implications of the Review Team's recommendations fall under several headings:

- **The employer contribution rates**. These are the critical indicators of the underlying costs of current and proposed arrangements.
- **The cash requirements and impact on unfunded liabilities**. The shift from unfunded defined benefit schemes to a funded defined contribution accumulation plan will replace the build up of unfunded liabilities to be met in the future with real funding set aside now. The cash required for this current funding is not, in any way, a measure of the costs of the new scheme.
- **The transitional impact on accrued liabilities.** This is a real cost (or saving), but is one-off and is not a measure of the underlying or continuing cost.

The **employer contribution rate** under the proposed new arrangements (i.e. the combined rate for ADF members across the DFRDB and MSBS as well as the new scheme) is projected to be broadly similar under the current and proposed arrangements though with a small increase over the first few years. The cost of the new scheme itself, in terms of the employer contribution rate for new scheme members only, is no higher than the cost of current arrangements.

The transitional arrangements proposed will bring forward previously **unfunded liabilities** accrued under the MSBS and DFRDB. This will require an immediate funding on introduction of the proposed scheme of about $7-8bn (based on a 2009 commencement). In addition, the Defence contribution for members in the proposed scheme will fund benefits directly rather than notionally. The Review Team notes that the Future Fund is the most obvious source of the cash required, it having been established precisely for the purpose of meeting the unfunded liability. In basic economic and financial terms, these cash requirements will not have any real impact if met from the Future Fund: they will merely bring forward future liabilities and they will transfer funds from the Future Fund's investments to the new superannuation fund's investments.

There will be a commensurate reduction in the unfunded liability that would otherwise continue to grow with the continued operation of the existing schemes. Indeed, the Actuary's estimates show that the total unfunded liability will drop instead of growing substantially and continuously.

The transitional arrangements will have a **'one off' impact on accrued liabilities** as members of DFRDB and MSBS choose whether to transfer into the proposed scheme. The Actuary suggests this impact might be a saving on accrued liabilities of around $150-200m, comprising savings as a result of current contributors transferring offset by the costs of MSBS preservers transferring.

Aside from the option to change DFRDB indexation arrangements, the costs of the recommendations on the **additional technical issues**, both in terms of ongoing employer contribution rates and in terms of accrued liabilities, can be met within the current broad cost envelopes along with the new scheme and the recommended transitional arrangements. As changes to DFRDB indexation could not be met within these envelopes, the Review Team's recommendation in this regard has been accorded a lower priority than the other recommendations. The Review Team also recognises there would be flow-on pressure for such a change to also apply to the Commonwealth Superannuation Scheme for public servants. The large one-off increase on the unfunded liability would, however, be paid out over many years with only a modest budgetary impact in the first few years.

Recommendations

Future military superannuation arrangements

Recommendation 1 The Australian Defence Force should continue to have its own mandated superannuation scheme with benefits that reflect the unique nature of military service.

Recommendation 2 Defence should close the Military Superannuation and Benefits Scheme to new members of the ADF and introduce a new superannuation scheme for all new members of the ADF comprising an accumulation plan for retirement and separate defined benefits for death and disability.

Recommendation 3 The new superannuation accumulation plan for retirement should be fully funded and taxed with the following key elements:

a. employer contribution rates of 16% of superannuation salary for the first six years of completed service, 23% for the next nine years of completed service and 28% after 15 years of completed service (with recognition of prior military service);

b. flexibility for members to set their own contribution rate, if any (with a default rate of 5% from after tax salary), select their investment risk profile and to make contributions following separation from the ADF;

c. members to have choice over the superannuation scheme into which their contributions will be invested whilst maintaining membership of the mandated death and disability benefits under the new scheme;

d. options for members with 15 years or more service, from age 55, to purchase indexed pensions (with a choice of indexation factors, at an unsubsidised price determined periodically by a Government-approved actuary) and/or an account based pension;

e. a range of options for the way members can access their benefits after preservation age, including through an account-based pension. This would allow members to take advantage of the Government's transition to retirement provisions; and

f. flexibility for spouses and children of members to contribute (personally and/or from an external employer).

Recommendation 4 Death and disability benefits under the new superannuation scheme should have the following key attributes:

a. Defence as employer should continue to meet the costs.

b. Compensable and non-compensable arrangements should be brought under one assessment and administration regime with an emphasis on rehabilitation, under the auspices of the Department of Veterans' Affairs.

c. Compensable disability benefits should be fully the responsibility of the *Military Rehabilitation and Compensation Act 2004* (MRCA) until age 60 at existing rates of benefits.

d. For non-compensable disability, the current three-tiered invalidity benefits should be replaced by a single benefit for loss of earnings, akin to the *Military Rehabilitation and Compensation Act 2004 (*MRCA) benefits and conditions, with a minimum of 40% and maximum of 70% of final salary (based on actual and prospective service), indexed to Defence earnings and payable to age 60.

e. Employer contributions to the superannuation retirement fund should continue whilst a person is in receipt of either MRCA or superannuation disability benefits at a rate of 23% of the 'salary maintenance', up to age 60.

f. Death benefits from the superannuation scheme should supplement the accumulated benefit on the basis of 23% of final salary for each year of prospective service to age 60, payable in addition to any MRCA death benefits. Where there is a surviving spouse, the superannuation death benefit may be converted to an indexed pension with additional payments for up to three dependent children.

g. In the case of terminal illness, early access to the death benefit should be allowed.

Recommendation 5 Superannuation for Reservists should be along the following lines:

a. Reservists should be allowed to contribute personally and/or from an external employer into the new scheme.

b. Reservists on full-time service should continue to be included in normal Defence superannuation arrangements including the proposed new scheme.

c. Reservists not on full-time service whose pay is tax-exempt should not be included in normal Defence superannuation arrangements and should not receive the proposed employer contributions under the new scheme.

Recommendation 6 Defence should meet the costs of administration of the scheme for individuals in receipt of an ADF employer contribution or a benefit from the scheme, family members of these individuals and Reservists who choose to use the scheme.

Recommendation 7 Contributing members of current schemes should be offered the choice, for a limited period, of remaining in their current scheme or having their existing accrued benefits funded and then taxed on transfer to the new scheme, or to a scheme of their choice.

Recommendation 8 Preserved members of the MSBS should be given the option, for a limited period, to have the current face value of their benefit funded and then taxed on transfer to the new scheme, or to a scheme of their choice.

Recommendation 9 A single governance structure should be put in place for the DFRDB and MSBS, as well as the new scheme, along the following lines:

a. The structure should be established under legislation, with a Trust Deed for the MSBS and new scheme.

b. There should be a seven member board of trustees comprising two employee representatives, two employer representatives and three independent representatives, including the chairperson.

c. A committee structure is to be determined by the Board to assist with all the Board's responsibilities for the DFRDB, MSBS and new scheme.

d. Pending establishment of the proposed new governance structure covering all schemes, the DFRDB Authority should have an independent chairperson, appointed by the Minister.

Recommendation 10 Defence, with the ADF Financial Services Consumer Council and in consultation with the MSBS (or new) Board, should conduct an extensive education and awareness campaign to support informed choice by ADF members and MSBS preserved members to transfer to the new scheme or to remain in their current scheme. This campaign should include access to computer modelling to allow individuals to estimate the likely effect of transferring or not transferring given their personal situation, and access for current ADF members to subsidised financial advice.

Recommendation 11 The new superannuation board, in consultation with Defence and the ADF Financial Services Consumer Council, should develop an ongoing education and awareness program to ensure ADF members are able to make informed choices about their superannuation investments (including member contributions) and benefits, with access to subsidised financial advice, for serving members, at key career points (including after six years service, 15 years service and on approaching age 55).

Technical issues concerning the schemes

Recommendation 12 The MSBS Maximum Benefit Limits should be abolished.

Recommendation 13 The proposed new scheme should recognise interdependent relationships. Recognition of interdependent relationships in the existing military superannuation schemes should be consistent with, and reflect, Government policy for the other Commonwealth defined benefit superannuation schemes.

Recommendation 14 If the Government is willing to go beyond the envelope of current costs, it should consider indexing DFRDB/DFRB pensions for those over 55 on a similar basis to that applying to age pensions. Because of the costs involved, this option does not warrant the priority attached to the other recommendations. An alternative option the Government could consider is to limit this change to pensions paid from age 65.

Recommendation 15 There should be no change to the MSBS pension indexation arrangements.

Recommendation 16 There should be no change to the DFRDB scheme life expectancy factors.

Recommendation 17 MSBS death and disability benefits should be calculated on the member's final salary or highest salary for superannuation purposes rather than the current final average salary.

Recommendation 18 Benefits for members or persons imprisoned because of a criminal offence should not be suspended, other than for those offences specified in the *Crimes (Superannuation Benefits) Act 1989*. The Review Team notes that State authorities may consider recovering amounts from prisoners' income to offset accommodation and administrative expenses, and/or to contribute to victim compensation.

Chapter 1: Introduction

Terms of Reference

The Minister Assisting the Minister for Defence, The Hon. Bruce Billson MP, announced the Review of Military Superannuation on 27 February 2007.

The independent Review Team comprised:

- Andrew Podger AO, former Public Service Commissioner and senior public servant with experience both in Defence and in superannuation policy;
- Dr David Knox, former President of the Institute of Actuaries of Australia and Foundation Professor of Actuarial Studies at the University of Melbourne. Dr Knox is currently a consulting actuary with Mercer Human Resource Consulting; and
- Air Commodore Lee Roberts, former Director-General Personnel, Air Force, and a member of the MSBS Board.

The Terms of Reference (TORs) identify two principles that provide the philosophical context for the Review. Firstly, the ‘unique nature of military service’ requires careful consideration of the design features in military superannuation schemes. Secondly, superannuation benefits are a key component of ADF conditions of service and have the potential to contribute to recruitment and retention in the ADF.

In summary, the TORs require:

- a review of the current schemes against the two principles, and in light of the contemporary superannuation framework in Australia and best practice superannuation, as well as developments in the ADF and elsewhere relevant to military superannuation arrangements, and
- analysis of a list of specific technical design issues of enduring interest to stakeholders that mostly concern the current schemes. This list was supplemented by the Minister’s letter to the Review Team requesting a review of the payment of superannuation benefits to individuals remanded in custody.

In making recommendations, the TORs require, inter alia, that they be consistent with the spirit and requirements of the regulatory environment for superannuation, and not be detrimental to former and current members of the ADF.

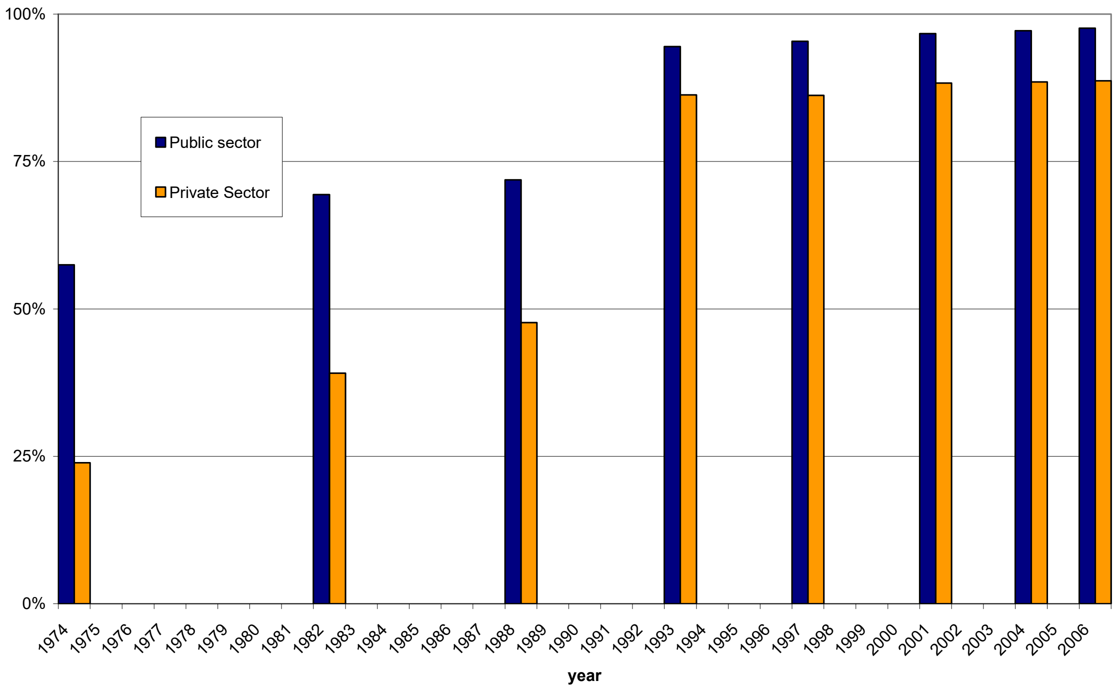
The full TORs are set out at the beginning of this report.

Background to the Review

Changes in the superannuation environment

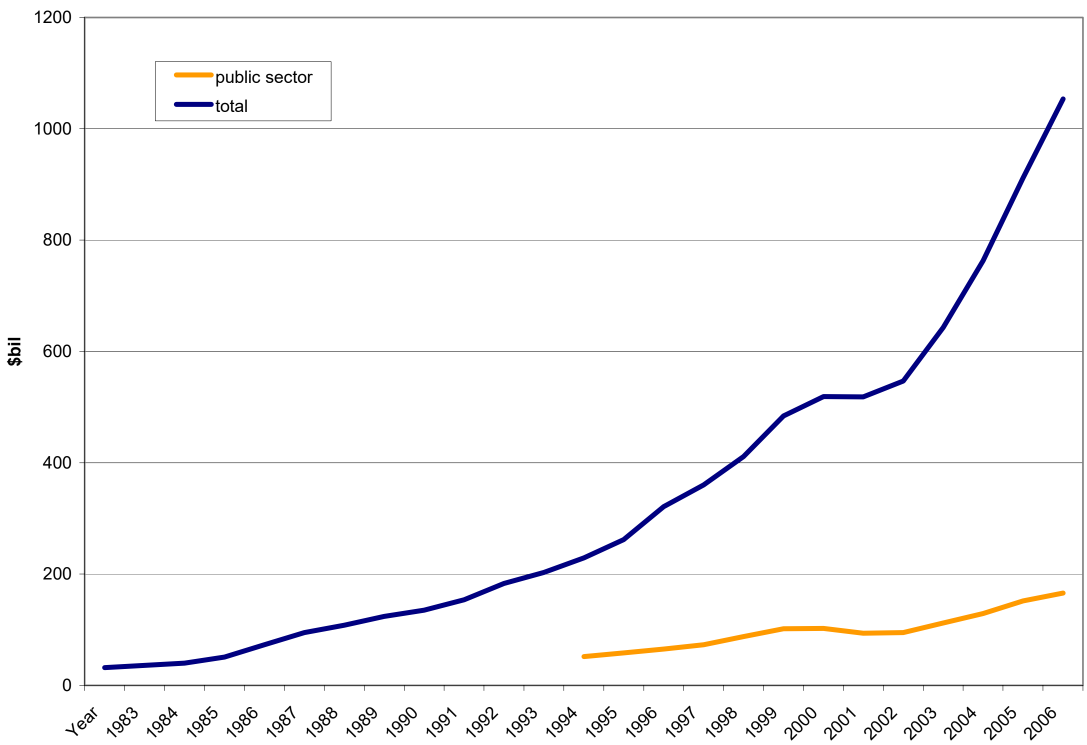
Occupational superannuation in Australia has changed enormously over the last 25 years. The scale of the changes is illustrated by the following two graphs. Figure 1–1 shows how the coverage of occupational superannuation has extended beyond the traditional public sector workforce with limited private sector coverage, to over 95% of the total workforce. Figure 1–2 shows how funds to meet the costs of superannuation benefits have increased almost exponentially from $32bn in 1983 to $1,054bn in March 2007, and are still growing quickly. Superannuation assets have grown from less than 40% of GDP in 1996 to more than 100% of GDP in 2007.

Figure 1–1: Australian employees covered by superannuation 1974 to 2006



Source Garry Barrett & Yi-Ping Tseng, Retirement Saving in Australia, SEDAP Research Paper No. 177, Table 1

Figure 1–2: Assets of superannuation funds 1983 to 2007



Sources APRA, Annual Superannuation Bulletin
APRA, Superannuation Trends, September 2004

Much of this change is in response to a series of policy reforms aimed at improving the effectiveness and efficiency of superannuation arrangements by improving the adequacy of retirement benefits for Australians while reducing their reliance on age pensions.

In the 1980s this involved reducing the bias towards lump sum benefits, improving preservation requirements, introducing Award superannuation and widening the vesting of benefit entitlements. It also involved the issue of indexed bonds to facilitate the availability of indexed pensions beyond the public sector.

In the early 1990s, employer contributions for superannuation were mandated through the Superannuation Guarantee, set at progressively higher levels (reaching 9% of employee earnings in 2002). The so-called 'three pillars' policy for retirement incomes was established, comprising the safety net of means-tested age pensions, mandated occupational superannuation and voluntary personal savings. The occupational superannuation industry, growing much larger and with strong competition amongst funds, introduced innovations in the range of products available and, influenced by government regulation, offered wider options for investment strategies.

A subtle but important shift in community attitudes towards superannuation was also taking place within the policy framework of mandated employer contributions, with individuals taking increasing control of their superannuation investments and benefits, rather than accepting the paternalistic guidance of employers. This demand for more responsiveness to individual preferences also led to increasing pressure for portability. In addition, many schemes moved from defined benefit to defined contribution, thereby moving the risk from the sponsoring employer to the members. These trends generated an attitude of greater ownership by members which, in turn, required greater transparency and funding and led to increased regulation.

One of the key drivers of the policy changes has been concern about the ageing population, and the risk of more adequate retirement incomes imposing unfunded liabilities to be met by future generations. There has also been a shift within the public sector away from unfunded, defined benefits schemes. The majority of these schemes have now closed and new employees are required to join funded, defined contribution schemes. This has also allowed the unfunded liabilities to be capped, while transferring much of the risk of future benefits from the sponsors to the members. The MSBS is now the only major Commonwealth scheme with unfunded defined benefits that remains open to new members, and hence is generating uncapped and increasing unfunded liabilities. The Commonwealth Future Fund, established by the *Future Fund Act 2006*, has been designed to ensure the current generation of taxpayers sets aside funds to meet the liabilities created by the unfunded, defined benefit schemes for Commonwealth employees that would otherwise be met by a future generation of taxpayers.

Concern about the ageing population has also led to the impending increase in the preservation age to age 60, and the introduction of incentives for continued employment after age 60 through 'transition to retirement' provisions allowing access to benefits while still working.

The most recent policy reform took effect from 1 July 2007, simplifying tax arrangements for superannuation and removing all tax from benefits paid from taxed schemes to people aged 60 or more. While also reducing tax from benefits paid from untaxed schemes, the new arrangements reflect a policy preference for taxed schemes over untaxed schemes, as well as reinforcing the policy shift to increase the preservation age to age 60 and to promote funded superannuation.

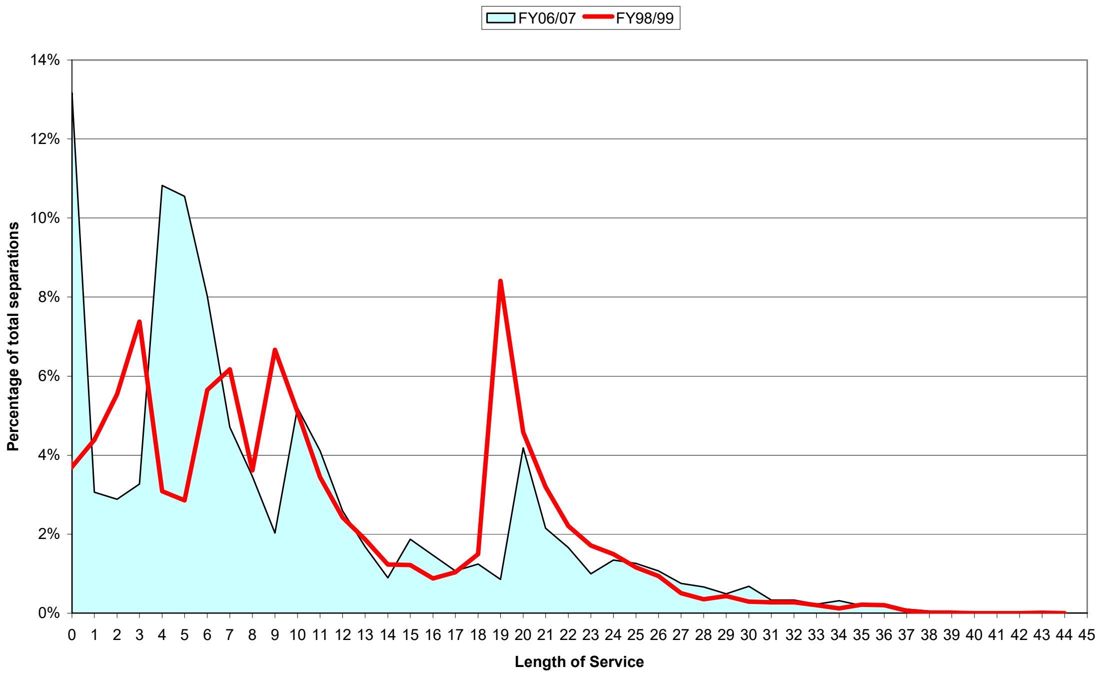
The history of military superannuation and its contemporary challenges correspond closely to this changing policy framework. The DFRDB scheme was introduced in 1972 when superannuation was not common in the wider community. It addressed the unique nature of military service by ensuring generous disability and death benefits, and it provided pensions for those with 20 years or more service but without any age limit. Following the superannuation reforms of the 1980s, Sir William Cole reviewed military superannuation and recommended the closure of the DFRDB and introduction of the MSBS. The MSBS continued DFRDB's generous disability and death benefits, but reflected the new environment by vesting retirement benefits for those with less than 20 years service, and requiring all retirement benefits to be preserved until age 55. Like the DFRDB (and the public service scheme introduced around the same time), the MSBS is a largely unfunded, defined benefit scheme.

Since the MSBS was introduced in 1991, the contemporary superannuation environment has further changed as outlined above. Changes that most clearly present challenges for the MSBS include the increased emphasis on flexibility and portability, increasing individual responsibility, a greater emphasis on transparency and funding, and the new 2007 tax arrangements.

Changes in Defence employment

The ADF has always comprised a majority who serve for less than ten years and a minority who choose a substantial career with the military, staying for up to 20 years or more. Changing employment patterns in the Australian workforce generally, and recent low levels of unemployment, have been reflected in increasing challenges to recruit and retain ADF members. Figure 1–3 illustrates patterns of mobility in the ADF in recent years.

Figure 1–3: Separations by years of service



Some of the shifts in separation rates at earlier years of service reflect changes in Service policies on enlistment and initial minimum periods of service. The sharp fall in separations after 20 years reflects the phasing out of the DFRDB. Overall separation rates have increased for those who have completed initial training but with less than ten years of service.

Recruitment patterns have also changed over the years, partly reflecting changing community attitudes but also reflecting changing ADF requirements and the competition for labour. In particular the ADF is now recruiting more mature age workers.

Even in 1991, the new MSBS was designed to address concerns about recruitment and retention. Vesting benefits for short-term members improved the overall remuneration package for recruits, and the increases in employer contributions after seven years of service and again after 20 years provided incentives to remain in the ADF (the latter offsetting the reduced incentive flowing from the cessation of DFRDB's 20 year pensions). The introduction of vesting and preservation was an important improvement but the long term Consumer Price Index indexation of preserved benefits now appears out of date.

Changes in provisions addressing the unique nature of military service

As detailed at the end of the TORs, the unique nature of military service involves in particular the significant risk of death and disability, and the likelihood that career ADF members will retire earlier than is standard practice in the Australian workforce. These characteristics have been reflected in military superannuation through the provision of generous death and disability benefits and through access to retirement pensions from age 55 (or earlier).

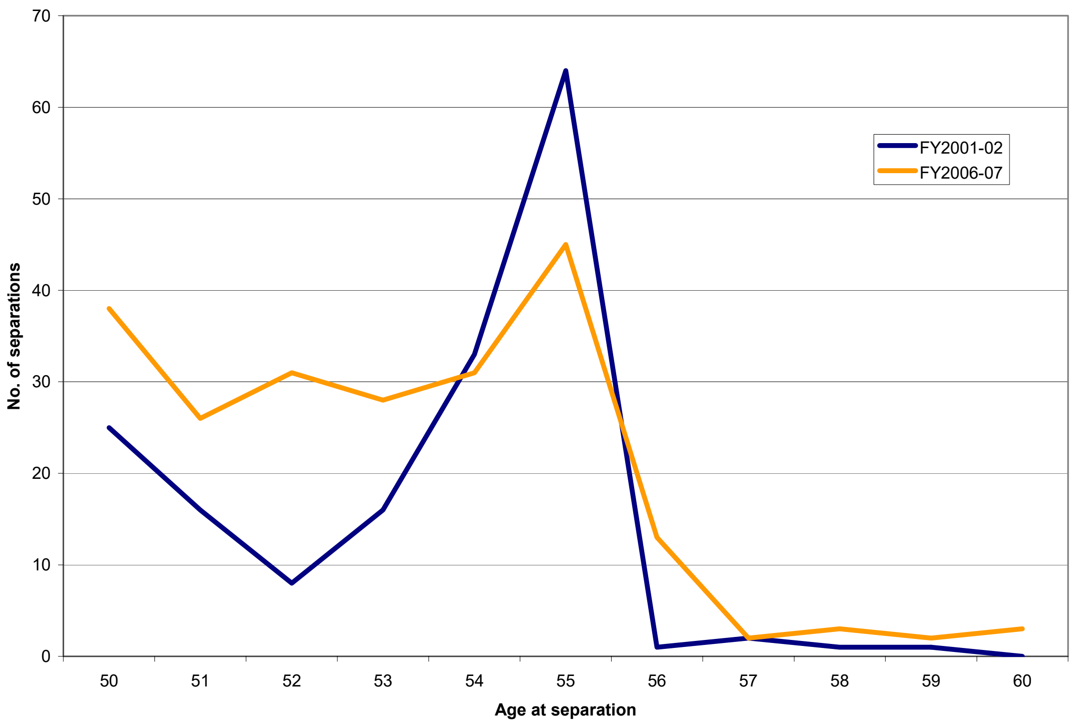
In earlier times, repatriation arrangements provided a mix of means-tested pensions that were more easily accessed than civilian social security benefits (eg from an earlier age) and non-means tested death and disability payments providing flat rates of compensation for war-related events. As military superannuation was introduced (initially after the First World War as part of the civilian scheme, and then specifically for the military after the Second World

War), superannuation benefits were paid in addition to any repatriation entitlement, adding an earnings-related component to death and disability benefits.

In 2004, the Military Rehabilitation and Compensation Act (MRCA) was introduced, effectively replacing the repatriation death and disability payments (that had evolved into what was known as 'veterans entitlements') with earnings-related compensation for disability and lump sums for work-related death and impairment, more in keeping with community workers' compensation and rehabilitation arrangements though at more generous levels. The disability payments topped up any superannuation payment to largely replace the earnings previously paid, while the death benefit supplemented superannuation death benefits. Notwithstanding the improvements flowing from the MRCA, the interaction with superannuation remains very complex, with separate systems for assessing disability, different approaches to rehabilitation and different coverage (one based on service-related events, the other on any event leading to death or disability).

As mentioned, the MSBS replaced the DFRDB's 20 year pension arrangement with retirement benefits preserved to age 55, in line with the then community requirement. While the preservation age is gradually being increased to 60 for the rest of the community, and the compulsory retirement age in the ADF has also recently increased to 60, the MSBS continues to allow indexed pensions from age 55. Figure 1–4 demonstrates the continuing practice in the ADF of retirements by age 55, and illustrates the increasing likelihood under the MSBS of retirements peaking at or near age 55 in the future.

Figure1–4: Separations by age for those over 50.



Conduct of the Review

The Review Team has been supported by a secretariat from the Department of Defence comprising civilian and military staff with experience in Defence personnel and superannuation matters. These staff are listed at Appendix A. The secretariat engaged actuarial services from the Australian Government Actuary and, in particular, Mr Michael Burt, who has provided ongoing advice to the Review Team on the financial implications of the options under consideration.

The Military Superannuation Reference Group, comprising senior officers from Defence and the three central agencies (the Departments of Prime Minister and Cabinet, Finance and Administration and the Treasury), provided guidance to the Review Team on Government superannuation and related policies and offered comments on options being developed. The Review Team also consulted ComSuper, the Department of Veterans' Affairs, the MSBS Board of Trustees and the DFRDB Authority as it developed its proposals.

The Review Team was ably assisted by these arrangements. It has nonetheless retained its independence, and the Review Team accepts full responsibility for its recommendations which may or may not be agreed by the agencies with which it has worked.

The Review Team consulted widely and systematically despite its tight time deadlines.

- Submissions were invited by newspaper advertisements and by written approaches to key stakeholders, both within the ADF and externally.
- Internal ADF submissions were also facilitated by on-line arrangements using a website set up for the Review and a simple submission form allowing long or very short submissions to be made by a member of the ADF. 381 submissions were received.
- Members of the Review Team visited ADF establishments in all States and territories except Tasmania, holding information sessions and seeking views on the current schemes and on contemporary arrangements outside the public sector.
- The Review Team met with the CDF and Service Chiefs, and the Chiefs of Staff Committee, during the Review.
- Other key stakeholders were invited to meet the Review Team to discuss their submissions, and some were consulted confidentially on the options being considered by the Review Team.
- When the Team's proposals were substantially developed, focus group discussions were held in Canberra, Sydney and Wagga Wagga with small groups of ADF members in three separate demographic categories (those with less than eight years of service, those with eight to 20 years of service and those with more than 20 years of service).

Appendix B sets out lists of people and organisations consulted, and from whom submissions were received. A table identifying the key issues raised in the submissions received is at Appendix C.

The Review Team also commissioned a telephone survey of ADF members to strengthen the evidence available of the actual and potential links between military superannuation and ADF recruitment and retention rates.

The Review Team was asked by the Minister to provide its recommendations by the end of June 2007. It did so under cover of an interim report explaining briefly the basis of its recommendations. The recommendations in this final report are essentially unchanged from those in the interim report.

In developing its recommendations, the Review Team divided the task into two main parts, corresponding closely to its first two TORs. The first involved a review of the current arrangements against contemporary best practice and current policy settings for superannuation (as well as the unique nature of military service and the potential to support recruitment and retention), and the development of preferred arrangements. The second involved an analysis of a list of technical issues that have been the subject of criticisms about the current schemes. This Report is broadly structured around these two parts.

The Review Team also approached the task on the basis of working within the broad envelope of the current costs of the existing schemes, while identifying for Government consideration options that might be supported, if additional funding were available. It did not approach the task as an opportunity for financial savings (particularly given the stated principles relating to the unique nature of military service and the potential to support recruitment and retention), but it was also conscious of the need to be financially responsible as implied by the several references to costs in the TORs. A discussion of the financial implications is set out in the final chapter of this report.

Chapter 2: Desirable characteristics of military superannuation in Australia today

Best practice superannuation

The fundamental purpose of superannuation is to ensure an adequate income when people finish their working lives by facilitating the spreading of lifetime earnings. The required financial levels are achieved through individual savings and employer superannuation contributions spread over the whole working life, and restricting access to these funds until genuine retirement, with the current preservation age in Australia being age 55 but increasing to age 60.

International superannuation

Overseas best practice superannuation schemes encourage total contributions that are sufficient, with government social security, to maintain an individual's living standards after retirement, and a standard of living commensurate with that of the rest of the community. While ILO Convention (1952) No 102 sets 40% as a minimum income replacement on retirement, more commonly a net income of around 60% or more of the net pre-retirement income is provided from age 60 to 65. The key risks faced by individuals, viz. inflation, years of life after retirement, and untimely death or disability, are often covered by indexed pensions and insurance benefits in the form of continuing income from these schemes.

The ageing of the population of many countries has triggered widespread reform of retirement incomes policies, particularly in developed countries. There has also been growing interest in ensuring that policies in developing/transition countries are effective and affordable, and support economic development. The OECD and World Bank encourage a 'three pillars' (or 'multi-pillars') approach involving, first, a publicly managed, tax-financed pension system; second, compulsory privately managed, funded schemes; and thirdly, voluntary (funded) retirement savings. To respond to ageing populations, both organisations support increasing the emphasis on the last two 'pillars' over the first, which should focus primarily on poverty alleviation. A fourth 'pillar' is now sometimes mentioned, being earnings from continued part-time work beyond normal retirement age.

In line with this broad approach, there has been a trend internationally towards funded schemes and away from unfunded social security systems with generous earnings-related benefits. Nonetheless, many overseas superannuation schemes, particularly military schemes, are still based on defined benefits, which commonly have the disadvantages of limited flexibility and increasing unfunded liabilities.

Australian superannuation

Australia is one of the pioneers of the 'three pillars' retirement incomes policy, and gives more emphasis than most other OECD countries to funded occupational superannuation and private savings and less emphasis to unfunded social security (by focussing on its 'safety net' role). It is frequently placed amongst the leading countries in terms of its preparedness for population ageing. As such, it may be considered to be close to international best practice in terms of the broad policy framework.

Best practice contemporary schemes in Australia provide maximum flexibility to members and recognise that members own their accumulated benefit. These schemes feature a menu of options for contributions (pre or post tax) and for benefits (lump sums and/or various types of retirement income streams). Consequently, members are given considerable choice in respect of their contributions and investments. Members are also kept informed, having disclosure of the current value of their accumulated benefits. The best schemes also provide access to information and calculators on the members' likely future benefits to enable sensible life choices.

The majority of Australian schemes are also financed in an equitable way across generations, so that each generation effectively meets the costs of its retirement benefits. Increasingly this equity is achieved through fully funded schemes. In delivering these best practice outcomes, however, contemporary Australian schemes leave the individual with some of the risks that might otherwise lie with the scheme's sponsor or an insurance company.

The most recent tax arrangements also favour taxed schemes, where concessional contributions are taxed and fund earnings are taxed, but benefits taken after age 60 are not assessed as taxable income.

Overall, the Review Team considers that best practice superannuation involves:

- benefit levels that maintain living standards in retirement;
- contribution rates sufficient to fully cover the costs involved without imposing a liability upon future generations;
- access to indexed pensions for life on retirement or on disability, and for dependants upon death;
- flexibility and portability of both contributions and benefits to meet individual preferences;
- keeping individuals and their families well informed of accumulated benefits and likely future benefits; and
- given Australian tax arrangements, providing benefits through a funded and taxed superannuation scheme, thereby providing tax-free benefits after age 60.

Recruitment and retention

The Review Team drew on the evidence of recent Defence and community surveys, its consultations, a commissioned survey of ADF members (conducted by ORIMA Research) and focus group discussions to assess the current and potential impact of superannuation on recruitment and retention. Some more details of this evidence is at Appendix D.

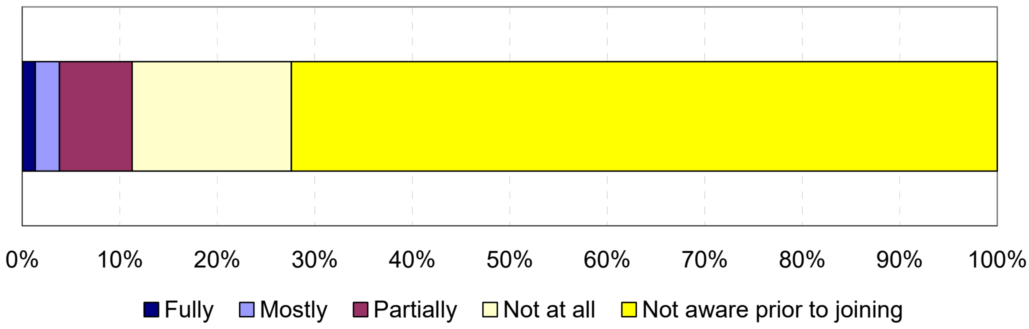
Recruitment

ADF and community surveys indicate that young people have little interest in superannuation. With around 85% of ADF recruits aged 25 or less (93% aged 30 or less), this substantially limits the potential role of superannuation as an attraction measure for the ADF.

The commissioned survey revealed that just over a quarter of ADF members were aware of military superannuation before they enlisted and 11% indicated they were at least partially influenced to join the ADF by the superannuation arrangements (see Figure 2–1 below).

Figure 2–1: Influence of superannuation scheme benefits on job

To what extent did your knowledge of military superannuation and its benefits influence your decision to join the ADF?



Focus group discussions suggested this influence may be substantially greater amongst (the increasing number of) mature age recruits and former ADF members considering re-enlistment, and would be greater still if the value of the employer contributions were more clearly understood. Younger recruits are also influenced by parents and other relatives (many of whom are currently serving or have served in the ADF), and their appreciation of the value of military superannuation may indirectly support recruitment.

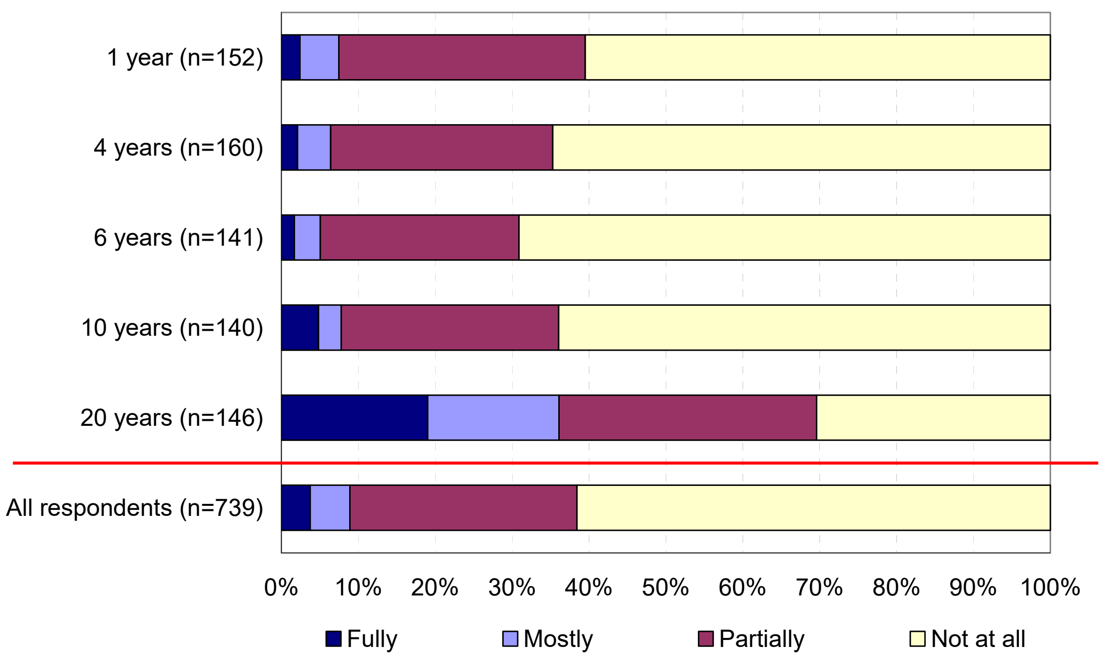
Retention

The Defence Personnel Environment Scan 2025 summarised from ADF exit surveys the top ten reasons for the exit of service members at four specific career points. Superannuation, and indeed remuneration in general, did not feature in any of the lists. The 2003 ADF Attitude Survey identified the top 15 influences on retention for various age groups; superannuation does not feature for members less than 30 years of age, but does become a factor for older members.

The commissioned ORIMA survey revealed that a significant minority (38%) felt that their superannuation arrangements at least partially influenced their decision to continue in the ADF, despite only a third being confident that they had a good understanding of their superannuation (a third indicated poor knowledge). The proportion of those with over 20 years of service who felt that superannuation had at least partially influenced their decision to stay was around 70%. See Figure 2–2.

Figure 2–2: Influence of superannuation upon members to remain in the ADF.

To what extent does your membership of your military superannuation influence your decision to remain in the ADF?



The limited understanding of the value of military superannuation was confirmed both in the consultations undertaken at the beginning of the Review and in the focus group discussions conducted later. There was almost universal ignorance of the value of the employer contribution and its impact on ADF members' total remuneration compared to remuneration available outside the ADF. The commissioned survey revealed that nearly 70% had at best a moderate understanding of the benefits of their military superannuation. This was confirmed by the findings that, while a clear majority believe the death and invalidity benefits are higher than under civilian schemes, views of the resignation and even the retirement benefits are much more equivocal, even though the fact is that, for most members, the MSBS is significantly more generous than civilian schemes.

This might help to explain the limited impact of the current schemes on retention. There is no clear correlation between MSBS employer contribution levels and separation rates. While the DFRDB has had a clear impact amongst the long-serving members (with low separation rates from about 15 years of service to 20 years, but a very sharp spike after 20 years when eligibility for pensions is gained), it did not affect the vast majority of ADF members who leave before 15 years of service without any employer benefit (other than special arrangements to meet the Superannuation Guarantee requirements).

Increasing the potential impact

Notwithstanding the evidence about the limited recruitment and retention effects of the current schemes, other evidence suggests there is scope for superannuation to play a more effective role in retention, and in attracting former ADF members to return. Focus group discussions and the earlier consultations demonstrated the critical importance of clarifying the value of employer superannuation contributions to ADF members and to potential recruits. If the value of superannuation for each individual member could be made more transparent and included in the standard remuneration package description, as occurs for jobs on offer from other employers, the competitive advantage of the ADF would be so much clearer and the pressure to increase pay rates might be reduced. This would not only have retention benefits but could be particularly valuable in attracting skilled mature aged workers into the ADF and encouraging the return of former members; it could also influence young people indirectly through the views of their parents.

This is not just a matter of better education and promotion, but concerns the basic design of the schemes: it is difficult to quantify the value of MSBS benefits for individual members even when the member separates from the ADF.

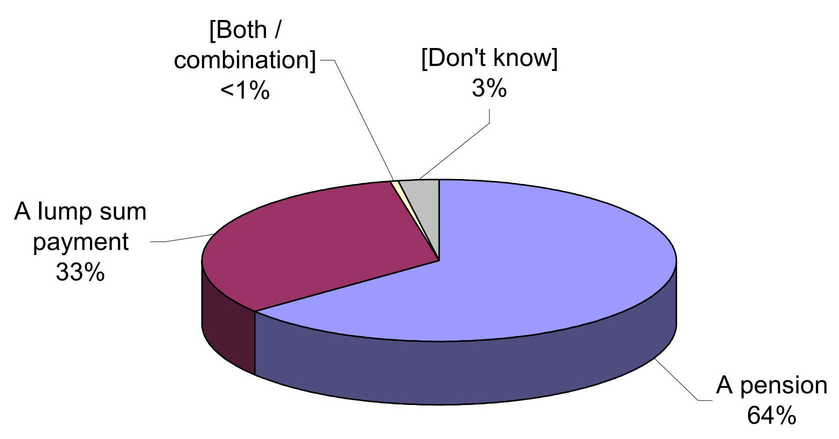
The commissioned survey also revealed that the most important features of the MSBS for members are the generous level of the employer benefit, the absence of administration fees and the insurance cover for death and disability. The two most important features supporting retention are the indexed pension (preferred over a lump sum by two thirds of those surveyed, as shown in Figure 2–3) and choice of investment. Focus group discussions confirmed, in particular:

- the importance of identifying clearly the employer contribution;
- the capacity to decide on investment strategies;
- having indexed pensions amongst the benefit options;
- offering opportunities for family members to participate in the scheme; and
- meeting the administrative costs of members and contributing family members.

Most ADF members also favoured flexibility over their own contribution levels but with encouragement to make such contributions.

Figure 2–3: Preferred form of benefit on retirement

From your current viewpoint, which benefit would you prefer at retirement?



More generally, superannuation contributes to the overall level of satisfaction with the ADF conditions of service package, and it is a significant hygiene factor in supporting a positive view of continued military service for longer-serving members. ADF members of all ages also understandably focus strongly on the support for themselves and their dependants in the event of death or injury, particularly in the present climate of high operational tempo and risk.

Balancing these considerations, the Review Team considers that, to support recruitment and retention, military superannuation should:

- identify clearly the employer contributions for each individual;
- provide more than the statutory minimum employer contribution;
- maintain the current overall generosity of military superannuation (if savings were to be identified, they would need to be redirected into the remuneration package);
- demonstrate Defence’s close concern for all members and their families;
- deliver clearly adequate retirement benefits for long-serving members including, but not limited to, indexed pensions;
- allow choice for members over the investment of their employer contributions;

- allow members to set their own contribution levels; and
- be provided through a funded and taxed superannuation scheme.

Impact of the unique nature of military service

There is a requirement for any military superannuation scheme to recognise the unique and special features of military service (detailed in the Terms of Reference). The requirement to accept being placed in life-threatening circumstances not covered by contemporary insurance arrangements, demands that there be superior death and invalidity benefits for members and dependants. The case for such benefits goes beyond service-related death or disability, as military service requires a level of physical and mental fitness that can be undermined by non-service incidents and lead to medical discharge.

Military service is also a special form of endeavour that places considerable stress on members and dependants, and posts them regularly to different locations disrupting family arrangements including spouse careers. There is therefore a justified expectation in the ADF that the employer should be somewhat paternalistic in taking extra care of members and their families so that members can focus their attention on military duties. The consultation process, both with ADF members and with other stakeholders (particularly the Defence Families of Australia), confirmed the importance of supporting family members as well as the ADF members in the superannuation arrangements.

For those who choose a full career in the ADF, notwithstanding compulsory retirement at age 60, the Review Team has been advised that the vast majority will retire by age 55; many of these individuals may then have limited opportunities to embark on a new career. The Review Team examined the practice of some of our allies in this regard, as outlined in Chapter 3. Canada and the US provide some benefits based on years of service (25 and 20 years, respectively) that are payable before normal retirement age, while the UK restricts retirement benefits to age 55. The Review Team is not persuaded of the justification to provide 20 or 25 year pensions, but notes that good international practice does seem to recognise that some form of benefit for the military should be available from a younger age than the community norm. It is a matter for judgement what that age should be. The Review Team considers the MSBS (and UK) age 55 standard is reasonable, particularly with the Australian preservation age increasing to 60.

The unique nature of military service and employment suggests that an appropriate military superannuation scheme would provide:

- benefits beyond community standards to members and their dependants where the member dies, is disabled or medically discharged;
- retirement benefits that are sufficient for a career ADF member to finance a pension from age 55 that broadly maintains his or her pre-retirement standard of living;
- preserved benefits for those who separate to embark on a different career, that represent a fair contribution towards an adequate retirement income (from the usual retirement age of 60 to 65), and not just the statutory minimum Superannuation Guarantee employer contribution; and
- a scheme designed to facilitate the preferences not only of members but also of their families, and of members who move in and out of the ADF.

Review Team Guiding Principles

Drawing together the desirable characteristics of military superannuation from best practice contemporary superannuation, the potential impact on recruitment and retention and the unique nature of military service, the Review Team has applied the following Guiding Principles for any new arrangements for military superannuation:

- **Flexibility**, to meet individual member preferences regarding both contribution arrangements and the form of benefits and to respond to future changes to the broader superannuation or ADF environments.
- **Simplicity**, to enable ADF members to clearly understand and measure the value of their current employer contributions to superannuation and the potential future benefits.
- **Adequacy**, for all members of the ADF, both short-term and long-term, with a level of benefit that facilitates the maintenance of living standards, both on and through retirement.
- **Tailored**, to address the unique nature of military service by providing generous life-time support for dependants in the event of death or disability and rewarding long and arduous military service.
- **Visibly attractive**, forming an integral part of the remuneration package, enhancing the ADF conditions of service package and, in particular, supporting retention at critical points for the ADF and attracting former ADF members to re-enlist.
- **Financially sustainable**, with stable employer contributions over time and no increasing unfunded liability.

These Guiding Principles, particularly the principle requiring benefits tailored to address the unique nature of military service, confirmed the need for the Australian Defence Force to have its own superannuation scheme.

Recommendation 1 The Australian Defence Force should continue to have its own mandated superannuation scheme with benefits that reflect the unique nature of military service.

Chapter 3: Assessment of current schemes

Table 3–1 summarises the Review Team's assessment of the DFRDB and the MSBS against the Guiding Principles outlined in the last chapter.

Table 3–1: Assessment of current schemes against Guiding Principles

Guiding Principle	DFRDB	MSBS
Flexibility		
• Contributions	No	In small part
• Benefits	In small part	Yes
Simplicity	No	No
Adequacy		
• Short term members	No	In part
• Long term members	Yes	Yes
Tailored		
• Death and disability	Yes	Yes
• Indexed pensions from age 55	Yes	Yes
Visibly attractive		
• For recruitment	Unlikely	Limited
• For re-enlistment	Limited	Limited
• For retention	Limited	In part
Financially sustainable	No	No

The DFRDB

The DFRDB was implemented on 1 October 1972 following the Joint Select Committee Review of Defence Forces Retirement Benefits Legislation, chaired by Mr J D Jess MP. This Committee was established in view of dissatisfaction with the provisions of the former Defence Forces Retirement Benefits (DFRB) Scheme (introduced on 1 July 1948).

Subsequently, a review of the DFRDB was undertaken by a small team led by Sir William Cole and the report of 25 June 1990 (which became known as the Cole Report) concluded that the DFRDB was no longer appropriate for the majority of ADF members, particularly younger personnel, and did not adequately meet the ADF's personnel management objectives. The Cole Report noted that the DFRDB was designed in a superannuation environment markedly different from that existing in 1990 with increased coverage through the inclusion of superannuation in industrial awards and through the vesting and preservation of employer–financed benefits. A history and description of the DFRDB are contained in Appendix E.

The consultation seminars and focus groups conducted by the Review Team indicated that there was a widespread view across the ADF that the DFRDB was a superior superannuation scheme to contemporary schemes, and to the MSBS, both for individuals and for ADF retention. There was little evidence to support this contention and few members were aware of the majority of the scheme design features or of the analysis of the scheme in the Cole Report. For instance, when the DFRDB closed in 1991, less than 5% of Navy personnel were qualifying for any employer benefit. While recognising that the DFRDB was a closed scheme, the Review Team assessed the DFRDB against the Guiding Principles to test whether the fondness for the DFRDB was warranted.

The Review Team re-affirmed the view of the Cole Report and concludes that:

- The DFRDB was not appropriate for the majority of ADF members who served less than 20 years (now more than 80% of those who join) and who received neither a return on their contributions nor any employer benefit from the DFRDB Scheme[2].
- While the DFRDB benefit after more than 30 years service, at an age close to 55, provided a generous retirement income, a DFRDB pension for those who separated just after the 20 years qualifying period was never sufficient to provide an adequate level of retirement income to maintain the member's lifestyle unless supplemented by post separation income and savings.
- Providing pensions before age 55 is not justified on the grounds of the unique nature of military service, particularly in the context of an increasingly mobile workforce where many people change employers and careers during their working lives.
- While the DFRDB benefit structure provided a small retention benefit between 15 and 20 years of service, the majority of members had already separated before completing 15 years of service, and the structure caused 'spikes' in ADF separation rates, particularly at the 20 year point. This led to a dramatic loss of experienced personnel in the 20-22 years service bracket.
- The unfunded and defined benefit nature of DFRDB-type schemes precludes ADF members from benefiting from the modern flexible retirement income stream and taxation arrangements available to other Australians.
- The death and disability arrangements in the DFRDB, however, were generous and generally reflected the unique nature of military service.

The Review Team believes it is important that the ADF leadership support better education and awareness of superannuation amongst ADF members and, inter alia, disavows the current widespread but ill-informed view of the DFRDB which has undermined appreciation of the MSBS and the Cole Report, and could undermine this Review Team's recommendations.

The MSBS

The Cole Report noted that the DFRDB arrangements failed to meet the requirements of the extant *Occupational Superannuation Standards Act 1987* in several key areas such as investment earnings on member contributions, the payment of retirement pensions before age 55 and the structure of the DFRDB Authority. Cole argued for a totally new ADF superannuation and benefits scheme to overcome these deficiencies against a background of the Government seeking to make superannuation more readily available and ensuring that the prime purpose of superannuation is the provision of genuine retirement income. The new MSBS structure and the associated Retention Benefit[3] were designed (in part) to smooth out exit rate spikes experienced under DFRDB and to encourage service beyond 20 years.

At the introduction of the scheme, the MSBS met these goals and complied with broader government guidelines on superannuation while retaining the generous death and disability benefits of the DFRDB based on prospective service. Nevertheless, while all members of the ADF now receive an employer benefit, regardless of length of service, the unfunded defined benefit nature of the employer benefit has prevented the MSBS from adapting to the contemporary expectations of ADF members, and in some cases, to changing legislation. A history and description of the MSBS are contained in Appendix E.

In assessing the scheme against the Guiding Principles, the Review Team found that the MSBS:

- provides very generous benefits to long-serving members with a choice of an indexed pension or lump sum, or both;

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2 It is noted that such a scheme design would no longer be acceptable under the Superannuation Guarantee legislation. For this reason special arrangements have had to be introduced.

3 The MSBS Retention Benefit, whilst not formally associated with superannuation, provided a benefit of one year of salary after 15 years of service for a commitment to serve for a further five years. The benefit was discontinued in October 2005 with grandfathering arrangements which will see declining numbers of personnel becoming eligible each year.

- for shorter serving members, provides a substantially less generous level of employer benefit than might appear from the benefit structure due to the preservation requirements; this may be less than necessary to contribute to full maintenance of living standards in retirement;
- is too complex for members to understand and does not allow members to exert any control over their employer-financed benefits;
- has not, in practice, contributed much to recruitment or retention because the complexity undermines the potential benefits of the scheme's structure;
- provides generous death and disability benefits, in line with the unique nature of military service.

Foreign military superannuation arrangements

The Review Team assessed the military superannuation arrangements of the US, UK, Canada and New Zealand against the Guiding Principles and to seek features that might be adopted as best practice. In each case, of course, the schemes were designed within the context of the different national approaches to the nature of military service, community superannuation and social security arrangements, and societal expectations.

The Review Team noted that:

- The US, UK and Canadian schemes offer a defined benefit in the form of an indexed pension based on salary and a multiple related to years of service. The NZ scheme is a defined contribution scheme paying a lump sum benefit.
- Canada offers a pre-retirement non-indexed pension after 25 years of service, as support for the member to join the civilian workforce, discounted if taken before certain ages based on rank. The indexed retirement pension is payable from age 60.
- The US benefits are based on years of service not age at retirement, and no benefit other than social security is payable for those with less than 20 years of service;
- The NZ benefits are not subject to preservation requirements (there are no such requirements for superannuation in NZ).
- Death and disability benefits in the UK are similar to those applying in Australia, though the benefit calculations are quite complex. There is no prospective service included in death and disability benefits within the US and Canadian superannuation schemes. Furthermore the Canadian plan requires ten years service before the indexed disability pension is payable. Benefits may be available through separate community arrangements which make comparisons difficult.
- NZ death and disability benefits are dealt with under separate universal accident and injury administrative arrangements for which the NZ Defence Force (NZDF) pays an annual premium. NZDF manages, under delegation from the Accident and Compensation Commission, the disability arrangements for NZDF members.

While the Canadian scheme, in particular, appears to be more generous than the MSBS in respect of retirement pensions, none of the schemes would rank well against all the Guiding Principles. Particular features of certain schemes are, nonetheless, attractive such as the availability of indexed pensions in most schemes and the flexibility of the NZ scheme. A summary of the features of each of the foreign military schemes examined is provided in Appendix F.

Other Australian Government superannuation arrangements

The Review Team assessed a number of superannuation schemes sponsored by the Federal and State Governments with emphasis on those that provided benefits to 'uniformed bodies' such as police, fire and ambulance workers. The differing work requirements and remuneration arrangements make comparisons with ADF conditions difficult despite the fact that, like the MSBS, these schemes operate in the same regulatory, social security and tax environments.

Overall, the level of benefits varies widely across the government sector although the MSBS is at least competitive for retirement benefits and generally superior for death and disability benefits. In many other schemes these benefits no longer include reversionary benefits or benefits related to prospective years of service, as members are given the option to purchase additional insurance themselves for death and permanent disability. A summary of some relevant superannuation arrangements is provided in Appendix G.

Conclusion

The Review Team determined that, while the MSBS compares reasonably well with most overseas military schemes and with other Australian schemes for ‘uniformed bodies’, it still falls well short of best practice contemporary superannuation and does not contribute significantly towards recruitment and retention. The DFRDB is rated well below the MSBS. While both are tailored to the unique nature of military service there is, even here, room for improvement (particularly to take advantage of the MRCA and its rehabilitation focus as mentioned in Chapter 1). Incremental changes to the MSBS might alleviate some of the weaknesses, but could not satisfy all of the Guiding Principles the Review Team believes should be followed.

In conclusion, the Review Team believes that a new scheme should be introduced that fully satisfies the Guiding Principles.

The Review Team does not consider any overseas scheme, or other Australian schemes, offer complete models that should be followed by the ADF. There may be some particular features, however, that should be taken up.

In recommending a new scheme, the Review Team also:

- suggests the overall generosity of the scheme and its cost should be commensurate with current arrangements;
- notes the requirement in its Terms of Reference of no forced detriment to current and former ADF members; and
- considers that:
    - while the special nature of military service dictates that a member should be able to fully retire from the workforce at an earlier age than community standards and have access to an indexed or flexible income stream from age 55, earlier access to superannuation benefits is not justified;
    - the ADF has a special responsibility to look after the interests of the significant number of young members, balancing a paternalistic approach with the development of increasing individual responsibility.

Chapter 4: A New Military Superannuation Scheme

To meet the Guiding Principles, the proposed new scheme should have a contemporary approach to providing for retirement income by being a taxed, funded, defined contribution scheme. Unlike many contemporary schemes, however, it should offer a range of retirement benefit options including indexed pensions. In view of the unique nature of military service, it must also retain generous defined benefits for death and disability.

Recommendation 2 Defence should close the Military Superannuation and Benefits Scheme to new members of the ADF and introduce a new superannuation scheme for all new members of the ADF comprising an accumulation scheme for retirement and separate defined benefits for death and disability.

In designing such a scheme, the Review Team has also taken into account:

- recruitment and retention considerations that require increasing the employer contribution rate with length of service;
- the current overall costs, in terms of the total notional employer contribution rate, using this as a benchmark for overall generosity; and
- the current levels and distribution of retirement benefits and the advantage of a broadly similar spread if the new scheme is to be widely accepted by the Defence community.

The Review Team has also included features which will be particularly attractive to ADF members and their families as they recognise the nature of military service and its impact on families.

In broad terms, the proposed new scheme will comprise:

- **an accumulation retirement plan**, with individual accumulation accounts built on generous employer contributions increasing with length of service and voluntary personal contributions. Members will be able to access their accumulated benefits in the form of a lump sum or an account-based pension on reaching preservation age. Members with 15 or more years of service will have the additional options of converting their lump sum into an indexed pension or an account-based pension from age 55.

- **death and disability benefits** which complement the accumulation retirement plan. For members discharged on medical grounds, disability income benefits will be paid in the form of rehabilitation-focussed salary maintenance payments until age 60. In addition, Defence will continue to make employer contributions to the accumulation plan building funds for retirement at age 60. Death benefits will supplement the funds accumulated in the retirement plan taking into account the members' prospective service to age 60. This total lump sum can be converted into an indexed spouse pension with additional payments for dependent children, similar to current pension arrangements.

The proposed new scheme will also allow membership beyond ADF members. Membership, without administrative fees, will be available to the spouse and dependent children of a serving ADF member. Membership will also be open to all Reservists, without administrative fees. Members from these groups will have their own individual accumulation accounts.

Details of these design arrangements are set out below, and a description of their impact on ADF members, and on the ADF, is set out in Chapter 5.

The scheme will operate as an Australian Prudential Regulation Authority licenced, complying superannuation scheme. Governance of the scheme will be conducted by a board (see Chapter 6). Contributions, both employer and voluntary employee contributions, will be credited to individual members' accounts and be invested by the board for the benefit of members.

Accumulation retirement plan

Recommendation 3 The new superannuation accumulation scheme for retirement should be fully funded and taxed with the following key elements:

a. employer contribution rates of 16% of superannuation salary for the first six years of completed service, 23% for the next nine years of completed service and 28% after 15 years of completed service (with recognition of prior military service);

b. flexibility for members to set their own contribution rate, if any (with a default rate of 5% from after tax salary), select their investment risk profile and to make contributions following separation from the ADF;

c. members to have choice over the superannuation scheme into which their contributions will be invested whilst maintaining membership of the mandated death and disability benefits under the new scheme;

d. options for members with 15 years or more service, from age 55, to purchase indexed pensions (with a choice of indexation factors, at an unsubsidised price determined periodically by a Government-approved actuary) and/or an account based pension;

e. a range of options for the way members can access their benefits after preservation age, including through an account-based pension. This would allow members to take advantage of the Government's transition to retirement provisions; and

f. flexibility for spouses and children of members to contribute (personally and/or from an external employer).

The proposed new retirement arrangements are summarised in the diagram at Figure 4–1.

Employer contributions – ADF members

Employer contributions will be made to the fund fortnightly for members who are serving ADF members or who are Reservists on continuous full-time service. Contributions will be a percentage of superannuation salary (base salary plus Service Allowance) increasing with longer periods of service. The percentage will be:

- on initial enlistment, 16%:
- increasing to 23% after six years of completed service; and
- increasing again to 28% after 15 years of completed service.

There will be no separate recognition of the 3% Productivity Benefit which features as a separate element in the current defined benefit schemes. The new employer contribution rates will be all encompassing.

Leading Seaman Jefferies is in her tenth year of service and is on a salary of $43,251 and receives Service Allowance of $10,098, providing a total superannuation salary of $53,349 ($2046.26 per fortnight).

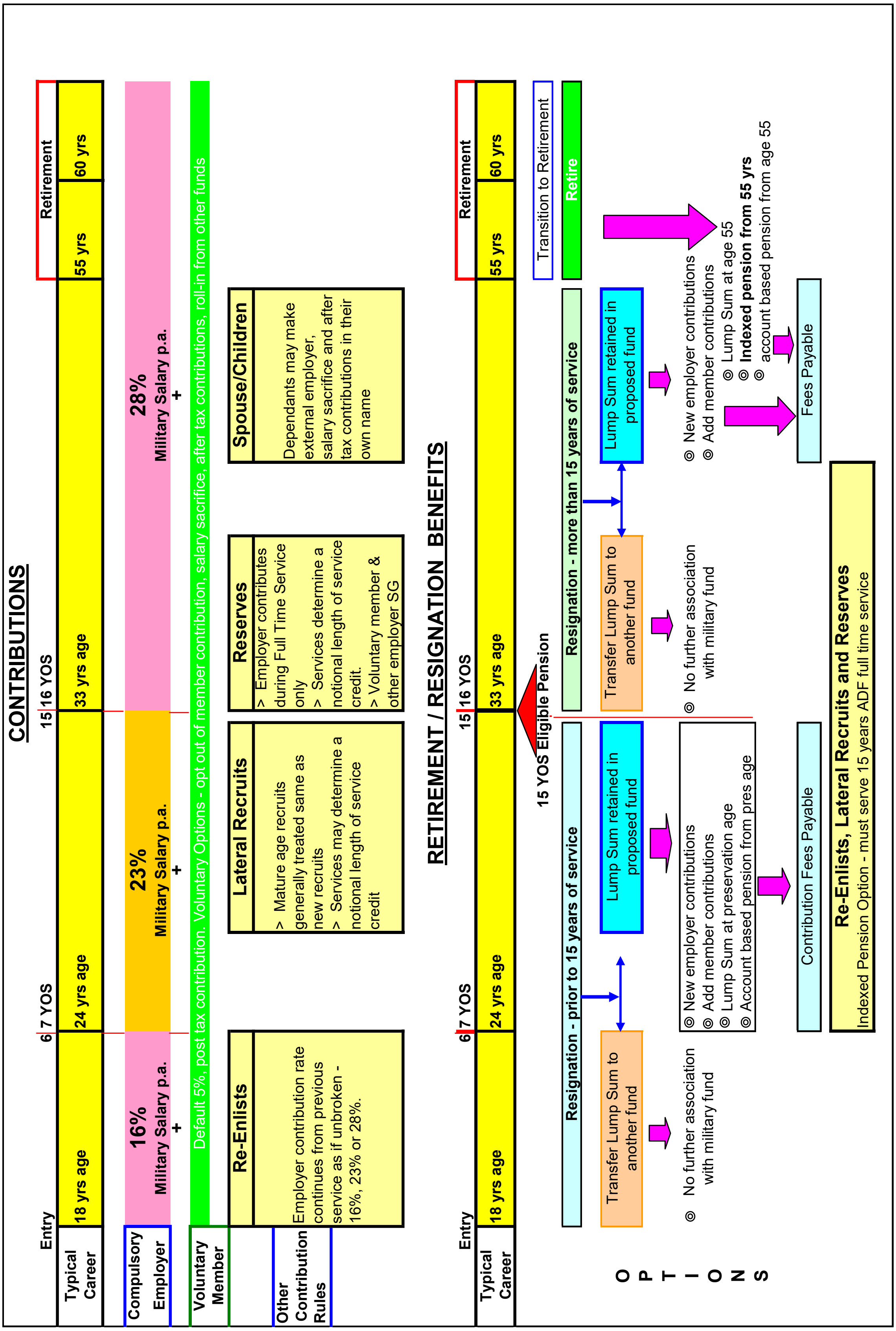
As LS Jefferies is in her tenth year of service employer contributions are made at 23% of superannuation salary to her superannuation account. The employer contribution paid by Defence to the accumulation plan for LS Jefferies will be:

$470.64 (i.e. 23% x $2046.26) per fortnight or **$12,270 per year**

When LS Jefferies enters her 16th year of service her contribution rate will increase to 28%.

The period of service relates to any time during which the employer contribution was being paid. It does not include periods of leave without pay. Periods on part-time pay count in full. For members re-enlisting, the rate of the employer contribution will take into account their previous service.

Figure 4–1: Scheme Design - Contributions & Retirement/Resignation Benefits



Lateral recruits, Reservists and transferees from the military of other countries may be given a 'notional' length of service on commencement in recognition of their military or work experience. Employer contributions paid to the scheme for those members will be at the rate applicable to the notional length of service.

At the completion of nine years of service, FLTLT Smith, having joined as an Officer Cadet at age 18, will have accumulated a benefit of $100,156 (or $80,197 in 2007 prices) on conservative assumptions[4]. The benefit will have accumulated along the following lines:

Age	Rank	Superannuation Salary	Employer Contribution rate	Net Employer Contributions	Accumulated Benefit	Accumulated Benefits in 2007 prices
18	OFFCDT	$20,010	16%	$2,721	$2,808	$2,740
19	OFFCDT	$24,812	16%	$3,374	$6,473	$6,161
20	OFFCDT	$32,464	16%	$4,415	$11,451	$10,633
21	OFFCDT	$35,927	16%	$4,886	$17,237	$15,616
22	FLGOFF	$64,619	16%	$8,788	$27,427	$24,241
23	FLGOFF	$69,158	16%	$9,406	$38,916	$33,557
24	FLGOFF	$74,046	23%	$14,476	$56,385	$47,435
25	FLTLT	$83,896	23%	$16,402	$76,976	$63,178
26	FLTLT	$90,090	23%	$17,613	$100,156	$80,197

Note Employer contributions shown are after the 15% contributions tax has been deducted.

Member contributions – ADF members

Members will be able to make voluntary contributions to the scheme. Contributions may be made from post-tax entitlement or as pre-tax superannuation contributions through salary sacrificing arrangements. Members will also be able to transfer funds from other complying superannuation funds.

Member contributions will not be mandatory. An initial default position will apply to newly commencing ADF members and Reservists on continuous full-time service. The default position will require members to make an after-tax contribution of 5% of superannuation salary. This will help eligible members to access the Government's co-contribution for lower income taxpayers. Members can elect to opt out of the default member contribution at any time, or vary the rate, or pay the member contribution through a salary sacrifice arrangement.

Private Patterson enlists and is in receipt of a salary of $36,585 plus Service Allowance of $10,098, providing a total superannuation salary $46,683 ($1790.58 pf). An employer contribution of $286.49 (i.e. 16% x $1790.58) per fortnight will be paid by Defence to his superannuation account.

Unless PTE Patterson elects to cease or reduce his rate of member contributions, he will be required to make the following personal contribution to his superannuation account from his after-tax salary:

$89.53 per fortnight (i.e. 5% x $1790.58) or **$2334 per year**.

PTE Patterson will continue to make member contributions at the 5% rate until he elects not to contribute or varies his rate of contribution.

Employer contributions - other members

Employer contributions from other sources will also be accepted by the scheme. Typically this would be from the employers of spouses or dependent children of ADF members. Reservists

4 These figures assume a 15% tax on employer contributions, a typical salary profile, all salaries increase by 4% per annum, that employer contributions are paid, on average, in the middle of the year and a conservative fund earning rate of 6.5% per annum. The accumulated benefit is deflated by 2.5% per year to express the benefit in 2007 prices.

might also choose to have contributions from their normal employers directed to their individual scheme account.

Members who leave the ADF but have retained funds in the scheme might also utilise this option. In this case, Defence would no longer meet the administrative costs involved. Similarly, the spouse and dependent children of someone who is no longer in the ADF, and who wish to remain active members of the scheme, will no longer have the administrative costs met by Defence.

Member contributions – other members

Spouses, dependent children and Reservists (not on continuous full-time service) will be able to make after-tax member contributions to the scheme.

Investment options

Members will be offered a suite of investment options from which to choose. Each investment option will provide a different risk profile. A default option will apply for those members who do not notify the board of their preferred option.

ADF members will also have the option to direct the employer contribution into a fund of their choice, including a self-managed superannuation fund. Of course, they can only have access to the new scheme's benefit options if they have funds in the retirement accumulation plan. They will, however, be fully covered by the new scheme's death and disability benefits.

Retirement benefits

Member benefits will continue to accumulate with investment earnings over the lifetime of the member's employment, not just over the period of employment with the ADF. On retirement, members will have options to convert the accumulated lump sums to retirement income streams:

- Members with less than 15 years of ADF service will have options to convert all or part of the accumulated lump sum into an account-based pension from the date of their preservation age (currently this is increasing to age 60).
- Members who have completed 15 or more years of ADF service may, from age 55:
    - convert all or part of their lump sum at any time before age 65 into an indexed pension payable for life: members will be able to choose the method of indexation for their pensions (Consumer Price Index (CPI) or wage based) with the conversion factor changing according to the choice; and/or
    - convert all or part of their lump sum into an account-based pension.

Indexed Pensions: As noted above, ADF members with 15 years or more service (including any years of receiving disability income) will be able to convert their accumulated lump sum into an indexed lifetime pension at any time between ages 55 and 65. The conversion rates will be regularly reviewed by a Government-approved actuary and will represent an actuarially fair price. That is, they will be cost neutral to the Government. Based on current market conditions, it is expected that these conversion rates will be 20-40% lower than the rates available in the commercial market.

Table 4–1 shows conversion rates that may be appropriate in today's market. For example, it shows that for each dollar of the initial CPI indexed pension at age 55, $20.10 of the accumulated lump sum would be required. Conversion rates are based on current conditions and will be subject to change by the Government-approved actuary.

Table 4–1. Examples of possible conversion rates for indexed pensions

Age at conversion	CPI indexation	Wage indexation
55	20.1	25.7
56	19.8	25.1
57	19.6	24.5
58	19.3	23.9
59	19.0	23.2
60	18.6	22.6
61	18.3	22.0
62	18.0	21.3
63	17.6	20.7
64	17.3	20.1
65	16.9	19.4

The same conversion rates should be used for all ADF members (i.e. males or females, married or single) thereby simplifying the process and removing any possible claim of discrimination, which has arisen in respect of the DRFDB commutation rates. (The Review Team considered varying the rates for single and married, but such rates would only be distinguishable if the rates were varied for males and females, which was not supported.)

Commander Morris retires from the Navy at age 55 in 2007. His accumulated benefit is $825,000.

Having served for 15 or more years CMDR Morris has the option to convert all or part of his lump sum to a CPI Indexed pension.

As he has already reached his preservation age he may take all of his benefit immediately as a lump sum. Alternatively, he may wish to receive the entire benefit in the form of a CPI indexed pension. If he wanted to convert the entire lump sum into a CPI indexed pension he would receive:

> **$41,045** ($825,000 ÷ 20.1) indexed over his lifetime.

As this pension is paid from a taxed plan it is tax-free from age 60.

CMDR Morris wishes to discharge a mortgage on retirement and have some additional lump sum to cover other commitments for the future. He might opt to take $300,000 as a lump sum and convert the rest to a CPI indexed pension. In this instance he would receive:

> a lump sum of **$300,000.00**; and
>
> pension of $**26,119** ($525,000 ÷ 20.1) indexed over his lifetime.

CMDR Morris may choose the ratio of lump sum to pension balance that best suits his future needs.

Indexed pensions will incorporate a reversionary component on the member's death. That is, in the event a member in receipt of an indexed pension dies, their surviving spouse would continue to receive 62.5% of the relevant pension.

Using the example of CMDR Morris (above), had he elected to convert all his lump sum to a pension on retirement, upon his death his spouse will be entitled to a reversionary indexed pension of 62.5% of his current pension. If he died in the first year this would be **$25,653** pa (62.5% x **$41,045**) indexed over her lifetime.

Access to transition to retirement provisions

On reaching preservation age, members of the scheme will be able to draw on their accumulated superannuation benefit without having to retire permanently from the workforce. This may apply where the member continues to work in a part-time arrangement and uses part of their superannuation to supplement their income, instead of leaving the workforce altogether.

The scheme will offer a non-commutable income stream to allow members to access the Government's transition to retirement rules.

Under these transition to retirement provisions, the scheme will similarly allow members to access their benefits from age 55 or preservation age (as appropriate to the individual) without having to leave the ADF. In these circumstances, the relevant benefit will be paid to the member and a new account will be established into which subsequent employer contributions will be made until the member retires from the ADF.

Resignation benefits

Members will have two benefit options available to them when they resign prior to the age of 55. They may choose to:

- transfer their accumulated funds to another complying fund under portability arrangements; or
- retain their funds in the scheme.

In the first circumstance the member severs all existing ties with the fund.

Members whose funds remain invested in the scheme will continue to accrue investment earnings in accordance with the performance of their chosen investment profile. No fees will be levied upon such members.

Members with funds in the scheme may also choose to add to their existing account through personal contributions or by directing their future employers' contributions into the member's account. Defence will not subsidise administrative fees in cases where members' accounts continue to operate with the addition of further contributions.

Private Kowalski enlists on his 18th birthday and serves for eight years as a rifleman (see table below). On leaving the ADF he retains his employer-financed accumulated benefits which would be $74,791 (or $61,360 in 2007 prices) assuming a fund earning rate of 6.5% each year[5]. On his 55th birthday his ADF employer-financed benefits will have grown to $186,221 in real terms.

PTE Kowalski does not have 15 years ADF service and therefore is ineligible to take his benefit as a pension at age 55. Because he was born after 1964 his preservation age is 60 and he cannot access his lump sum until he turns 60. Assuming his funds remain in the scheme, on his 60th birthday his ADF employer-financed benefits will have grown in real terms to $225,506.

PTE Kowalski can claim his benefit as a lump sum at age 60, or may elect to take part, or all, of the benefit as an account-based pension. The benefit would be tax-free.

Age	Rank	Annual Salary	Employer Contribution rate	Employer Contributions (less 15% contributions tax)	AccumulatedBenefit	Accumulated Benefits in 2007 prices
18	PTEt	$26,552	16%	$3,611	$3,727	$3,636
19	PTEt	$31,216	16%	$4,245	$8,350	$7,948
20	PTE	$50,492	16%	$6,867	$15,979	$14,838
21	PTE	$52,512	16%	$7,142	$24,388	$22,094
22	PTE	$54,613	16%	$7,427	$33,638	$29,731
23	PTE	$56,797	16%	$7,724	$43,796	$37,765
24	PTE	$59,069	23%	$11,548	$58,560	$49,265
25	PTE	$61,432	23%	$12,010	$74,791	$61,360
55					$464,317	$186,221
60					$636,151	$225,506

5 These figures also assume a 15% tax on employer contributions, a typical salary profile, all salaries increase by 4% per annum, and that employer contributions are paid, on average, in the middle of the year. The accumulated benefit is deflated by 2.5% per year to express the benefit in 2007 prices.

Re-enlisting members who had previously opted to transfer their resignation benefits to another complying fund will be permitted to transfer their accumulated superannuation benefits back into the scheme.

Death and disability element

The proposed new scheme will provide a defined benefit where a member dies or is medically discharged from the ADF. This death and disability element will complement the accumulation plan. Serving ADF members who have elected to have their employer contributions directed to another scheme will remain eligible for the death and disability element.

The death and disability benefits arrangements will differ in structure from current arrangements under the MSBS and DFRDB for two reasons:

- the need to complement the separate accumulation retirement plan (the MSBS and DFRDB defined benefit arrangements substantially merge the retirement and death and disability benefit arrangements and their funding); and
- the advantages of building upon the recently introduced Military Rehabilitation and Compensation Act (MRCA), and clarifying the relationship between compensation and superannuation death and disability payments.

Recommendation 4 Death and disability benefits under the new superannuation scheme should have the following key attributes:

a. Defence as employer should continue to meet the costs.

b. Compensable and non-compensable arrangements should be brought under one assessment and administration regime with an emphasis on rehabilitation, under the auspices of the Department of Veterans' Affairs.

c. Compensable disability benefits should be fully the responsibility of the *Military Rehabilitation and Compensation Act 2004* (MRCA) until age 60 at existing rates of benefits.

d. For non-compensable disability, the current three-tiered invalidity benefits should be replaced by a single benefit for loss of earnings, akin to the *Military Rehabilitation and Compensation Act 2004* (MRCA) benefits and conditions, with a minimum of 40% and maximum of 70% of final salary (based on actual and prospective service), indexed to Defence earnings and payable to age 60.

e. Employer contributions to the superannuation retirement fund should continue whilst a person is in receipt of either MRCA or superannuation disability benefits at a rate of 23% of the 'salary maintenance', up to age 60.

f. Death benefits from the superannuation scheme should supplement the accumulated benefit on the basis of 23% of final salary for each year of prospective service to age 60, payable in addition to any MRCA death benefits. Where there is a surviving spouse, the superannuation death benefit may be converted to an indexed pension with additional payments for up to three dependent children.

g. In the case of terminal illness, early access to the death benefit should be allowed.

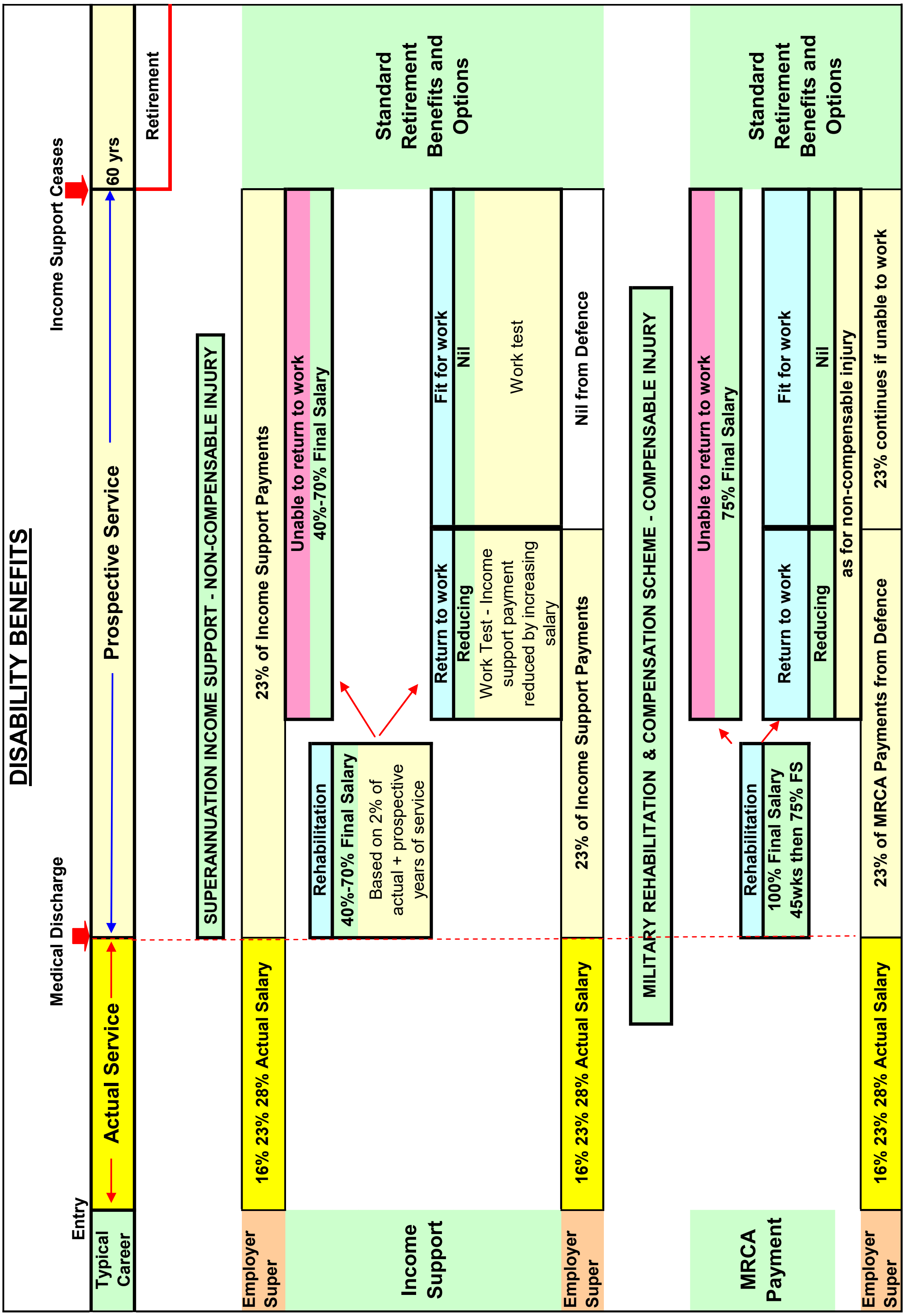
Notwithstanding the different structure proposed under the new scheme, the Review Team has tried to ensure in the design of the new scheme that the death and disability benefits are at least as generous as under the existing schemes unless, of course, a medically discharged member can be successfully rehabilitated.

Disability benefits

Disability benefits will be paid to members on medical discharge from the ADF. These disability benefits will constitute both a salary maintenance payment directly to the member (in the form of income) plus an employer contribution to the member's superannuation account. The purpose of the continuing employer contribution is to provide a separate retirement benefit for the member when the compensation and salary maintenance payments cease at age 60. Upon turning 60, members will be able to draw upon their superannuation account for benefits in retirement.

The proposed new disability benefit arrangements are summarised in the diagram at Figure 4–2.

Figure 4—2: Scheme Design - Disability Benefits



Salary Maintenance

Where the injury responsible for the medical discharge is a compensable injury, the level of salary maintenance will be determined under the MRCA. Generally this is 100% of salary for the first 45 weeks, reducing to 75% thereafter. The current arrangement of a superannuation disability payment plus a top-up of compensation will be replaced by making MRCA fully responsible for these cases. This is in line with normal contemporary (workers compensation) practice, and will remove the duplication of assessment and payment arrangements that is the source of many complaints about inconsistency.

Where a non-compensable injury is involved, salary maintenance will be met under the new superannuation scheme, and will be determined taking into account the total service of the member along broadly similar lines as apply now in the MSBS. Total service is the sum of actual service undertaken by the member plus prospective service from date of discharge until the member's 60th birthday. The base salary maintenance rate is calculated at 2% of salary for each year of total service. To maintain consistency between the compensable and non-compensable entitlements the base rate has a maximum cap of 70%. To protect later entrants a minimum cap of 40% will also apply.

Like the MRCA salary maintenance, salary maintenance for non-compensable injuries under the new superannuation scheme will be indexed by Defence earnings, not just the CPI (as applies currently to MSBS and DFRDB payments).

Sergeant Green has been medically discharged at age 30 after 11 years of completed service due to an injury which does not qualify for compensation. At the time of his discharge his salary is $50,065 and he is in receipt of $10,098 Service Allowance. His total superannuation salary is $60,163.

At discharge he therefore has total service, for the purpose of determining his salary maintenance level, of 41 years (that is, 11 years of actual service plus 30 years of prospective service to age 60). The base rate for his salary maintenance is:

41 years x 2% = 82%

As this exceeds the maximum cap, SGT Green's base rate for salary maintenance is 70% of superannuation. His base salary maintenance level is:

70% x $60,163 = $42,114 pa

This is a base rate which will be indexed with Defence earnings. The actual level of payment will take into account SGT Green's ability to work as determined by the economic and work test.

The actual rate of salary maintenance paid to members under the scheme's disability provisions will take into account the member's ability to undertake paid employment. This will be undertaken in a similar fashion to the economic and work test assessments currently undertaken under the MRCA.

For compensable injuries, the rate of salary maintenance is adjusted under the MRCA in accordance with an economic and work test administered by the Department of Veterans' Affairs. Table 4–2 details the effect the member's ability to earn income has upon compensable benefits.

Table 4–2: Compensable cases – effect of economic and work test

Actual Hours of employment	Rate of income/salary maintenance Compensable conditions
Nil	75% of normal earnings minus actual earnings
25% or less of normal weekly hours	80% of normal earnings minus actual earnings
More than 25% but less than 50%	85% of normal earnings minus actual earnings
More than 50% but less than 75%	90% of normal earnings minus actual earnings
More than 75% but less than 100%	95% of normal earnings minus actual earnings
100% of normal weekly hours	100% of normal earnings minus actual earnings

For non-compensable cases, the new scheme will mirror these provisions. The same economic and work tests will be conducted (and it is the Review Team's recommendation that for consistency this also be undertaken by the Department of Veterans' Affairs). The ability of the member to be able to undertake employment will affect the amount of salary maintenance payment to the member according to Table 4–3.

Table 4–3: Non-compensable cases – effect of economic and work test

Actual Hours of employment	Rate of income/salary maintenance Non-Compensable conditions
Nil	base rate minus actual earnings
25% or less of normal weekly hours	(base rate + 5%) minus actual earnings
More than 25% but less than 50%	(base rate + 10%) minus actual earnings
More than 50% but less than 75%	(base rate + 15%) minus actual earnings
More than 75% but less than 100%	(base rate + 20%) minus actual earnings
100% of normal weekly hours	(base rate + 25%) minus actual earnings

In the earlier example of SGT Green (above), his base rate for salary maintenance was set at $42,114 pa (i.e. 70% of $60,163).

If he is unable to work, and hence is not earning any other income, his salary maintenance benefits under the scheme will be **$42,114 pa** ($1615.33 pf)**.**

In the event his condition improves and he is able to undertake employment working 12 hours per week he will continue to qualify for salary maintenance.

His new employment has an annual full-time salary of $50,000 pa ($1917.81 pf). Working 12 hours a week he will earn $302.81 per week ($605.62 pf). Because he is working between 25% and 50% of normal hours, his entitlement to salary maintenance under the scheme becomes:

(base rate + 10%) minus his actual earnings from the new employment

= ($42,114 x 110%) minus actual earnings

= $46325 pa ($1776.86 pf) minus actual earnings

= $1776.86 - $605.62

= $1171.24 pf

The $1171.24 paid from the scheme plus his actual earnings of $605.62 allow him to earn more than the base rate of salary maintenance.

Employer contribution

While the salary maintenance is being paid, an employer contribution will also be paid to the superannuation account of the member. Employer contributions are paid in both situations, compensable and non-compensable injuries. The rate of contribution will be 23% of the actual salary maintenance payments being made to the member.

The accumulation of these employer contributions and investment earnings will provide retirement benefits for the member at age 60. Members who have 15 years or more of service will be able to convert part or all of their lump sum into an indexed pension. This period of service includes actual service, plus periods during which the member qualified for salary maintenance.

SGT Green receives a salary maintenance payment of $42,114 pa ($1615.33 pf) where he is unable to undertake any employment (see above).

While receiving this rate of salary maintenance Defence will pay an employer contribution of 23% to SGT Green's superannuation account. Therefore he will receive an employer contribution of:

$371.53 (23% of $1615.33) per fortnight or **$9,686 over a year.**

In the example of SGT Green undertaking 12 hours of employment a week, his salary maintenance under the scheme is $1171.24 per fortnight. In this example Defence will pay an employer contribution of:

$269.39 (23% of $1171.24) per fortnight or **$7,023 over a year**

SGT Green will, of course, also be paid an employer contribution by his other employer which must comply with the *Superannuation Guarantee (Administration) Act 1992*.

Death Benefits

Death benefits will consist of the accumulated account plus 23% of superannuation salary (or salary maintenance) for each year of prospective service to age 60. Surviving spouses will have the option of converting the lump sum into an indexed pension, with additional payments for dependent children. These death benefits will be in addition to any compensation benefits available under the MRCA.

The particular arrangements will vary slightly according to the following possible circumstances of the death:

- a serving ADF member (i.e. death in service);
- a member on salary maintenance after having been medically discharged;
- a former ADF member who has retained accumulated benefits in the scheme; or
- a former ADF member in receipt of a pension from the scheme.

The scheme will also provide a terminal Illness benefit where a member has a terminal illness and is expected to die within two years.

A summary of the death benefit arrangements is set out in Figure 4–3.

Death in service

Where a serving member dies, the death benefit is the sum of:

- the accumulated benefit at the time of death; and
- a lump sum calculated at 23% of final superannuation salary for each year of prospective service to age 60.

Lieutenant Brown, who joined the scheme as a new entrant in 2007, dies after having completed eight years of service. At the time of her death, she had just turned 29. She was on a superannuation salary of $79,251 ($65,963 plus the then $13,288 Service Allowance).

At the time of her death LT Brown's accumulated benefits in the scheme were:

$89,067 (or $73,101 in 2007 prices)

LT Brown's prospective service from age 29 to age 60 is 31 years. Her lump sum for prospective service is therefore calculated as:

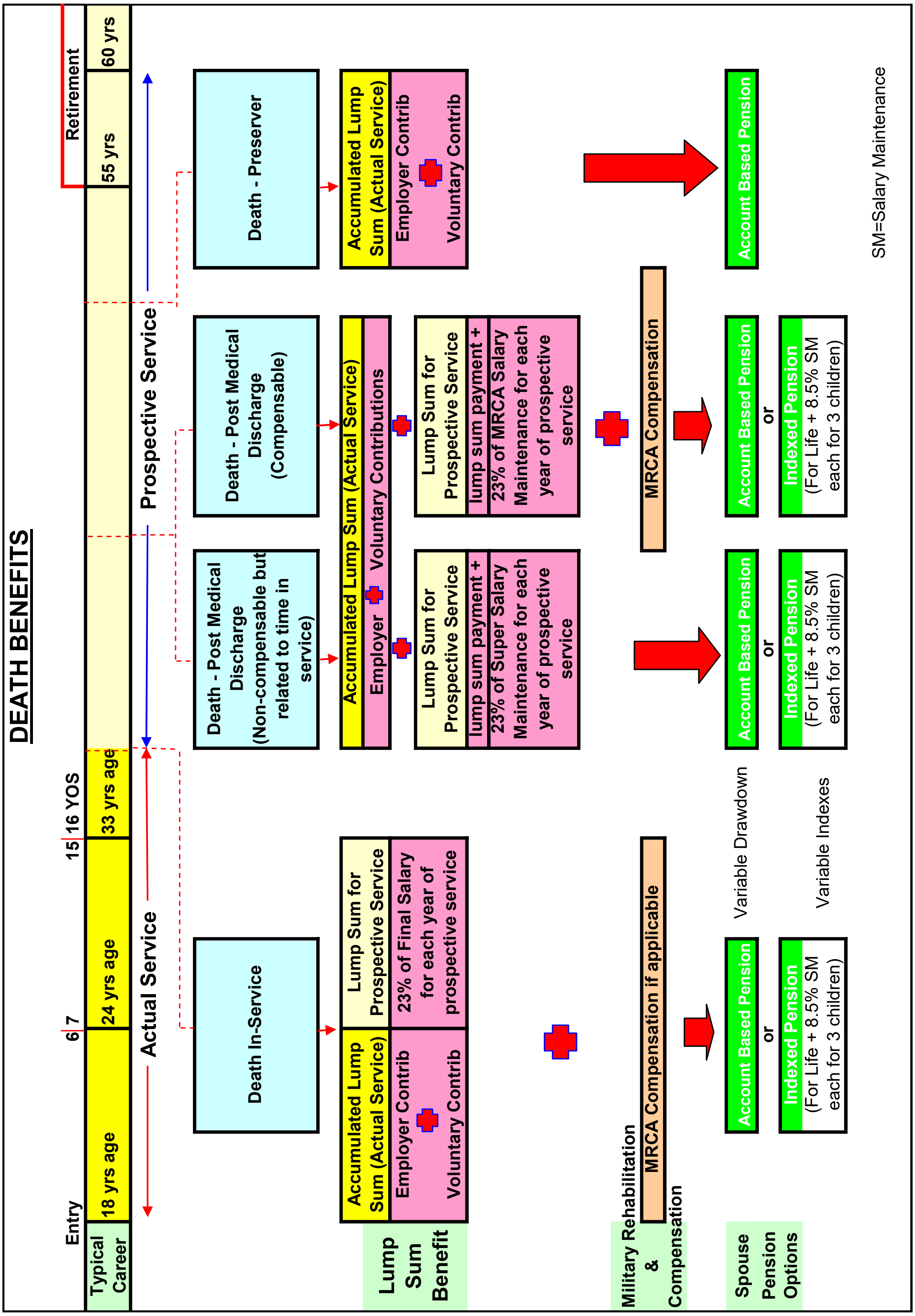
23% x $79,251 x 31 years

$565,060 (or $463,771 in 2007 prices)

Total lump sum on death is $89,067 plus $565,060:

= **$654,127 ($536,872 in 2007 prices)**

Figure 4–3: Scheme Design - Death Benefits



Surviving spouses will be able to convert the lump sum benefit into an indexed pension at a single rate irrespective of the age of the spouse. The conversion factor to be utilised in these circumstances is that applicable to pensions taken by ADF members at age 60. Where a spouse elects to take a pension, an additional pension is payable in respect of eligible children. The benefit is a maximum of 8.5%[6] of the member's salary (per child) for up to three children. The additional pension will continue while the children remain dependant.
In all other circumstances the benefit will be paid as a lump sum to eligible recipients.

> Lieutenant Brown's surviving spouse elects to convert 70% of the lump sum into a CPI indexed pension for life. The benefits payable are:
>
> Lump sum **$196,238** (30% of $654,127) plus
>
> CPI Indexed pension (conversion factor 18.6) calculated as:
>
> (70% x $654,127)/18.6
>
> = **$24,618 pa (or $20,205 on 2007 prices)**
>
> An additional pension will be paid in respect of her two children. Because the surviving spouse has chosen only to convert 70% of the lump sum to pension, the additional pension is calculated as:
>
> 8.5% x $79,251 x 70% x 2 children
>
> = $4,715.43 x 2 children
>
> **= $9,431 pa (or $7,740 in 2007 prices)**
>
> Therefore, LT Brown's spouse will receive a lump sum of **$196,238**, plus CPI indexed pensions of **$34,049** pa while the two children remain dependants. The pension will revert to **$24,618** pa (as indexed by CPI) when the children are no longer eligible.

Where the death is caused by a compensable injury, additional benefits in the form of permanent impairment payments may also be paid in accordance with existing MRCA (or predecessor) provisions.

Death after medical discharge

Where a member dies while in receipt of salary maintenance payments as a result of medical discharge, the death benefit is the sum of:

- the accumulated benefit at the time of death; and
- a lump sum of 23% of the salary maintenance rate (at the time of death) for each year of prospective service to age 60.

Surviving spouses will be able to convert the lump sum benefit into an indexed pension (with additional payments for dependent children) in the same way as in the case of death in service.

In circumstances where a member dies within five years of having been discharged on medical grounds, and that death is due to a compensable condition, the lump sum payment for prospective service will be based on final superannuation salary (rather than the salary maintenance rate). A discount to that superannuation salary will apply according to the period elapsed between discharge and death according to Table 4–4.

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6 8.5% is paid where the spouse converts the whole lump sum to a pension. Where a smaller proportion is converted, the rate of the child's pension is reduced commensurately (i.e. if only half of the lump sum is converted, the child's pension will be 4.25% of the member's salary).

Table 4–4: Salary for superannuation purposes to be used in the case of a compensable death within five years of medical discharge.

Number of years between medical discharge and death	Rate of final superannuation salary
Up to 1 year	100%
More than 1 year and up to 2 years	95%
More than 2 years and up to 3 years	90%
More than 3 years and up to 4 years	85%
More than 4 years and up to 5 years	80%
More than 5 years	75%

In these cases, additional benefits in the form of permanent impairment payments may also be paid in accordance with existing MRCA (or predecessor) provisions.

Death of a former ADF member

Upon the death of a former ADF member with accumulated funds retained in the scheme, the accumulated benefit will be paid to the member's beneficiaries. Surviving spouses may elect to convert that lump sum into an indexed pension on the same basis as if the death was in service (other than the availability of additional benefits for dependent children), provided that the deceased member had achieved at least 15 years of ADF service.

Death of a pensioner

In the circumstances of the death of a member in receipt of an indexed pension, a reversionary pension will be paid to the member's spouse. In this circumstance, a spouse would continue to receive 62.5% of the relevant pension.

Terminal Illness Benefit

A special provision will apply, in limited circumstances, where the member has a terminal illness and is expected to die within two years. In effect, the member will have early access to the death benefit, which comprises the accumulated benefit plus a prospective lump sum calculated on the same basis as a death after medical discharge. Salary maintenance payments will continue until the member’s death, but no employer superannuation contribution will be paid as this will have been accessed through the lump sum. Similarly there will be no option for a spouse to purchase a pension as the lump sum will already have been accessed.

Approval for such payment will be at the discretion of the Board subject to Superannuation Industry (Supervision) requirements.

Scheme membership

Reservists

All Reservists may become members of the scheme and make their own post-tax superannuation contributions to the scheme or have Superannuation Guarantee contributions from other employers made to the scheme.

While remaining active Reservists, they will be exempt from any administrative fees.

They will not be eligible for the defined benefit death and disability benefits from the scheme unless they are on continuous full-time service, in which case they will be full members of the new scheme, attracting employer contributions and all of the benefits of the scheme (as if they were permanent ADF) while they remain on such service.

The concept of broader superannuation options for Reservists requires a more holistic evaluation of their total remuneration package which is addressed in Chapter 5.

Recommendation 5 Superannuation for Reservists should be along the following lines:

a. Reservists should be allowed to contribute personally and/or from an external employer into the new scheme.

b. Reservists on full-time service should continue to be included in normal Defence superannuation arrangements including the proposed new scheme.

c. Reservists not on full-time service whose pay is tax-exempt should not be included in normal Defence superannuation arrangements and should not receive the proposed employer contributions under the new scheme.

ADF family members

Membership of the scheme will be open to the spouse and dependent children of a serving ADF member (Recommendation 3f).

While the ADF member remains in service, the family members will be exempt from administration fees.

Having established their individual membership, family members will continue to be members even if the ADF member either subsequently leaves the ADF or the scheme. However, fees will not be subsidised from that time.

Recommendation 6 Defence should meet the costs of administration of the scheme for individuals in receipt of an ADF employer contribution or a benefit from the scheme, family members of these individuals and Reservists who choose to use the scheme.

Under this type of membership ADF family members may make their own post-tax superannuation contributions to the scheme or have employer contributions made to the scheme. They are not eligible for the defined benefit death and disability benefits from the scheme.

Public Offer

The Review Team believes that the proposed new scheme should not be a public offer scheme, but should be clearly identified with the ADF.

Transitional arrangements

With the MSBS closed, all new ADF members will become members of the new scheme.

The Review Team considers that it is important for retention purposes to offer all current ADF members the option of transferring to the new scheme from whichever scheme they currently belong (MSBS or DFRDB).

In view of the understandable complaints from MSBS members with preserved benefits about the current inability to invest most of their employer-financed benefits, which would be more loudly voiced if current ADF members were allowed to transfer to the new scheme, the Review Team also considers that preserved MSBS members should be allowed to transfer to the new scheme. The reduced level of complaints from the ex-service organisations might also have some secondary recruitment benefits, including with regard to re-enlistment.

Importantly, the Actuary has indicated that the costs of these transitional arrangements can be broadly met within the current cost envelope (see Chapter 10). It would be unreasonable therefore, in the Review Team's view, to deny the opportunity for current ADF members and MSBS preserved members to transfer to the new scheme.

Recommendation 7 Contributing members of current schemes should be offered the choice, for a limited period, of remaining in their current scheme or having their existing accrued benefits funded and then taxed on transfer to the new scheme, or to a scheme of their choice.

Recommendation 8 Preserved members of the MSBS should be given the option, for a limited period, to have the current face value of their benefit funded and then taxed on transfer to the new scheme, or to a scheme of their choice.

More details of the proposed transitional arrangements are at Chapter 7.

Chapter 5: The impact on the ADF and ADF members

This chapter provides a high level assessment of the proposed new scheme, and sets out the impact on ADF members and on the ADF as a whole, particularly with regard to recruitment and retention. The impact on some specific groups is discussed in more detail.

Overall assessment of the proposed new scheme

Table 5–1 summarises the Review Team's assessment of the proposed new scheme against the Guiding Principles set out at the end of Chapter 2, and compares this with the assessment of the current open scheme, the MSBS.

Table 5–1: Assessment of MSBS and proposed scheme against the Guiding Principles

Guiding Principle	MSBS	Proposed Scheme
Flexibility • Contributions • Benefits	 In small part Yes	 Yes Yes
Simplicity	No	Yes, but disability benefits remain complex
Adequacy • Short term members • Long term members	 In part Yes	 Yes, but with member risk Yes, but with member risk
Tailored • Death and disability • Indexed pensions from age 55	 Yes Yes	 Yes, with enhanced rehabilitation Yes, for members with 15 years service
Visibly attractive • For recruitment • For re-enlistment • For retention	 Limited Limited In part	 Yes Yes Yes
Financially sustainable	No	Yes

The following comments expand on this assessment:

Flexibility. ADF members will have the full range of member contribution options available to members of other Australian superannuation schemes. They will also have access to fund choice and full portability of the employee and employer-financed benefits on resignation. On retirement, ADF members will have a full range of benefit options including lump sums, account-based pensions and, for those with 15 or more years of service, indexed pensions with a choice of indexes. A range of investment options will also be available during both the pre-retirement and post-retirement periods.

Simplicity. The proposed defined contribution structure is in line with the vast majority of superannuation schemes in Australia. ADF members will have full transparency of their employer contributions and their value. The contemporary funded and taxed nature of the proposed scheme means that administration is relatively simple and can be provided by a broad range of commercial providers. The removal of complex employer benefit formulae significantly lessens the likelihood of the systemic errors that were evident in both the DFRDB and MSBS. The relationship between superannuation death and disability pensions and military compensation will be clarified and overlapping assessments removed.

Adequacy. The minimum employer contribution of 16% of salary ensures that Defence more than meets its obligation as an employer to contribute towards an adequate income in retirement for members with shorter periods of service. For these members, despite the risks involved, the resulting retirement benefits are likely to be higher than under the MSBS, and for all such members the benefits are higher than under contemporary civilian schemes including for the Australian Public Service. For longer periods of service the employer contribution is particularly generous compared to contemporary Australian schemes, although there is risk of lower benefits than under the MSBS. To an extent, the final outcome in terms of adequacy is in the hands of members who choose the level of investment risk that they are prepared to take to achieve a desired long term outcome. More details on likely retirement benefit levels are set out below.

Tailored. The unique nature of military service is primarily addressed through the death and disability arrangements. The arrangements have been tailored for the ADF through compulsory membership of this element of the scheme, and through being employer-financed rather than funded by employee insurance contributions, as is typical in contemporary schemes. The defined benefit nature of the benefits with reversionary benefits for dependants and the inclusion of prospective service in the benefit calculation ensure that current generous death and disability payments are preserved and, if anything, enhanced, but with a stronger focus on rehabilitation. The benefit design also ensures access for longer serving members to indexed pensions from age 55.

Visibly Attractive. The proposed scheme clearly has all the beneficial features of contemporary Australian superannuation schemes. Accumulated benefits would be clearly visible to members on a daily basis through the internet. Future benefits can also be projected under a range of scenarios through a web-based calculator and taken into account in future financial planning and lifestyle decisions. The level of generosity of the employer contribution is clearly visible to the ADF member and can be quantified as a financial element of the remuneration package for recruitment and retention purposes. This is likely to be particularly important for mature age recruitment and re-enlistment, and for retention purposes, as detailed below.

Financially Sustainable. While costing about the same as the current schemes, the new scheme will cap unfunded liabilities which would otherwise continue to grow under the MSBS; indeed, liabilities will decline substantially over the next 40 years (see Chapter 10). In addition, the scheme will sharply reduce the risks to Defence and the Government of future changes in life expectancy and inflation.

Benefit levels and impact on ADF members

Retirement Benefits

Figures 5–1 and 5–2 show the employer-financed benefit payable at age 55 under both the MSBS and the proposed new scheme for a typical member separating from the ADF at various ages. Figure 5–1 is based on an 'other ranks' member joining at age 18 and Figure 5–2 is based on an officer member joining at age 21 using the most common patterns of career advancement. The illustrative investment returns in the following graphs have been selected because investment modelling suggests a 70% chance of the long term return being between 6% and 8.5% per year, and more than 80% chance of the long term return being between 5.5% and 9% per year.

Figure 5–1: Comparison of employer-financed benefit for an 'other rank' member

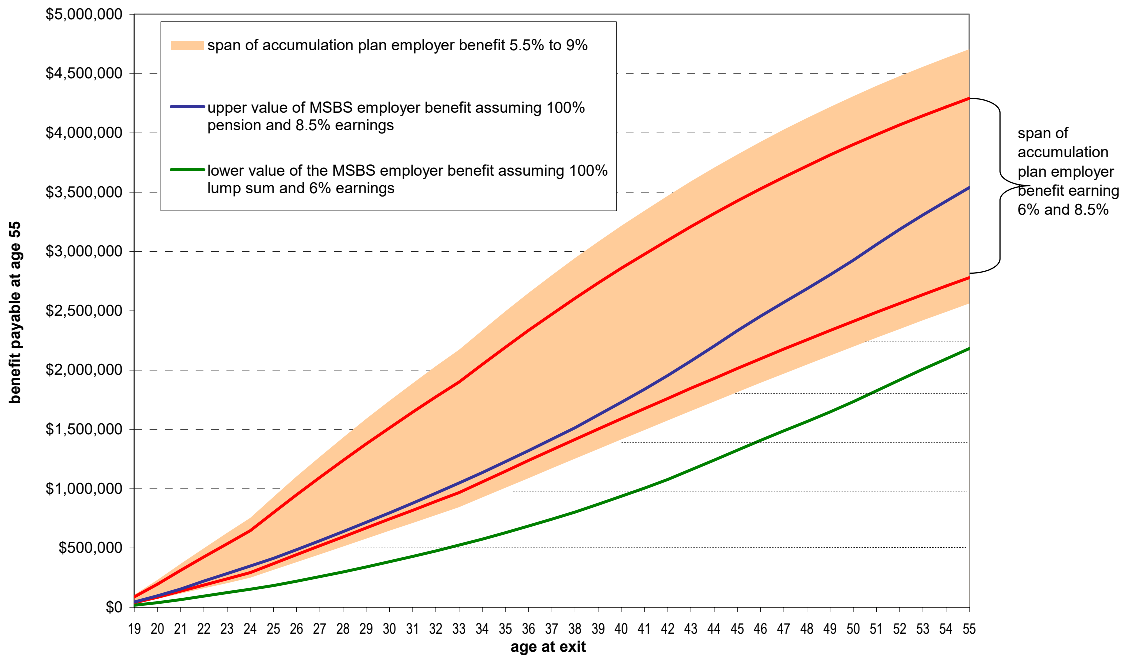
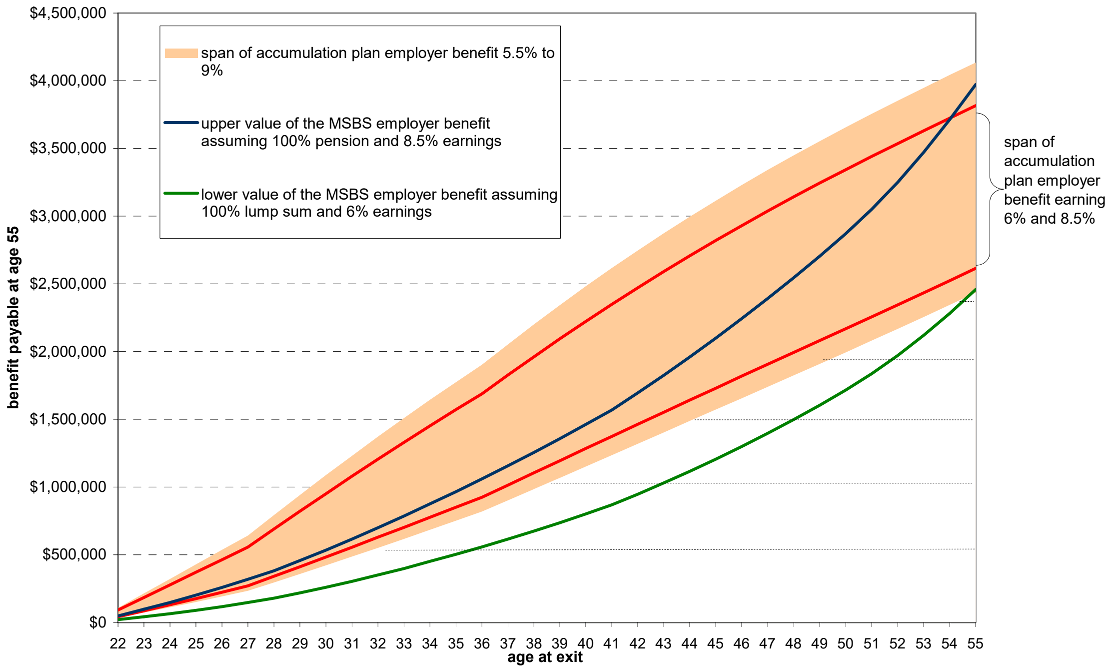


Figure 5–2: Comparison of employer-financed benefit for an officer



The graphs demonstrate:

- the likelihood of gains in employer financed benefits (after tax) for members separating with under 20 years of service;
- the broad comparability of expected benefits (after tax) at age 55 for longer serving members; and
- the risks borne by members under the proposed scheme associated with uncertain investment returns. In particular, there is a risk of lower benefits for long serving members when compared to MSBS members who choose to receive their benefit as an indexed pension (there is also the probability of higher benefits than under the MSBS for all other ranks and most officers).

The apparent inconsistency of many 'winners' and few 'losers' but with the same long-term cost to Government is explained by the transfer of risks from Government to members. As a result, members will have the potential to achieve greater returns from the market (but with the risk of a similar or lower return).

The benefit levels under the proposed scheme, and comparisons with benefits under the MSBS, depend not only on investment returns and the risks associated but also depend upon personal circumstances, such as particular career paths and entry and exit points.

Table 5–2 draws on some common career paths and identifies likely benefit levels at age 55 under the new scheme and under the MSBS, based on entry into the ADF in 2007.

These cameos confirm the broad picture illustrated in the earlier graphs, but also reveal some other impacts of the proposed new scheme.

Even with modest investment returns, members of the ADF who join at an early age are likely to receive higher benefits under the new scheme than under the MSBS. This reflects, in large part, having more years prior to retirement during which the employer contributions are receiving investment earnings and not Consumer Price Index (CPI) indexation. This gain is less marked amongst those who, having joined at a young age, stay on until retirement age; this is the group that is most advantaged by the MSBS (and also by the DFRDB).

Those who enlist at a later age may not receive higher benefits under the new scheme as they have fewer years during which the employer contributions receive investment earnings. The MSBS is most likely to be more generous than the new scheme for those who then stay to age 55, as their MSBS benefits are not constrained by the MSBS preservation arrangements that only allow CPI adjustments rather than investment returns. Nonetheless, the new scheme remains a highly generous scheme for all these members compared to any contemporary civilian scheme, including the contemporary Australian Public Service scheme (the Public Sector Superannuation accumulation plan). Moreover, most such members should already have accumulated retirement benefits from earlier periods of employment.

Those who re-enlist at an older age will gain both from the compound interest on their employer contributions received during their first period of service, and from quickly gaining access to high levels of employer contributions when their total years of service reach six completed years or 15 completed years. They are likely to do better under the new scheme than the MSBS.

Table 5–2: Value of employer-financed benefit at age 55 in today's dollars (after tax)

	Fund earning rate of 6%				Fund earning rate of 8.5%			
	MSBS		New Scheme		MSBS		New Scheme	
	lump sum $'000	pension $'000	lump sum $'000	pension $'000	lump sum $'000	pension $'000	lump sum $'000	pension $'000
Officer joins AF at age 18 as an OFFCDT is promoted to FLGOFF after 4 years and FLTLT after 7 years								
Resigned after 10 years	139.0	13.2	239.6	n.a.	176.9	16.3	449.7	n.a.
Promoted to SQNLDR after 12 years								
Resigned after 15 years	263.9	24.6	406.2	21.9	310.8	29.1	744.5	42.0
Promoted to WGCDR after 17 years and GPCAPT after 23 years								
Retired at age 55 after 37 years	1,184.4	104.1	1,368.9	75.5	1,200.5	105.3	2,007.3	107.3
Officer joins Army at age 21 as an OFFCDT is promoted to 2LT after 2 years, LT after 4 years and CAPT after 8 years								
Resigned after 10 years	133.7	12.7	236.3	n.a.	167.5	15.5	421.2	n.a.
Promoted to MAJ after 14 years								
Resigned after 15 years	245.9	22.9	379.1	20.3	284.4	26.6	656.9	36.9
Promoted to LTCOL after 19 years and COL after 25 years								
Retired at age 55 after 34 years	1,030.2	91.8	1,115.7	62.6	1,042.4	92.7	1,581.5	85.8
Officer joins Army at age 30 as a LT is promoted to CAPT after 4 years								
Resigned after 10 years	142.0	13.2	210.9	n.a.	159.6	14.7	313.5	n.a.
Promoted to MAJ after 10 years								
Resigned after 15 years	249.1	23.4	328.8	17.6	266.3	25.1	471.4	26.1
Promoted to LTCOL after 15 years and COL after 21 years								
Retired at age 55 after 25 years	634.1	58.1	648.7	36.7	639.2	58.5	831.3	47.6
Other Rank joins Air Force at age 18 as an AC is promoted to LAC after 2 years								
Resigned after 4 years	38.5	3.2	83.7	n.a.	57.0	4.8	189.3	n.a.
Promoted to CPL after 4 years								
Resigned after 6 years	61.7	5.2	126.8	n.a.	88.9	7.5	273.4	n.a.
Promoted to SGT after 8 years								
Resigned after 10 years	122.3	10.3	248.9	n.a.	163.9	13.8	477.2	n.a.
Promoted to FSGT after 12 years and WO after 17 years; commissioned as a FLTLT after 26 years and promoted to SQNLDR after 29 years								
Retired at age 55 after 37 years	862.5	84.8	1,069.4	61.4	876.9	85.9	1,620.3	94.2
Other Rank joins Navy at age 18 as a SMN is promoted to AB after 2 years								
Resigned after 4 years	38.1	3.2	76.0	n.a.	55.8	4.7	171.5	n.a.
Resigned after 6 years	58.5	4.9	115.9	n.a.	84.2	7.1	252.7	n.a.
Promoted to LS after 6 years								
Resigned after 10 years	115.2	9.7	233.9	n.a.	154.8	13.0	446.6	n.a.
Promoted to PO after 12 years, CPO after 17 years and WO after 24 years								
Retired at age 55 after 37 years	775.5	75.9	979.2	56.0	788.8	76.9	1,480.8	85.9

Note Value in 2007 prices, assuming 2.5% inflation rate and 4% per annum movement in ADF pay rates

Disability benefits

Table 5–3 compares the employer-financed disability income benefits for the medically discharged under the MSBS and the proposed scheme (based on modest assumptions of investment returns and on accessing indexed pensions). The table shows income at the point of discharge, at age 59 (just prior to retirement) and at age 60 (after retirement).

Table 5–3 demonstrates:

- the unchanged disability benefits for compensable injuries during the years before age 60;
- the improved disability benefit for non-compensable injuries particularly through improved indexation arrangements; and
- the likelihood of improved benefits at age 60, with access to a substantial accumulated lump sum that can be converted into an indexed pension at least as generous as current MSBS arrangements, particularly after the new tax rules are taken into account.

Receipt of a disability income benefit would also count towards the 15 years service required to purchase an indexed pension from between age 55 and 65.

These disability income benefits would be reduced, of course, if the individual is successfully rehabilitated into employment and is therefore able to attract new superannuation contributions from a new employer. The table focuses on those who are fully disabled and unable to work. The rehabilitation focus may mean that some who under the MSBS might retain access to a Class B pension for partial disability would receive a lower benefit under the new scheme if they are successfully rehabilitated.

Table 5–3: Comparison of Class A disability income benefits in today's dollars

	Officer joining at age 21			Other Rank joining at age 18		
Compensation	**MSBS**	**Proposed**	**% change**	**MSBS**	**Proposed**	**% change**
Medical discharge after 5 years of service						
Income at discharge	$35,246	$35,246	0%	$31,084	$31,084	0%
Income at age 59	$56,928	$56,928	0%	$52,442	$52,442	0%
Income at age 60	$35,872	$44,520	24%	$34,924	$45,807	31%
Medical discharge after 8 years of service						
Income at discharge	$39,583	$39,583	0%	$34,883	$34,883	0%
Income at age 59	$61,206	$61,206	0%	$56,341	$56,341	0%
Income at age 60	$40,487	$49,018	21%	$38,353	$50,360	31%
Medical discharge after 12 years of service						
Income at discharge	$47,677	$47,677	0%	$37,213	$37,213	0%
Income at age 59	$69,560	$69,560	0%	$56,711	$56,711	0%
Income at age 60	$49,377	$57,226	16%	$42,151	$53,017	26%
Medical discharge after 20 years of service						
Income at discharge	$70,123	$70,123	0%	$50,215	$50,215	0%
Income at age 59	$91,082	$91,082	0%	$68,129	$68,129	0%
Income at age 60	$66,910	$75,390	13%	$56,914	$66,567	17%
Non-Compensation	**MSBS**	**Proposed**	**% change**	**MSBS**	**Proposed**	**% change**
Medical discharge after 5 years of service						
Income at discharge	$30,906	$33,290	8%	$30,155	$29,405	-2%
Income at age 59	$32,197	$53,768	67%	$31,358	$49,610	58%
Income at age 60	$35,872	$41,997	17%	$34,924	$43,243	24%
Medical discharge after 8 years of service						
Income at discharge	$34,550	$37,356	8%	$32,930	$32,969	0%
Income at age 59	$36,318	$57,762	59%	$34,420	$53,249	55%
Income at age 60	$40,487	$46,609	15%	$38,353	$47,891	25%
Medical discharge after 12 years of service						
Income at discharge	$41,432	$44,935	8%	$36,081	$35,168	-3%
Income at age 59	$44,257	$65,558	48%	$37,811	$53,595	42%
Income at age 60	$49,377	$54,914	11%	$42,151	$50,936	21%
Medical discharge after 20 years of service						
Income at discharge	$57,285	$65,938	15%	$48,186	$47,357	-2%
Income at age 59	$59,479	$85,646	44%	$50,805	$64,251	26%
Income at age 60	$66,910	$73,397	10%	$56,914	$64,856	14%

Notes A modest investment return of 6.5% has been assumed for the proposed plan. A higher return would increase the benefits under this plan. There is, of course, a risk of a lower return. Prices are assumed to increase at 2.5% per year.

The disability income currently provided under compensation ceases at age 65. This effect is shown in Table 5–3 at age 60 for comparison purposes.

Figures assume salary growth of 4% per year.

Death benefits

Table 5–4 shows the employer-financed death benefit (not including the additional Military Rehabilitation and Compensation Act payments in the case of compensable death) at different ages as a lump sum or indexed pension, based on modest assumptions of investment returns. The table demonstrates the likelihood of more generous death benefits than under the MSBS.

Table 5–4: Comparison of death benefits in today's dollars

	Officer joining at age 21				Other Rank joining at age 18		
	MSBS	**Proposed**	**% change**		**MSBS**	**Proposed**	**% change**
Death after 5 years of service							
Lump sum	$438,003	$480,407	10%		$424,839	$450,302	6%
Widow's pension	$21,485	$22,631	5%		$20,871	$21,280	2%
Pension for widow + 3 children	$30,906	$33,572	9%		$30,155	$31,049	3%
Death after 8 years of service							
Lump sum	$497,225	$536,870	8%		$468,848	$504,521	8%
Widow's pension	$24,293	$25,213	4%		$22,970	$23,761	3%
Pension for widow + 3 children	$34,550	$37,300	8%		$32,930	$34,511	5%
Death after 12 years of service							
Lump sum	$611,323	$646,463	6%		$517,585	$540,546	4%
Widow's pension	$29,679	$30,200	2%		$25,309	$25,445	1%
Pension for widow + 3 children	$41,432	$44,332	7%		$36,081	$36,873	2%
Death after 20 years of service							
Lump sum	$874,935	$942,917	8%		$715,536	$750,023	5%
Widow's pension	$40,804	$42,067	3%		$34,683	$34,963	1%
Pension for widow + 3 children	$57,285	$63,413	11%		$48,186	$49,540	3%

Notes A modest investment return of 6.5% has been assumed for the proposed plan. A higher return would increase the benefits under this plan. There is, of course, a risk of a lower return. Prices are assumed to increase at 2.5% per year.

Figures assume salary growth of 4% per year.

Impact on recruitment and retention

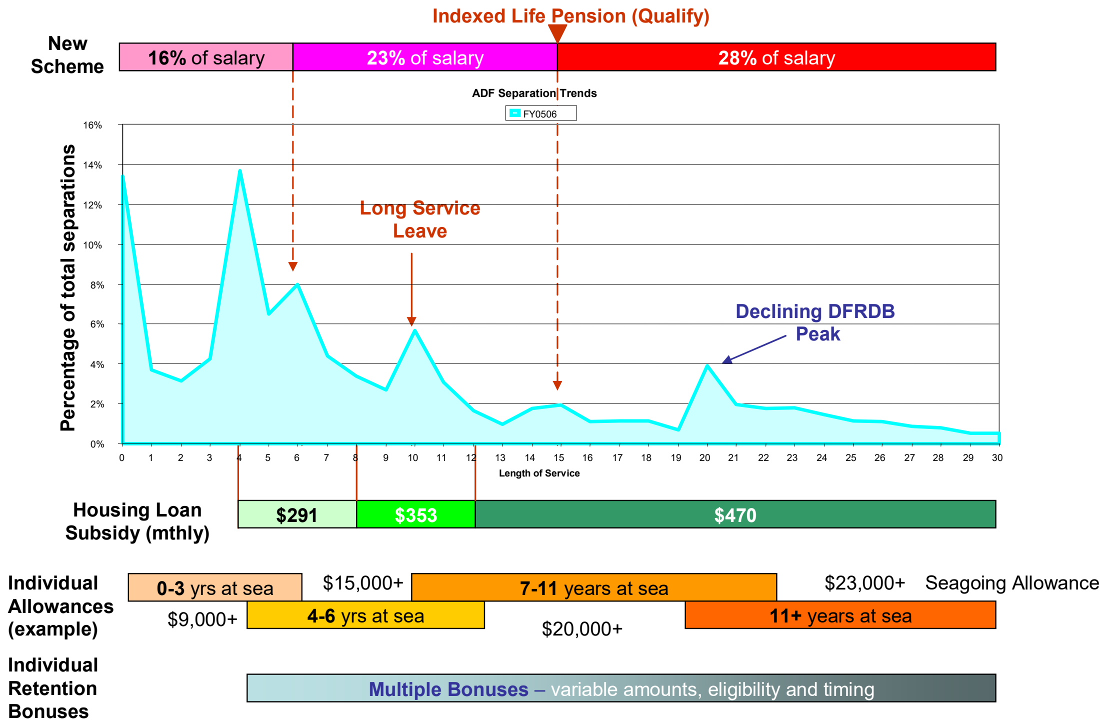
Retention

The Review Team considers that the new scheme will have a positive impact on retention, in particular, by making very transparent the value of the employer contribution as a component of the remuneration package, demonstrating its generosity compared to the level of employer superannuation contributions elsewhere. In so doing, it should take pressure off demands for increases in ADF pay and hence give better value for money to Defence from its total remuneration package.

This retention advantage is particularly relevant to the more skilled and experienced ADF members who, under the new scheme, will generally receive employer contributions at the 23% and 28% levels, not just 16%.

Discussions with the three Services highlighted the importance of retaining skilled and experienced staff beyond six years and preferably beyond 10 years. In designing the proposed new scheme, the Review Team took these concerns into account while noting recent decisions to use other levers to encourage retention. It considers that the proposed parameters of the new scheme fit well with those other incentives providing a series of ‘hooks’ to encourage continued service beyond the six year point. This is illustrated in Figure 5–3.

Figure 5–3: ADF retention initiatives by years of service



Recruitment

While superannuation does not have a major impact on recruitment of young people, the increased transparency of the value of the employer-financed benefit under the new scheme, and its enhancement of the remuneration package, should have a positive effect. There is likely to be a more significant advantage for attracting older and more experienced recruits. Effective marketing will enhance these positive effects.

Recruitment of Ex-ADF members. Ex members who re-enlist into the ADF currently become contributing members of the DFRDB or MSBS with complex provisions for prior service determined by legislation. The process is complex, often results in administrative errors and disputes and in some cases acts as a disincentive to re-join. Under the proposed new scheme, members can join with a clear understanding of their current and future superannuation entitlements. The ADF will set the employer contribution rate for an individual at a level which recognises past service, as now, but consideration could also be given to include experience and skills gained outside the ADF and the need to attract specific trained personnel.

Recruitment of foreign military and mature age candidates. Currently, trained foreign military personnel join as members of the MSBS and are given a notional length of service for employer contribution purposes based on the total of their previous military service. This is a significant benefit which is certainly appreciated by those joining but the 'one size fits all' approach does not always represent value for money and precludes targeted attraction measures for specific employment groups. Under the proposed scheme, the simple notion of recognising past service in a foreign military would be replaced by the ADF setting the employer contribution rate for an individual at a level which recognises the level of skill and experience brought to the ADF and the relative importance of those skills for recruitment purposes. A similar approach would be taken to attract skilled professionals who bring a breadth of skills and knowledge to the ADF.

Benefits of transitional arrangements

These impacts on retention and recruitment would be reduced, or at least delayed, if current ADF members and current MSBS preservers were not offered the opportunity to transfer to the new scheme. It is particularly important to allow current ADF members to transfer, and to see the value of their employer contributions. But there is also advantage in offering preserved MSBS members the opportunity to transfer, both directly in terms of re-enlistment incentives and indirectly in terms of the influence of Ex-service Organisations and their public attitudes towards military superannuation. Moreover, as explained in Chapter 10, the transitional arrangements are not expected to add to the costs to Defence or the Government, and they would ensure an attractive total package.

Other effects

Implications from Better Super

The Government introduced significant changes to the taxation treatment of superannuation known as ‘Better Super’ from 1 July 2007. The proposed new scheme will take advantage of the improvements introduced. The members of the new scheme will be eligible for tax-free superannuation lump sums and income streams from age 60, in contrast to the more limited 10% taxation rebate applicable to superannuation benefits paid to DFRDB and MSBS pension recipients over age 60. Secondly, members of the new scheme will not be required to include these benefits in their annual income taxation returns so that any additional income will be taxed at lower rates. This contrasts to DFRDB/MSBS members whose additional income will be taxed at the member’s marginal tax rate.

New scheme members will be subject to the new indexed contribution limits of $50,000 pa for concessional contributions and $150,000 pa for non concessional contributions. MSBS members have a $1m cap on the employer-financed benefit which would not apply to members of the new scheme.

Impact on Senior Officers

The generous nature of the new scheme’s employer contribution rates after 15 years of service (28% of salary) would see some senior officers reaching the concessional contribution limit. At 1 July 2007, affected officers would include 4-Star, 3-Star and the small number of 2-Star officers on pay band five or six.

The superannuation taxation treatment of these officers would be no different to that applying to other Australian employees receiving this level of remuneration. Excess contributions above the concessional $50,000 limit (indexed) would be treated by the ATO as non-concessional contributions and taxed, in total, at the top marginal tax rate (currently 46.5%). That is, there would be an additional 31.5% tax payable on the excess (i.e. in addition to the 15% contributions tax). This tax is the same as if this excess were received as income.

Impact on the Gap Year Scheme

On 15 October 2006 the Minister for Defence, announced the Military Gap Year Scheme (MGYS) to enable young Australians to experience ADF training and the Service lifestyle. The scheme will be implemented from early 2008 and will provide up to a thousand positions across the ADF to school-leavers for 12 months paid military 'work experience'.

Since MGYS personnel will be part of the permanent ADF, under current arrangements they will be required to contribute to the MSBS. The military salary for MGYS personnel is expected to be in the range of $30,000 to $35,000 pa, with no Service Allowance payable. The preserved MSBS employer benefit after one year’s service would be around $5,400 to $6,300, with the funded productivity component comprising about $900 on average. Currently therefore, if a 19 year old MGYS member leaves the ADF after the 12 month initial period of enlistment, the (largely unfunded) MSBS employer benefit will have to be preserved for at least another 36 years (to the age 55 pension point) with the majority of the benefit indexed to CPI. The real value of the benefit at this point will not have changed in 36 years providing a poor reflection of military superannuation.

The features of the proposed scheme around choice, portability and preservation will provide more appropriate superannuation arrangements for MGYS participants who join the ADF after implementation of the scheme and who serve for short periods. The capacity to transfer from the MSBS to the proposed scheme will ameliorate issues for those who join prior to the introduction of the scheme as will portability of any preserved MSBS benefits for former MGYS members. The benefits of the proposed scheme can be used as an incentive to take up the option of joining the Services at the end of their MGYS period.

Impact on Reservists

As set out in Chapter 4, the Review Team does not recommend that Reservists, other than those on continuous full-time service, be eligible for employer-financed contributions to the new scheme. It believes more careful consideration of the role and nature of Reservists is required, and that this should flow through to consideration of the appropriate remuneration package including the applicability and level of superannuation.

The Review Team received submissions from Reservists and consulted with Reserve Policy Staff and the Defence Reserves Support Council, where proposals were made to extend employer-financed superannuation to Reservists.

In assessing these suggestions, the Review Team considered two fundamental issues. Firstly, is the nature of ADF Reserve service a form of part-time ADF employment or a unique form of service – or perhaps elements of both? Reserve service has changed from the traditional Citizen Military Force concept to include elements such as High Readiness and Specialist Reserves which clearly provide significant levels of capability on a daily basis. Arguably, if Reserve service is determined to be a form of part-time ADF employment, it would be appropriate to provide full-time ADF conditions of service on a fair pro-rata basis, including superannuation. However, if Reserve service is determined to be uniquely different to full-time ADF service, it may well be appropriate to apply unique conditions of service. The Review Team did not receive sufficient input to form an opinion on this issue and believes that it is a matter for Defence to determine. Once the nature of modern Reserve service is determined, the appropriate remuneration and conditions of service package can be determined.

The second issue is the connection between superannuation, taxation and the current tax-free remuneration arrangement. It was put to the Review Team on a number of occasions that there is no connection between the tax-free status of Reserve remuneration and superannuation. The Review Team believes otherwise. Superannuation is an element of the remuneration package paid by the employer which is taxed at a lower rate than other income because of restricted access to that income by employees. In the case of Reservists, however, their pay is exempt from taxation, so that were superannuation included in the remuneration package it would be taxed at a higher rate than the other income. The *Superannuation Guarantee (Administration) Act 1992* (section 29) recognises the connection between superannuation and the tax-free status of Reservists' pay by stating that income exempt from income tax is not taken into account in determining whether the ADF meets its obligation to pay a minimum of 9% of salary for its employees.

The situation is stark in a practical sense. If Reserves were provided with an increase in remuneration of, say, 9% through a salary increase, they would get the full 9% available to use now or to put into superannuation as a non-concessional contribution (with a $150,000 annual limit) without any taxes. If the additional 9% remuneration were paid as an employer contribution, it would be reduced by the 15% contribution tax, preserved and further taxed if accessed before age 60. It would also impact on the Reservists concessional contribution threshold of $50,000 per annum and, in some cases, their status as ‘self-employed’ for superannuation deductions against other income.

Overall, the solution to the vexed problem of superannuation for the Reserves is to firstly determine the nature of modern Reserve service or its components, determine the total remuneration that should be paid for each component and then determine the applicability of and level of superannuation that should form part of the package.

Flexibility for future adjustments

When the DFRDB was introduced in 1972 and the MSBS in 1991, both schemes were significant improvements over their predecessors and reflected prevailing superannuation policies. As explained elsewhere in this report, the defined benefit nature of the schemes no longer reflects best practice either for members or for Defence and the Government. The nature of the schemes has also constrained incremental adjustments over time to meet the changing superannuation environment. For example, the DFRDB could not easily be adjusted to the superannuation taxation arrangements introduced in 1983 or the introduction of the Superannuation Guarantee legislation. The MSBS could not be adjusted for recent contemporary superannuation initiatives such as choice of fund and the beneficial ‘Better Super’ benefits introduced from 1 July 2007. Where changes were made, such as incorporating the 3% Productivity Benefit into the DFRDB, the result was a complex and poorly understood arrangement that invited administrative errors.

Experience has shown that there will be continuing changes to superannuation legislation and practice with the likely emphasis on more options and flexibility. The proposed scheme should allow the benefits of such changes to flow to the ADF without increasing complexity. Some examples of future changes that could be easily adopted are:

- allowing more flexibility within the remuneration package including, for example, an option to take the additional employer contribution levels above 16% as salary;
- introducing additional benefit options such as the recent Government provision to allow for transition to retirement income streams; and
- adjusting employer contribution rates or changing the contribution step points either universally or for specific employment groups to aid recruitment and retention.

In addition, the new scheme will now have a defined contribution framework that will be similar to most Australian superannuation schemes. This will mean that it will be much easier to respond to future legislative changes.

Chapter 6: Governance arrangements

In considering possible changes in the governance and administration of military superannuation, the Review Team considered both concerns about current arrangements and the requirements of its proposed new scheme. In doing so, the Review Team has considered closely the report of the *Review of Corporate Governance of Statutory Authorities and Office Holders* (the Uhrig Report) and the Government's response to that report in August 2004. Assistance was also provided through the MSBS Board's submission to the Review and subsequent consultations with the Board.

Following the Government's response to the Uhrig Report, the Minister for Defence undertook assessments of both the DFRDB Authority and the MSBS Board against the governance templates set out in the Uhrig Report. The only outstanding issue from those assessments is an agreement that the appointment of an independent chairperson of the DFRDB Authority will resolve the lack of separation of duties, responsibilities and accountability inherent in having a Chair who is, ex officio, the Commissioner for Superannuation (the DFRDB Administrator).

The Review Team agrees the current arrangements in this regard are inappropriate, presenting possible conflicts of interest. They also involve constraints on the financing of the administration of superannuation, denying opportunities for competing the supply of these services and possibly restricting the capacity of Defence as well as the Board to oversee the costs and performance of the administrator.

In considering governance arrangements for the proposed new scheme, the Uhrig Report 'best practice principles' in relation to Board size, committees, trustee appointment processes, tenure and development, and performance were taken into account.

Legislation

The DFRDB and MSBS are legislated under the *Defence Force Retirement and Death Benefits Act 1973* and the *Military Superannuation and Benefits Act 1991*, respectively. The MSB Act also provides for the MSB Scheme Trust Deed.

The proposed new scheme should also be established under an Act of Parliament, supported by a Trust Deed. The principle for legislative drafting should be to keep the Act as simple as possible, with details in the Trust Deed (a 'legislative instrument' signed by the Minister Assisting the Minister for Defence).

In the Minister's assessment of the MSBS Board following the Uhrig Report, it was agreed that it continue to operate outside of the governance frameworks established by the *Commonwealth Authorities and Companies Act 1997* (CAC Act) and the *Financial Management and Accountability Act 1997* (FMA Act). This was due to the unique nature of the scheme and that it was established under its own legislation. This is also considered to be appropriate for the proposed new scheme and board, given the Review Team's governance model set out below which reinforces the position that the Board should operate with financial independence.

A single military superannuation board

There is a distinct blend of skills and abilities required of superannuation fund trustees under Australian Prudential Regulation Authority (APRA) licensing requirements.

The responsibilities of the proposed scheme will require added capacity not only because of the substantially increased level of funds under management, but also because of the requirement for innovation in product development, marketing and communication.

For military superannuation, as well as these skills and integrity standards, the board needs a blend of experience and knowledge to best serve the military environment, including understanding the unique nature of military service. Therefore, a central consideration of the Review Team is to ensure military superannuation trustees collectively have the legislated skills, knowledge and abilities, as well as an appropriate knowledge of members, ex-members and Defence interests. This, combined with increasing training and development requirements, suggests there are advantages and efficiencies to be gained in forming a single board of trustees with responsibilities for all military superannuation schemes. A new board should assume all responsibilities for management of the DFRDB, MSBS and the proposed new scheme.

Oversight of various functions (including the administration of the DFRDB) would be undertaken by committees as determined by the board. Membership of committees may include appropriate industry experts.

If needed, as an interim step to this arrangement, the DFRDB Authority could be retained in all its current aspects other than the appointment of an independent chairperson.

Board composition

In line with the Uhrig Report ‘best practice principles’ (suggesting six to nine members), the board should comprise seven trustees one of whom would be an independent chairperson.

The Review Team proposes that the other six trustees should comprise two ‘employer’, two ‘employee’ and two independent trustees. While the normal Superannuation Industry (Supervision) (SIS) requirements suggest that a seven member board should have three employer and three employee trustees, the distinction between employer and employee representatives in the ADF is somewhat artificial. Indeed, a unique feature of military service is the denial of the right to belong to a union. The Review Team believes its proposals are more likely to ensure an appropriately skilled board without disenfranchising either employees or employers.

The Chief of the Defence Force is best placed to nominate trustees with appropriate skills and experience and knowledge of issues impacting current and ex-Service members of the ADF (the ‘employee’ trustees). The Head of Defence’s Personnel Executive is best placed to nominate trustees with appropriate skills and experience and knowledge of issues impacting Defence (the ‘employer’ trustees). These particular arrangements, however, confirm the somewhat artificial distinction between employer and employee representatives.

The Minister for Defence would be responsible for the appointment of all trustees including the two independent trustees and chairperson. In establishing the inaugural military superannuation board, the Minister should seek the advice of the current MSBS Trustees and the Secretary of the Department of Defence, in line with the Uhrig Report ‘best practice principles’, as well as the Chief of the Defence Force and the Head of Defence’s Personnel Executive. This would include advising on potential candidates and their respective capabilities. The Minister should also follow the same process when filling vacancies as they arise.

In exercising the powers of appointment, the Minister will need to be mindful of the collective skills and experience of the board as well as SIS requirements that individual trustees meet fit and proper person tests. That is, across the seven trustees, there is to be an appropriate blend of skills, knowledge and abilities that encompass an understanding of all regulated requirements, entrepreneurial, investment and financial audit skills as well as the capacity to uphold the interests of serving and separated ADF members and Defence.

Committees

The new board will need to use committees to help manage its responsibilities, possibly along the following lines:

- **Audit and Risk Management.** With responsibility to ensure the integrity and reliability of business processes and financial statements including through external audit.
- **Investment.** With responsibility for ongoing development and implementation of investment strategies.
- **Administrative Review.** With particular responsibility for responding to complaints and enquiries, and for reviewing decisions of the board’s delegates in regard to member entitlements and benefits.
- **Communications.** With responsibility for providing effective communication to members, and with the Minister and the Government.
- **Policy Committee.** Providing support to the board on its policies on products and services, and an avenue for members and the board to express their views to the Government on wider superannuation policy matters affecting the scheme.

Whilst meeting any regulated requirements, the new board should be empowered to vary its committee structure as necessary to support the proficient management, administration and investment of the scheme.

As mentioned, the new board would assume responsibility for management of the DFRDB, MSBS and the proposed scheme. It could use a committee structure along the above lines to distribute responsibilities in a way that ensures the board itself focuses primarily on its strategic responsibilities.

Recommendation 9 A single governance structure should be put in place for the DFRDB and MSBS, as well as the new scheme, along the following lines:

a. The structure should be established under legislation, with a Trust Deed for the MSBS and new scheme.

b. There should be a seven member board of trustees comprising two employee representatives, two employer representatives and three independent representatives, including the chairperson.

c. A committee structure is to be determined by the Board to assist with all the Board's responsibilities for the DFRDB, MSBS and new scheme.

d. Pending establishment of the proposed new governance structure covering all schemes, the DFRDB Authority should have an independent chairperson, appointed by the Minister.

Funding arrangements

The Review Team understands that the Review of the Role of Government in Superannuation Administration for Australian Government Employees is examining the legislative requirement that ComSuper be the mandated provider of administration services for Commonwealth superannuation schemes. The Review Team is supportive of the view that the new board should be responsible for scheme administration and financially accountable for the costs of that administration. Accordingly, the board should negotiate fees and services directly with the relevant service providers (whether that be ComSuper, the Department of Veterans' Affairs or others) and negotiate funding for those fees directly from the employer sponsor for services funded by the employer sponsor. In addition the board would determine appropriate fees and services. For example, ADF members who have separated and keep their accumulation plan account active via external employer contributions would pay fees to be determined by the board.

Australian Prudential Regulation Authority

During the development of the Review Team's recommendations APRA was consulted both in terms of the overall scheme design and specific governance arrangements that are being recommended.

An initial preliminary view was provided by APRA on a range of matters and these will need to be pursued as part of the implementation once the Government has decided upon the Review Team's recommendations. Areas of most interest to APRA included proposals relating to:

- three independents on the seven member Board;
- the new scheme not being a 'Public Offer' scheme, despite being open to the family of serving ADF members;
- benefits available from age 55; and
- access to benefits in terminal illness cases.

These, and other matters will need to be pursued with APRA following the Government's consideration of the Review Team's recommendations. The Review Team is of the view that the special nature of military service provides enough justification for the recommendations it has made and that none of APRA's areas of concern are insurmountable. These will need to be dealt with by negotiation with APRA and in the legislative drafting process to ensure compliance with appropriate superannuation legislation.

Chapter 7: Implementation and transition

Each of the two elements of the proposed new scheme, the retirement accumulation plan and defined benefit death and disability arrangements, will require more detailed development than set out in this report and the establishment of appropriate administrative arrangements. Considerable cooperation across agencies will be required, together with further consultation with stakeholders, in addition to the normal process of ministerial and Cabinet decision-making and the passing of legislation.

Given the lead times that will be necessary, the Review Team believes the proposed scheme should commence in the first half of calendar year 2009, allowing the initial budgeting impact to be spread over two financial years (2008-09 and 2009-10). This timing assumes Government agreement to the major recommendations soon after the Review Team reports at the end of July 2007.

On commencement of operation of the proposed superannuation scheme, and closure of the MSBS, all new members of the ADF will be required to join the new scheme. The Review Team has recommended members be provided with fund choice for the accumulation of the employer contributions, but that all members must remain in the scheme for the defined benefit death and disability arrangements. At the commencement of the new scheme the Review Team has recommended current members of the ADF, and MSBS preserved benefit members, be provided a once only, year long opportunity to transfer to the proposed scheme. This choice would be facilitated by an education and awareness campaign, and subsidised individual financial advice, as detailed in Chapter 8.

While further work will need to be undertaken on implementation and transitional arrangements, the following describes the overall approach recommended by the Review Team.

Implementation of the retirement accumulation plan

A detailed implementation plan will need to be developed once the Government's responses to the Review Team's recommendations are known. Some matters will need to be addressed in sequence, while some will be able to be achieved in parallel.

The following issues will need to be addressed in the implementation plan for the retirement accumulation plan.

Resourcing and staffing

- Agreement to funding of implementing agencies (the Department of Defence, ComSuper and the MSBS Board of Trustees).
- Recruitment of staff with the necessary skills, knowledge and abilities.

Scheme design – policy, legislation and administration

- Negotiating, drafting, briefing and supporting the development and passage of legislation, Trust Deed and Rules for the proposed scheme and any necessary amendments to the MSBS and DFRDB legislation.
- Working with the chosen Administrator on the implementation of the new scheme.
- Resolution of issues under discussion with the Australian Prudential Regulation Authority – see Chapter 6.

Board of Trustees

- Identifying suitable candidates and making recommendations to the Minister for the proposed seven member Board of Trustees.
- Support to the Board in preparation for the proposed scheme's commencement, including in their application for necessary licences and the selection of service providers.
- Identification and appointment of an interim independent chair of the DFRDB Authority and transfer of secretariat services from ComSuper to the extant MSBS Board Executive.

Communication

- Development of new Product Disclosure Statements and amendment to existing communications material.
- Development and execution of a communications strategy, covering the existing MSBS and DRFDB benefits, as well as the proposed scheme and its retirement options.

Provision of financial advice

- Development of a web-based model to allow individuals to assess the likely effect of transferring to the new scheme.
- With the ADF Financial Services Consumer Council and the new Board of Trustees, development of a strategy for the provision of subsidised financial advice for:
    - DRFDB and MSBS members to be offered the opportunity to transfer to the proposed new scheme; and
    - on-going member education and awareness, including subsidised financial advice at critical retention/decision points.

Service standards/relationship management

- Development of protocols, operating procedures and standards, and reporting mechanisms, in the form of a Service Level Agreement or similar, across all participating bodies.

System changes

- Managing necessary systems changes in the Department of Defence and ComSuper.

Post implementation

- Post-implementation monitoring and trouble-shooting.

Implementation of the proposed death and disability arrangements

The introduction of the proposed defined death and disability arrangements will require substantial and additional effort to that identified above. It will involve the establishment of an entirely different, rehabilitation-focused arrangement administered by the Department of Veterans' Affairs (DVA) and not ComSuper.

The following will need to be developed and finalised:

- the redirection of funds (and forward estimates) for death and disability between the military superannuation scheme and the MRCA;
- the significantly changed roles for both ComSuper and DVA in both assessment and payment of benefits;
- service standards and reporting between Defence, the new Board of Trustees, DVA and ComSuper; and
- appropriate appeal mechanisms.

Additionally, agreement will need to be reached on what is to remain the responsibility of ComSuper in administering death and invalidity arrangements for the extant DFRDB and MSBS schemes.

Possible early implementation of some recommendations

The Review Team has suggested the Government could agree to the early implementation of some recommendations. These relate to changes to the MSBS Maximum Benefits Limits and final salary for death and invalidity purposes (see Chapter 9), and the appointment of the Chair of the DFRDB Authority. If it is agreed to implement these changes in advance of other recommendations, priority would need to be given to appropriate legislative change, member communications, regulatory and compliance issues, systems changes, and the identification and appointment of an independent chair of the DFRDB Authority.

Ongoing administration

Ongoing administration should be easier overall, both for the retirement accumulation plan and the defined death and disability arrangements. The retirement plan will involve real money in individual accounts not requiring formulae to be checked against Defence records to monitor entitlements. Into the future, there will be a much smaller number of indexed pensioners and a smaller number of preserved members as some will choose to switch their accumulated benefits into different funds. In addition, the disability payments for both superannuation and compensation will draw directly from a single administrative framework.

On the other hand, there will be more family members with accounts whose administrative costs will be covered by Defence. There will also be the need for the fund to offer new products including account-based pensions and pensions with different indexes. Most importantly, the scheme will need to adapt to the requirements of its members for information and support to ensure they can and do make informed choices in managing various flexibilities allowed and the risks involved. This information and support is also essential for Defence to maximise the potential benefits in terms of recruitment and retention, by ensuring ADF members fully appreciate the value of the new arrangements as part of their total remuneration package.

The Review Team is supportive of the view that the board should be responsible for scheme administration and financially accountable for the costs of that administration. Accordingly, the board should negotiate fees and services directly with the relevant service providers (whether that be ComSuper, DVA or others) and negotiate funding for those fees directly. In addition the Board would determine appropriate fees and services. For example, ADF members who have separated and who keep their accumulation plan account active via external employer contributions, would pay fees.

Transitional arrangements

As mentioned in Chapter 4, in conjunction with closing the MSBS to new members, a one-off opportunity should be offered to current ADF members and MSBS preserved members to transfer to the proposed scheme. The opportunity should occur within a window of 12 months from the commencement of the proposed scheme. Elections to transfer will be binding and unable to be revoked. Members not completing a valid election to transfer at the expiry of the window will remain in their existing scheme.

The methodology for the calculation of the transfer values will differ from scheme to scheme.

Transition from the DFRDB

Transfer of the member contributions made by DFRDB members would be on a basis consistent with that undertaken for the DFRDB transferees to MSBS in 1991. That is, the long-term bond rate would be applied to contributions actually made by the DFRDB members to establish the transfer amount for the member contribution. In respect of the employer contribution, the factor will be based on their actual years of service in DFRDB but utilising the MSBS accumulation factors (18% for seven years, 23% for the next 13 years and 28% for any additional years of service) multiplied by the average salary over the last three years of service. The total amount would then be funded and taxed where relevant, and placed in the proposed new scheme. Subsequently the member may choose to transfer the funds to another scheme.

Transition from the MSBS

Current contributors. The member contributions for MSBS members are already funded (apart from the DFRDB component of those that transferred in 1991) and can be transferred directly into a different accumulation scheme if the member wishes. The total employer contributions for MSBS contributors can be derived from the total employer benefit accrued at the time of transfer (that is, accrued multiple times Final Average Salary). The total employer component has two elements, a funded productivity component and the remainder an unfunded component. To effect a transfer to the proposed scheme the productivity component can be transferred directly into an accumulation scheme (along the same lines as the member benefit). The remainder will have to be funded prior to transfer. The total amount would therefore be funded, taxed where relevant, and placed in the proposed new scheme.

Those who are still entitled to the retention benefit that was associated with the MSBS (but not formally part of that Scheme) should keep that entitlement if they choose to transfer to the new scheme.

Preserved members. An MSBS preserved member's benefit will already have been allocated a value at the time of separation from the ADF. The member-financed benefit is fully funded and may already have been withdrawn or rolled out. The employer benefit comprises two parts; a funded productivity element (which grows with the fund's investment earnings) and an unfunded element which grows at the Consumer Price Index (CPI). All three amounts can be crystallised at the point of transfer, with that total amount becoming the transfer value. Funding will be required for the previously unfunded amount, taxed where relevant, and placed in the proposed new scheme.

Invalidity Cases

While the main recommendation is that all current ADF members and MSBS preserved members should have a year long opportunity to transfer to the new scheme, careful consideration will also need to be given to members discharged on medical grounds to ensure they are treated fairly.

These members have not chosen to leave the ADF but have separated due to their medical situation. The level of incapacity is subject to review by the MSBS Board or the DFRDB Authority.

MSBS members. In summary, MSBS members receive the following benefits:

- Invalidity Class A: a CPI indexed pension taking into account prospective service to age 55, and a member benefit preserved until preservation age.
- Invalidity Class B: half the employer-financed Class A rate of pension, and a member benefit preserved until preservation age.
- Invalidity Class C: same options as if the members resigned. That is, the employer benefit is preserved and can be accessed as a pension at age 55 (or lump sum from preservation age), and a member benefit preserved until preservation age.

Whilst a member remains a Class A or Class B benefit recipient they should be treated like any other MSBS pensioner and no opportunity to transfer should be provided. Given an Invalidity Class C determination effectively provides the same benefits as a member who resigns (i.e. all benefits are preserved), a member who has received a Class C benefit will be provided with the opportunity to transfer to the proposed scheme by the end of the transfer period. The Review Team believes that those classified as Class C during that year should have up to a further six months to decide whether to transfer.

Further, because being reclassified from a Class A or Class B to a Class C effectively makes the person a preserved MSBS member, there is a strong case to give such people the choice to transfer to the new scheme at the time this occurs, even if this is after the normal 12 month window open to others. The opportunity should be a once-only offer within a six month window from being reclassified. This opportunity should be only offered to members less than 55 years of age.

DFRDB members. In summary, DFRDB members receive the following benefits:

- Invalidity Class A: a CPI indexed pension at 76.5% of final salary (this is the maximum benefit provided to any members of the DFRDB Scheme).
- Invalidity Class B: half the Class A rate of pension or the member's accrued benefit based on years of service, whichever is the higher.
- Invalidity Class C: unless the member has already qualified for retirement pay, refund of member contributions multiplied by 1.5 (with a Superannuation Guarantee supplement where required).

Under the Review Team's recommendations only current serving members of the DFRDB will be provided an opportunity to transfer to the proposed scheme. A DFRDB member who is, or becomes, Invalidity Class A, B, or C after the expiry of the year long election period will not be provided a choice to transfer to the proposed scheme, with the one following exception.

It is possible that an ADF member, who chose in 1991 to stay in the DFRDB because they intended to remain in the ADF for at least 20 years, may be medically discharged before reaching the 20 years service, and be eligible only for the Class C benefit and lose any entitlement to a DFRDB pension. Had they known this unlikely event would happen, they would have transferred to the proposed new scheme during the year-long window of opportunity recommended by the Review Team. Accordingly, the Review Team believes it would be fair to make an exception to the standard arrangement for a DFRDB member (who is a serving ADF member at the end of the election period) who is determined Invalidity Class C before 1 October 2011 (20 years of operation of the DFRDB Scheme). This (at most) small number of members will be provided a six month opportunity to transfer to the proposed scheme. DFRDB members with broken service, that is, who would not have 20 years service at 1 October 2011, will need to have made their election during the election period and base their decision on their personal circumstances and the offer of subsidised financial advice.

MSBS and DFRDB invalidity members who are provided an opportunity to transfer to the new scheme will be offered the subsidised financial advice recommended by the Review Team in Chapter 8. The choice will be a once only opportunity on the first occasion the member becomes eligible for the choice.

Members re-enlisting

Currently DFRDB members who re-enlist may elect to rejoin the DFRDB or join the MSBS. Where a member does not make an election prior to rejoining, they are placed in the MSBS by default. The MSBS Board submission recommended that the default option be changed to DFRDB as this is the most popular choice. Since the DFRDB scheme is closed and is not a complying scheme, the Review Team considers that the default option should remain the MSBS. Once the MSBS is closed, the new scheme should become the default option while members retain the right to elect the DFRDB.

MSBS preservers who re-enlist during the transition period will have the option of transferring to the new scheme or continuing as contributing members of the MSBS. After the transition period, MSBS preservers who re-enlist would continue as contributing members of the MSBS. All other re-enlistees, including ex-MSBS members who chose to transfer to the new scheme, will be members of the new scheme.

Chapter 8: Education & awareness

The proposed new scheme will require substantial effort by Defence, the new board and others to educate members not only during the transition but also on an ongoing basis.

Transitional education and awareness campaign

The education and awareness campaign conducted in 1991 to aid ADF members in choosing whether to transfer to the MSBS was extensive. The 12-month campaign involved base level information sessions, newspaper articles, what-if models and individualised information packages. The material has been reviewed and, on the face of it, it appears to be comprehensive and sufficient for members to make an informed decision. Nevertheless, the Review Team found that it was almost folklore across the ADF that members were misled into either remaining with the DFRDB or transferring to the MSBS (depending on the outcome in hindsight).

While hindsight will always cause some individuals to question their choices (and the advice on which those choices were made), the Review Team believes there are lessons to be learned from the way the campaign was conducted in 1991, notwithstanding the quality of the information presented and the access ADF members had to that information. In particular, the involvement of the command chain in providing information and advice may have detracted from the independence of the advice and reduced acceptance by individuals of their own responsibility in making a choice.

The lessons learnt from the DFRDB/MSBS transfer experience should be applied to the proposed transition. Firstly, it is much more widely known now that anyone who does not hold an appropriate Australian Financial Services Licence (AFSL), including commanders, must not give personal financial advice to ADF members. While this removes some of the risk of poor advice or the perception that members were not given a real choice, it makes the availability to ADF members of independent personal financial advice even more important.

The Review Team proposes that Defence arrange for professional financial planners across Australia to be trained to give individual financial advice relating to the transfer option. One model would see a panel of national financial planning providers agreeing a fixed price for the service and Defence subsidising a portion of the fee. For a majority of serving ADF members, the most appropriate transfer decision for them should be relatively easy and not require an external advisor. For some, however, the choice will not be simple, but will depend upon such factors as their future career aspirations including how certain they are about those aspirations. Whether or not the financial advice is availed upon, its availability at a subsidised price significantly reduces avenues for future complaint that the member’s decision was ill-informed.

The transition education and awareness campaign should comprise:

- national road-shows providing general information on MSBS and the proposed scheme, preferably given by a contracted organisation with an AFSL to provide general financial advice;
- continuous advice and information through Service communication channels such as newspapers and internal magazines;
- web-based (and DVD-based) calculators that allow members to generate their own scenarios based on their own circumstances and assumptions on length of service and long-term investment returns;
- personalised information packs that set out current accumulated entitlements and long term benefit comparisons based on a standard set of assumptions; and
- optional subsidised personal financial planning advice (limited to the issue of transferring or remaining with the current scheme).

To enhance the acceptance of independence of advice, the ADF Financial Services Consumer Council (ADFFSCC) should oversee the process, ensure quality control and represent the broad interests of ADF members.

Recommendation 10 Defence, with the ADF Financial Services Consumer Council and in consultation with the MSBS (or new) Board, should conduct an extensive education and awareness campaign to support informed choice by ADF members and MSBS preserved members to transfer to the new scheme or to remain in their current scheme. This campaign should include access to computer modelling to allow individuals to estimate the likely effect of transferring or not transferring given their personal situation, and access for current ADF members to subsidised financial advice.

Ongoing education and awareness of superannuation

The new scheme will require a very different approach by ADF members towards their superannuation into the future. It will involve a shift from the paternalism of the past to much greater responsibility being shouldered by members for the management of their superannuation savings. It will also offer Defence the opportunity to 'sell' its employer contributions towards superannuation as a generous element of the remuneration package, and to enhance its other recruitment and retention strategies. In both respects, this will require ongoing education and awareness of superannuation.

Throughout the consultation and focus group periods, the Review Team noted the significant lack of knowledge of superannuation in general, the military schemes in particular and the value of the overall remuneration package for the ADF. These deficiencies undermine the retention effects of the considerable funding allocated to ADF conditions of service and, if not addressed, could present risks to the success of the new scheme for the members themselves.

The primary problem is that young people who form the bulk of the ADF are not engaged by the long-term nature of superannuation. On the positive side, the Review Team noted that when even the current scheme (with the significant employer contributions) was explained, members became interested in the choices and control over money that was available to them. This level of engagement would clearly increase with the greater flexibility of the new scheme, providing the information was 'pushed' to ADF members.

There is no shortage of information available to members on their superannuation schemes or financial education in general. The ADFFSCC has a website that provides educational information on a wide range of financial topics. The DFRDB and MSBS have websites with the latest information and on-line calculators that provide some guidance on likely future benefits. The Military Superannuation Communication Committee oversees communication activities for both DFRDB and MSBS and provides two newsletters addressed directly to members, along with the annual members' statements. The Superannuation Directorate in Defence provides information on current issues through a variety of internal publications.

Nevertheless, the nature of military service makes standard education and communication activities difficult. These factors include:

- The majority of ADF members are young and in their first job after school.
- The initial training period is very intense and any 'extraneous information' provided is not assimilated.
- Following entry to the trained workforce, members are difficult to contact because they are mobile, and often do not have common communication channels such as the internet available to them.

Notwithstanding these structural impediments and the inherent difficulty of getting younger ADF members engaged with superannuation, there are a number of other deficiencies with the current approaches:

- Superannuation is not marketed or even acknowledged as a component of the ADF remuneration package at all levels.
- The current schemes do not have positive support from the command chain.
- Information is provided in too many areas and there is a lack of coordination across the organisations providing communication and education. Much of the information is not in a form that engages the bulk of ADF membership.

In addition, of course, the structure of the current schemes makes it difficult to explain the value of the benefits members will receive.

The Review Team acknowledges the continuing efforts being made to improve financial education and communication on superannuation and remuneration more broadly, but emphasises the importance of addressing the current deficiencies and putting into place a much more effective approach. That approach should include the following specific improvements:

- The Board should provide ADF members with regular reports of their accumulated superannuation benefits, and regular reminders of the options available to vary the investment profile and their own contribution levels. The latter should be supported by ongoing access to information on investment performance and computer modelling.
- The ADF remuneration package should be specifically defined and marketed, internally and externally, with support from the command chain.
- The ADF should have a single website that addresses all conditions of service, including the superannuation schemes, from a member point of view, rather than the current organisational view. The current ADFFSCC website is a good example of style. The new website should also be accessed through the Single Service personnel portals.
- The ADF should provide greater access to the Defence intranet in accommodation and recreation areas in addition to the workplace.
- The ADF should incorporate education on remuneration, superannuation and conditions of service after completion of initial training, rather than at the commencement of training when the member's focus is elsewhere.
- The ADF should incorporate further direct communication of the remuneration package, together with access to subsidised financial advice on superannuation, at critical retention points – e.g. prior to the expiry of fixed periods of service, when the employer contribution increases to 23% and 28% and prior to retirement.
- The ADFFSCC should oversee the content and represent the broad interests of ADF members in the presentation of information.

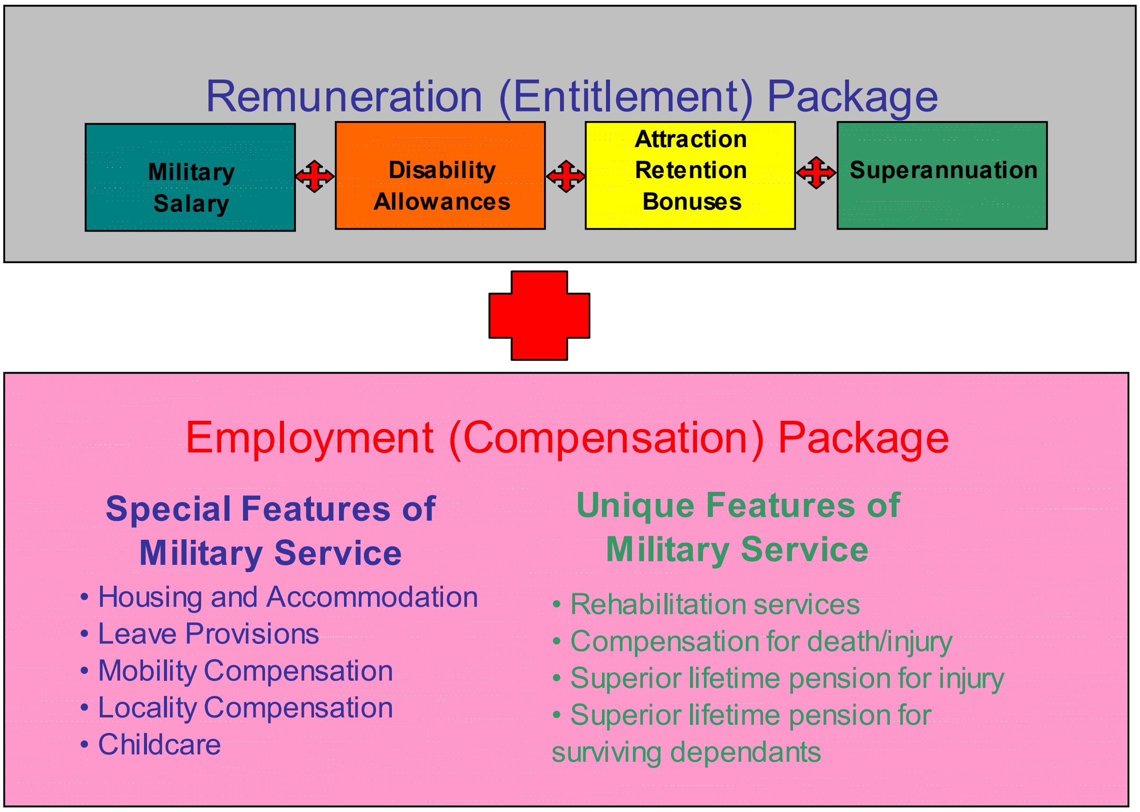
Recommendation 11 The new superannuation board, in consultation with Defence and the ADF Financial Services Consumer Council, should develop an ongoing education and awareness program to ensure ADF members are able to make informed choices about their superannuation investments (including member contributions) and benefits, with access to subsidised financial advice, for serving members, at key career points (including after six years service, 15 years service and on approaching age 55).

Emphasising the total remuneration package for recruitment and retention purposes

The Review Team believes that the introduction of the new Superannuation scheme will provide the opportunity to present, more clearly and positively than in the past, the total remuneration package for ADF members, thereby, maximising the package's impact on recruitment and retention. The following suggests a way in which this might be done.

The ADF conditions of service package can be split into two broad categories – a remuneration package and an employment package. The remuneration package contains elements that should be used to compare with commercial employment conditions while the additional elements in the employment package generally relate to the special features of military service, some of which nonetheless are very attractive. Figure 8–1 is a diagrammatic representation of the total package.

Figure 8–1: Diagrammatic representation of the conditions of service package



In setting the remuneration and overall conditions of service packages, Defence should support both individual and organisational goals: to act in the best long term interests of members and to enhance the recruitment and retention value of the packages. The proposed superannuation scheme supports two key messages:

- Military superannuation is an important element of the remuneration package when considering enlistment and when considering external employment; and
- The features of military superannuation exceed community standards and increase with length of service.

The remuneration package compensates in cash terms for both the unique and special nature of military service and traditional work value. The remuneration package comprises salary, allowances and superannuation. At the basic entitlement where military work is conducted in peacetime conditions, the salary component of the remuneration package recognises civilian equivalent work conditions based on individual circumstances. The special nature of military work is then compensated through allowances that have similarities to some other work groups in the community. At the high end, unique deployment allowances and income taxation exemptions compensate for the unique stresses and risks of active service and are provided on the traditional military 'all of one company' principle.

ADF members have traditionally regarded the remuneration package as comprising only the basic salary for market comparison purposes. This was a common theme throughout the Review Team's consultation and focus group process. This view is supported by the fact that the Defence Force Remuneration Tribunal is restricted to considering basic salary and certain salary-related allowances rather than the broader remuneration package. Defence itself publishes public salary tables that emphasise basic salary rather than military salary – the $10,098 pa Service Allowance paid to all members at Major (Equivalent) Rank and below is only noted on the brochures as a side comment rather than treated as an integral element of income. The defined benefit nature of the DFRDB and MSBS has precluded a meaningful assessment of the remuneration value of the employer contribution for market comparison purposes. The proposed new scheme offers an opportunity to significantly enhance the value of the ADF remuneration package for recruitment and retention purposes allowing a more realistic appraisal of ADF remuneration against the external employment market.

The Review Team suggests:

- General reference to ADF salaries in recruiting and retention literature should refer to military salaries (basic salary plus service allowance).
- The ADF 'Compare Your Package' calculator should be adjusted to emphasise all the remuneration elements of the package, including superannuation, and actively marketed to ADF members.
- Officers, Warrant Officers and Senior Non-Commissioned Officers should be familiarised with the concepts of a remuneration package and the elements of the ADF package as an aid to retention of subordinate personnel who are making choices at various stages of their career.

Chapter 9: Additional technical issues

The Terms of Reference (TORs), paragraph 2, require the Review Team to analyse a list of specific issues which have been highlighted by emerging and extant Government policy and member feedback. These issues, which mostly concern technical aspects of current schemes, are considered below together with the additional matter raised by the Minister (concerning pensions for those remanded in custody).

Operation of Maximum Benefit Limits

The Maximum Benefit Limited (MBL) is a design feature of the MSBS that has existed since implementation of the scheme. MBLs impose a ceiling on the employer-financed benefit based on a member's final average salary and the benefit multiple on separation.

As at 30 June 2007, 290 personnel (out of 46,793) active MSBS members had reached the pension MBL and ceased contributing to the scheme. This number has grown steadily since mid-2004, partly because of the maturing of the scheme and partly as a result of the higher MSB Fund investment returns since July 2003. These members represent an increasing proportion of the ADF's more senior personnel (being MSBS as opposed to DRFDB contributors), though still representing less than 1% of all serving scheme members.

There is increasing concern and dissatisfaction regarding the MSBS MBL provisions and a general perception, especially among more senior, long-serving members, that the value of their total ADF remuneration is significantly undermined when they reach their MBL point. The issue was raised in each of the Service submissions to the Review and the submission from the Head of the Defence Personnel Executive, as well as those from the RSL, the RDFWA and other Ex-Service Organisations. The perception of reduced remuneration is not entirely valid, as annual adjustments to the MBLs and extra years of service do generally add to employer-financed benefits after reaching their MBLs. However, there is a reduction in effective employer contributions, and the perception of total cessation of employer contributions may well affect retention of some critical ADF members.

The MBL provisions are also complex, difficult to administer and confusing to members in their application. They reflect the philosophy of the time, when such limits were also introduced into the Public Sector Superannuation (PSS) scheme, and Reasonable Benefit Limits (RBLs) were imposed on the superannuation system. This philosophy effectively imposed a constraint on the role of superannuation to spread lifetime earnings, by limiting support for those on higher incomes. However this approach has been changed recently with the removal of the RBLs in the tax system from 1 July 2007 and the reform of MBLs in the PSS scheme commencing 1 January 2008.

Under the PSS changes, the MBL multiple (of Final Average Salary (FAS)) for most scheme members will increase from eight to ten (for FASs of $50,000 or more). While the Review Team considered aligning the MSBS MBL to the levels now applying to the PSS, this would be difficult as the PSS MBL applies to a single defined benefit element while the MSBS MBL includes both the member accumulation and (notional) employer benefit components. Moreover, with many more ADF members retiring at age 55, the number exceeding the PSS Scheme's new MBL of ten times FAS is very small, while retaining such an MBL would require a cumbersome administrative arrangement for no significant financial gain. It would also continue an impediment to retaining a small number of highly valued ADF members. The Review Team therefore favours abolition of MBLs for the MSBS.

The Review Team also considered the option to limit the benefits of abolition to future years of service, which would avoid a one-off cost (and a one-off benefit to those already affected by the MBLs) while addressing the retention concern by ensuring full employer support for future benefits. The Review Team, however, believes this would be unreasonable given that the costs can be met within the current overall cost envelope and it would leave the affected members feeling discriminated against; it also notes that it would require new and complex administrative procedures.

The Review Team therefore recommends that MSBS MBLs be fully abolished for all currently serving MSBS members at the date of that change. Consideration could be given to abolishing the MSBS MBLs before the implementation date for the new military superannuation accumulation scheme.

Recommendation 12 The MSBS Maximum Benefit Limits should be abolished.

Recognition of interdependent relationships

From 30 June 2004 the *Superannuation Industry (Supervision) Act 1993*, the *Retirement Savings Account Act 1997* and the *Income Tax Assessment Act 1936*) were amended to broaden the category of people who can receive tax-free superannuation benefits on the death of a scheme member. The definition of 'dependant' in these Acts was expanded to include people in a recognised interdependent relationship, which exists where two persons are in a 'close personal relationship', they live together and one or both provides the other with financial/domestic support and personal care. The broader interdependent relationship provisions are intended to cover same-sex partners and dependency arrangements involving siblings, parents or persons with a disability; there is no requirement for these persons to be 'related by family'.

Initially, there was no consideration given to the impact of the interdependent relationship legislative changes on defined benefit superannuation schemes that provide reversionary pension death benefits and/or whose operation is covered by separate legislation. Reversionary death benefits (usually pensions) provided by defined benefit schemes such as the DFRDB Scheme and the MSBS are not covered by the interdependent relationship legislation, which basically applies to the tax treatment of death benefits paid from lump sum accumulation arrangements. Consequently, only people who meet the existing definition of spouse (i.e. eligible married and defacto couples of opposite sexes) are eligible to receive reversionary death benefits from the military schemes.

The issue of superannuation benefits for interdependants in public sector defined benefit schemes has been under consideration by policy officers from the responsible Government departments (including Defence) for some time. This issue is complex and involves some seven Commonwealth defined benefit schemes with differing designs and membership profiles.

The Review Team believes the new scheme, like the Public Sector Superannuation accumulation plan (PSSap), should reflect contemporary practice and recognise interdependent relationships. It does not consider that the unique nature of military service would justify an exception. This would not substantially affect the cost of the new scheme as it is primarily a defined contribution scheme, though it will marginally affect the cost of the (defined) death benefits, where these are converted into a pension.

In principle, there is a strong case also for recognising interdependent relationships in the existing schemes. The Review Team understands, however, that the costs to all Commonwealth defined benefits schemes would be of the order of $2bn in unfunded liabilities, and suggests that any change to the MSBS and DFRDB be made in conjunction with any such changes to the other Commonwealth defined benefit schemes.

Recommendation 13 The proposed new scheme should recognise interdependent relationships. Recognition of interdependent relationships in the existing military superannuation schemes should be consistent with, and reflect, Government policy for the other Commonwealth defined benefit superannuation schemes.

Indexation of military superannuation pensions

The Review Team received many submissions (including from the RSL, the RDFWA and most other ex-service organisations, and many retired ADF members) expressing concern that the value of DFRDB/DFRB and MSBS pensions had not kept pace with the 'costs of living' despite using the Consumer Price Index (CPI). Many of these submissions called for an indexation method tied to an average earnings-based system, or more closely aligned to that applying to members of the community in receipt of the age pension.[7]

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[7] The indexation method applying the age pension seeks to maintain the value of the age pension at 25 percent of male ordinary time average weekly earnings.

Indexation based on the CPI does, in fact, adjust pensions for the costs of living. There is no evidence that, over time, the costs of living of pensioners such as DFRDB and MSBS benefit recipients increase faster than those of the broader Australian community around which the CPI index is based. It is true, however, that the CPI does not reflect movements in community living standards which relate more closely to changes in earnings.

It is also true that DFRDB and MSBS pensions generally provide only modest incomes to retired ADF members, as shown in Table 9–1.

Table 9–1: DFRDB and MSBS pension levels

	Proportion of DFRDB/MSBS Pension Recipients	
	DFRDB %	**MSBS** %
Less than $10,000 pa	2.2	32.0
$10,000 - $20,000 pa	53.2	20.6
$20,000 - $20,000 pa	34.4	21.3
Over $30,000 pa	10.2	26.1

In considering the case for varying current indexation arrangements, the Review Team analysed the differing arrangements under the DFRDB and the MSBS.

DFRDB Pensions. The Review Team considers that there is an in-principle case for changing the indexation arrangement of DFRDB pensions:

- The original DFRDB scheme contained a wage-based indexation element which was removed in the mid-1970s when the Government decided to apply the CPI to a wide range of social security and superannuation pensions.
- In recent years the Government has changed indexation arrangements for social security pensions to include a wage-based index.
- While CPI indexation does maintain the purchasing power of pensions, it does not maintain relativity with community incomes.
- DFRDB members have limited choice between pensions and lump sums, which is confined to the once-only commutation election at the point of separation from the ADF.

On the other hand:

- The DFRDB is already a particularly generous scheme for those in receipt of pensions.
- CPI indexation does maintain purchasing power, and is generous when compared to most contemporary superannuation schemes that may only provide account-based pensions at the member's risk.
- Changing the DFRDB indexation arrangements would also add pressure for a similar change to the Commonwealth Superannuation Scheme (CSS) indexation provisions, at considerably higher cost, given that the CSS has a similar history to the DFRDB.
- Most importantly, changing the indexation method would be expensive, and the additional expense could not be absorbed within the envelope of the costs of current arrangements, which the Review Team has aimed to achieve with its recommendations.

Given government policy on preservation arrangements, the Review Team considers there is no case to increase the generosity of benefits payable prior to age 55, but there is a case for older DFRDB pensioners.

In light of the above, the Review Team recommends that, only if the Government is willing to go beyond the envelope of current costs, it should consider indexing DFRDB pensions on a similar basis to that applying to age pensions. Any such improvement should be limited to pensions paid from age 55. An alternative option with a lower cost, which the Government could consider, is to limit this improvement to pensions paid from age 65, in line with age pension arrangements.

Recommendation 14 If the Government is willing to go beyond the envelope of current costs, it should consider indexing DFRDB/DFRB pensions for those over 55 on a similar basis to that applying to age pensions. Because of the costs involved, this option does not warrant the priority attached to the other recommendations. An alternative option the Government could consider is to limit this change to pensions paid from age 65.

MSBS Pensions. The MSBS provides lump sum benefits, with a choice to convert at least 50% of the lump sum employer component into an indexed pension. The conversion factor of 12 at age 55 means that, on reaching the current preservation age, an eligible member who converts their lump sum employer benefit will receive 1/12th of the lump sum as an annual pension. This is a very generous option, especially when compared to the actuarial value of the indexed pension, which would be in the order of 1/20th of the lump sum on a cost-neutral basis. It would be difficult to justify an even higher subsidy for pensions by indexing them on the basis of earnings rather than prices.

The Review Team therefore does not recommend a change in indexation arrangements for MSBS pensions.

Recommendation 15 There should be no change to the MSBS pension indexation arrangements.

New scheme. Under the proposed new scheme, retiring members with 15 or more years of service will have the option to purchase indexed pensions, with the index based on the CPI or some wage index, but on the basis that they pay a fair price determined by a Government-approved actuary from their lump sum benefit. This price would also be reviewed on a regular basis. Disability benefits, not funded from accumulated benefits but paid directly by the employer, will be indexed according to Defence earnings, in line with MRCA arrangements.

The operation of life expectancy factors

On retirement, eligible members of the DFRDB Scheme can commute part of the pension for an immediate lump sum. The maximum amount that can be commuted is currently five times the retirement pay (expressed as an annual amount). On commutation, annual retirement pay is reduced by the lump sum commutation figure divided by the recipient's life expectancy, which is based on life tables applying in the 1960s. A number of submissions (most particularly from the Returned and Services League of Australia, the Regular Defence Force Welfare Association and the Vietnam Veterans' Federation of Australia) highlighted the increase in life expectancy since then, seeking a lower reduction in the pension for commutation; several also seek restoration of the pension level if and when the member reaches their identified life expectancy (and has purportedly 'paid back' the commuted lump sum).

The Review Team acknowledges the significant improvement in life expectancy since the 1960s, but is not persuaded by the claim for a more generous treatment of commutation arrangements. The facts are 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 solely on current life expectancy figures would be even more excessively generous. Table 9–2 compares a cost-neutral conversion factor at age 45 (the typical age at which a DFRDB member leaves the ADF) with the DFRDB factor and a factor based solely on current life expectancy.

Table 9–2: DFRDB commutation conversion factors*

	Males	Females
Current factor at age 45 (based on 1960s life expectancy)	27.4	32.4
Factor at age 45 if current life expectancies are used (as advocated by ex-service organisations)	35.0	39.2
Factor at age 45 on a fair price (cost neutral) basis	16.4	16.7

*The factor is the annual (partially indexed) pension reduction required in exchange for a lump sum at age 45.

As mentioned earlier regarding indexation arrangements, the current MSBS employer benefit pension conversion arrangement is also heavily subsidised (though in the opposite direction) with a lump sum to pension conversion factor of 12 applying at age 55, and a factor of 11 at age 60.

If any change were made to the DFRDB, it should be to require a substantially larger reduction in pension in return for the commuted lump sum, not a smaller reduction. In line with the TORs requirement of no detriment, the Review Team recommends no change to the life expectancy factors currently applying to the DFRDB commutation calculation.

Recommendation 16 There should be no change to the DFRDB scheme life expectancy factors.

Transition to retirement provisions

In February 2004 the Government announced its Transition to Retirement policy as part of 'a more flexible and adaptable retirement system'. The *Superannuation Industry (Supervision) Regulations 1994* were amended to implement this change and since 1 July 2005 participating schemes have been permitted to release superannuation benefits to members who have reached their preservation age, but not yet retired from the workforce. Transition to retirement benefits must be taken in the form of a non-commutable income stream (i.e. a pension).

The transition to retirement changes are not mandatory for superannuation schemes in order to avoid imposing undue compliance costs associated with amending legislation and/or scheme rules (particularly in the case of defined benefit arrangements). The new PSSap currently makes transition to retirement benefits available to members; however, because of technical complexities and budgetary issues there are no plans to extend the transition to retirement provisions to the closed civilian defined benefit schemes (CSS and PSS).

There are existing arrangements available to military personnel that enable them to either work part-time and continue to draw a retirement pension, or work part-time and accrue full superannuation benefits. Members of the permanent ADF are presently able to work part-time and continue to accrue full military superannuation entitlements for any period of service under the part-time leave-without-pay provisions. Additionally, former permanent ADF members can perform part-time Reserve duty (for tax-free remuneration) whilst in receipt of a retirement pension.

As outlined in Chapter 4, the Review Team considers that the proposed new scheme should allow transition to retirement benefits by allowing recipients of pensions to continue in employment, including in the ADF (see Recommendation 3e.). However, to extend the Government's transition to retirement provisions to the current defined benefit superannuation schemes would present technical design and funding problems similar to those which have precluded such extensions to the CSS and PSS.

Preservation and portability arrangements

As mentioned in Chapter 2, portability of accrued benefits is one of the desirable characteristics of a contemporary Australian superannuation scheme and the ability to move superannuation balances from one fund to another is particularly important to Generation X and Y individuals.

While the MSBS employer benefits are vested and preserved, they are not readily portable. On resigning from the ADF, the major part of the preserved MSBS employer benefit is maintained as a promise, not as real money in an account, and is indexed annually in line with CPI movements rather than invested with a real rate of return. (The much smaller funded productivity component is also only notionally maintained, but it grows according to the MSB Fund (default strategy) earnings.). This is a major source of complaint from former ADF members who served for shorter periods and wish to consolidate their superannuation balances in a new employer accumulation fund with investment-based earnings growth (as opposed to CPI). The Review Team received submissions on this issue from the Returned and Services League of Australia, Regular Defence Force Welfare Association and other Ex-Service Organisations, and from many individual preserved MSBS members.

The effect of the current arrangements is very substantial for many members of the ADF. For example, an MSBS employer-financed benefit accrued after seven years service (with enlistment at age 18) would ostensibly equal 1.26 times Final Average Salary (ie seven times

18%) but, as it would remain preserved for at least 30 years and mostly adjusted only with CPI, the final benefit is likely to be much less than an equal amount invested in an accumulation scheme over the same period. Even if the member chooses to take the heavily subsidised pension option at age 55, the employer-financed benefit is equivalent to an employer contribution rate of 15.5% under the new accumulation plan assuming a long-term fund earning rate of a conservative 6% per year, or a contribution rate of only 9.8%, if the fund earning rate was 8.5% per year. These rates are below the apparent 18% under the MSBS arrangements.

In July 2005, Government legislation introduced the requirement for most Australian employers to offer employees fund choice where Superannuation Guarantee contributions, including a default option for employees who did not make an election. There were a number of exemptions to this requirement, including APS employees and the military where members were required to remain in existing defined benefit schemes. However, since 1 July 2006 Australian Government employers have been required to offer of superannuation fund choice to members of the PSSap, and other new civilian employees and statutory office holders covered by SG arrangements.

The Review Team's proposed new scheme will offer fund choice, member investment choice and full portability of accumulated benefits as set out in Recommendation 3. Allowing current ADF members and MSBS preserved members to receive funded benefits, as set out in recommendations 7 and 8, will extend portability to many current and former ADF members.

Superannuation splitting

Changes to the *Family Law Act 1975* in December 2002 means that, in the event of marriage breakdown, superannuation is treated as an asset and split in the same way as other property. Spouses can agree to adjust the division of property to compensate for superannuation imbalances, they can agree on a division of superannuation balances themselves, or they can have the Family Law Court determine the split of superannuation interests.

Apart from the Family Law arrangements, under the *Tax Laws Amendment (Superannuation Contributions Splitting) Act 2005*, superannuation contributions made from 1 January 2006 can be voluntarily split between spouses, either within the same scheme or to a different complying scheme, subject to age and workforce participation conditions. This is a voluntary regime and superannuation funds are not compelled to offer spouse contribution splitting. Splittable contributions include employer SG amounts, salary sacrifice contributions and co-contributions paid by the ATO.

Under current military superannuation arrangements, there are scheme-specific mechanisms for splitting DFRDB and MSBS entitlements for Family Law purposes. The resulting non-member spouse interests are transferred to the MSBS as associate benefits. For both schemes, these provisions are complex and lead to residual benefit calculations that are confusing to members and former spouses, and difficult to administer. For example, one component of the non-member spouse associate benefit is subject to MSB Fund earnings and can be rolled out, while the other (unfunded) portion is subject to scheme preservation rules and is indexed to the long-term Government Bond rate. As the number of associate benefit holders grows (in line with divorces of serving military personnel) ComSuper staff will be presented with an increasing administrative burden which will in turn result in more costs to Defence.

The Review Team notes that the proposed new military superannuation scheme will be subject to the Family Law superannuation benefit splitting provisions. However, unlike the DFRDB and MSBS, there does not appear to be a requirement for scheme-specific valuation and member benefit reduction factors as the new scheme will be a pure accumulation arrangement (other than disability benefits). Accordingly, any non-member spouse benefit will be fully funded and can be rolled out on settlement.

The Review Team considers the facility to split concessional contributions (including employer and salary sacrificed contributions) with a spouse is a desirable feature of the new military superannuation scheme.

The ability for spouses of scheme members to contribute to the scheme (personally or from an external employer) is also proposed at Recommendation 3f.

The calculation of final salary

In the DFRDB Scheme superannuation benefits are calculated using final salary (the salary rate at the highest increment for the substantive/provisional rank held on the last day of ADF service). However, the MSBS FAS is calculated over the last 1095 days (three years) of contributory service. This is similar to the FAS regime used in the civilian PSS (introduced in July 1990) which is based on superannuation salary at the member's last three birthdays.

The DFRDB and MSBS benchmark salary calculations are presently used to determine resignation, retirement, invalidity and death benefits provided by the respective schemes.

There were two reasons behind the introduction of FAS. Firstly, benefits based on salary received on the final day of service (the DFRDB scheme model) would be unrepresentative of the member's ADF career. Secondly, the importance of a specific payday on the final benefit resulted in considerable selection effects on separation. For example, in August 2004 the inclusion of Qualification and Skill allowance components in superannuation salary was a factor in some members' decisions to leave the ADF and access DFRDB entitlements. Actual salary paid has less relevance in the MSBS because pay fluctuations arising from promotion, or an increase/reduction in superannuable allowances, takes three years to fully impact on the FAS calculation.

These two features do not apply in the case of death and disability since the benefit is based on prospective service rather than past, and the member cannot choose the date of death, injury or separation. Furthermore, the use of FAS can have a significant disadvantage on the death benefit provided to eligible dependants where the member has recently received material increases in salary or superannuable allowances. Disability benefits are also designed to compensate a member for loss of potential earnings and it is noteworthy that current MRCA benefits are based on final paid salary.

As detailed in Chapter 4, death and disability entitlements under the proposed new military superannuation accumulation scheme are more aligned towards the MRCA benefit regime and will be based on final salary (not FAS) and prospective service to age 60 as set out in Recommendation 4d.

The Review Team similarly considers a similar approach should be adopted for MSBS death and invalidity benefit calculations. The Team recommends that these benefits under the MSBS be calculated on a member's final salary, or the highest superannuation salary received during their eligible service. The higher superannuation salary would not include higher duty payments.

Recommendation 17 MSBS death and disability benefits should be calculated on the member's final salary or highest salary for superannuation purposes rather than the current final average salary.

The Review Team notes DFRDB members already have the option to elect and maintain contributions on their higher superannuation salary in the event of a reduction in pay.

Military superannuation scheme complexity

The main concern raised about the complexity of current schemes relates to the three-tiered incapacity classification system under both the MSBS and the DFRDB. This was raised in particular by the Superannuation Complaints Tribunal which identified problems with the inability to obtain a higher classification once a class C invalidity benefit is confirmed, the requirement for determination of an exact disability percentage and the somewhat artificial distinction between the A, B and C classification.

The MSBS Board, the RSL, the RDFWA and a number of individuals also raised concerns about the complexity of assessing disability under the MRCA and the MSBS and DFRDB arrangements.

The Review Team considered marginal changes to existing arrangements, but decided that the most appropriate option was to replace the current three-tiered approach in the proposed new scheme, with disability benefits more closely aligned to MRCA arrangements and with the Department of Veterans' Affairs (DVA) managing both the MRCA and the new scheme's disability benefits (see Recommendation 4b.). It notes, however, that further work will need to be undertaken to settle the appeal processes under the proposed new arrangements.

The Review Team considered the possibility of varying the disability benefit arrangements for those who remain with the MSBS or DFRDB, but decided it was too difficult to do so while also meeting the requirement in the TORs of no detriment to former and current ADF members. Accordingly, some of the current complexities will remain for some years.

The other concern about complexity relates to the MSBS MBLs, raised by ComSuper. The Review Team's proposes full removal of the MBLs (see Recommendation 12).

The impact of the Compulsory Retirement Age

As detailed in the TORs, the unique nature of the military service includes the likelihood that most long-serving members will retire at or before age 55, notwithstanding the new compulsory retirement age of 60. Accordingly, the proposed new scheme offers pensions from age 55 to those with 15 or more years of service. Under the new 2007 tax arrangements, such pensions will be taxed until the member reaches age 60 although the pension rebate would be available from preservation age, where this is under 60. The Review Team sees no particular reason to introduce an additional tax concession for ADF members of the new scheme. Of course pensions after age 60 will be tax free.

Similarly the Review Team believes there is no need to change the MSBS provisions that allow members to take a retirement pension from age 55 and to use the same age in the calculation of prospective service for death and invalidity benefits.

The appropriateness of the three-tiered invalidity classification system

As discussed in Chapter 4 and in this Chapter under the heading 'Military Superannuation Scheme Complexity', the Review Team does not support continuation of the three-tiered invalidity classification system under its proposed new scheme, but accepts it is necessary to continue the system for those who choose to stay with the MSBS or DFRDB. This is reflected in Recommendation 4.

The Review Team agrees with the 1990 Cole Report that invalidity should remain linked to superannuation. The reasons for linkage remain valid:

> "… the special nature of military service requires that the ADF be able to shed unfit personnel who do not fall within the total and permanent invalidity category….";
>
> "…retain the right to retire on invalidity grounds those members who would not meet the stringent medical standards of the ADF, even though they might be capable of employment of a similar nature in the civilian workforce…"; and
>
> "…maximum invalidity benefits are payable only to those who are genuinely unable to participate in the workforce…".

The Review Team considers, however, that a stronger rehabilitation approach should be introduced, for the benefit of members as well as Defence, and that superannuation arrangements should draw on the experience and expertise developed by the Department of Veterans' Affairs in managing the MRCA.

Suspension of benefits upon imprisonment

During the course of the Review, the Minister Assisting the Minister for Defence raised with the Review Team the applicability to military superannuation of provisions for the continuation of pensions for individuals remanded in custody by Federal or State Authorities.

Current arrangements are complex and not particularly coherent. Under DVA benefit suspension provisions affecting recipients who are remanded in custody on Federal, State and Territory offences:

- Service pensions and associated income support payments are suspended (pensions to spouses and payments for dependants may continue);
- Veterans' Entitlement payments for disabilities and compensation are not suspended;
- MRCA payments for loss of earnings are suspended; and
- MRCA payments for impairment are not suspended.

MSBS and DFRB/DFRDB pensions, whether for disability or retirement, are not suspended. The invalidity pensions subsume any entitlement to an employer benefit and are therefore more in the nature of superannuation entitlements. Additionally, if an MSBS Class A or B invalidity pension is ceased before age 55 (for example, on downgrade to class C during a periodic review) then the recipient's full preserved employer benefit is restored.

Under the *Crimes (Superannuation Benefits) Act 1989* (the 'CSB Act'), employer superannuation benefits of ADF members, Commonwealth employees, Judges and Members of Parliament can be forfeited when these individuals are imprisoned for more than 12 months on corruption offences. A corruption offence is defined as a criminal offence that involves abuse of office or an attempt to pervert the course of justice committed when the individual is a Commonwealth employee. Similar provisions exist for AFP members under Part VA of the *Australian Federal Police ACT 1979*.

Apart from the CSB Act provisions, there are no (civil imprisonment) benefit forfeiture or suspension measures applying to CSS, PSS or Parliamentary Contributory Superannuation Scheme entitlements. The general Australian workforce is not subject to the loss of employer funded superannuation benefits on imprisonment, whether for corruption offences or any other reason.

Apart from the existing provisions for corruption, the Review Team is inclined to an approach along the following lines:

- Safety net payments such as Service pensions should be suspended when government covers living expenses directly while the person is imprisoned.
- Compensation payments for loss of earnings and impairment should not be suspended.
- Superannuation payments either from accumulated funds or via defined benefit disability payments should not be suspended.
- In the last two cases State authorities could, should they choose to, pursue recovery of costs to offset accommodation and living expenses associated with imprisonment, or to contribute to victim compensation.

Alternatively, the Government could distinguish between members' entitlements to their accumulated benefit, and their access to more discretionary defined benefits for disability, along the following lines;

- Accumulation retirement benefits would not be suspended as they are owned directly by the member.
- Defined disability payments could be treated in the same way as MRCA payments for loss of earning and be suspended.

It would be difficult (and unfair), however, to make such a distinction under the current MSBS and DFRDB schemes as invalidity pensions under these arrangements actually substitute for the employer benefit entitlement. Consideration would also need to be given to protect financially dependent family members. Moreover, such an approach would not be the same as applies to civilians in either the public or private sectors. For these reasons the Review Team prefers the first approach.

Recommendation 18 Benefits for members or persons imprisoned because of a criminal offence should not be suspended, other than for those offences specified in the *Crimes (Superannuation Benefits) Act 1989*. The Review Team notes that State authorities may consider recovering amounts from prisoners' income to offset accommodation and administrative expenses, and/or to contribute to victim compensation.

Whichever of these approaches is adopted by the Government, the Review Team would not support the recovery of payments made prior to conviction or to recovery of payments made before any legislative change.

Ordinary Time Earnings

From 1 July 2008 the Government is changing the Superannuation Guarantee (SG) requirements. In particular, the Government has determined that 'protected earnings bases' for SG compliance calculations will no longer apply. Accordingly, the next DFRDB and MSBS Benefit Certificates (provided by the Australian Government Actuary) will be required to certify that the schemes provide superannuation benefits that are no less than equivalent benefits provided by the SG based on 9% of Ordinary Times Earnings (OTE). The new scheme will also need to comply with the new definition of earnings for SG purposes.

A number of current ADF allowances which are not counted towards military superannuable salary will be included under the broader OTE definition. In a recent response to a query from the Actuary on this matter, the ATO has stated that all ADF base pay and non-reimbursement type allowances (including tax-exempt operational and deployment allowances) will be considered as OTE for future SG compliance calculations.

While it is understandable that the SG provisions need to ensure that employers meet their minimum obligations, salary for superannuation purposes, particularly in more generous schemes, should normally reflect ongoing pay and allowances that determine the living standards which are intended to be maintained in retirement. The Review Team does not propose therefore any change to the current definition of salary for superannuation purposes in military superannuation schemes. The new scheme will meet the revised SG requirements in the vast majority of cases, other than in respect of overseas operational allowances, given its generosity.

The Review Team considers that tax-free overseas operational allowances provided for limited periods of war-like service should not be included in the OTE for SG compliance calculations as overseas deployment/operational allowances are not considered to be part of ‘normal’ ADF salary. There is also a case for treating the ADF as a special case as the concept of OTE (based on ‘ordinary hours of work’) does not apply. ADF members are expected to be available for duty at all times and are not eligible for overtime. The Review Team suggests that a formal ATO ruling on military OTE components be sought by Defence.

Chapter 10: Financial implications

The Review Team used the services of the Australian Government Actuary (the Actuary) to provide estimates of the costs associated with the introduction of the proposed new scheme, which are set out below. These estimates do not take into account tax or social security impacts: the Actuary considers that the tax and social security effects should roughly even out in the long term between the current unfunded arrangements and proposed funded arrangements. The estimates are based on membership data as at 30 June 2006 and, for the most part, the new scheme starting from that date. The Actuary has advised that the main features disclosed by the costings would still be present if the implementation date were in 2009. A more detailed report by the Actuary is at Appendix H.

The financial implications fall under several headings:

The employer contribution rates. These are the critical indicators of the underlying costs of current and proposed arrangements. The rates for the current schemes are mostly 'notional'[8] in that they do not relate to funds actually being set aside, but are the Actuary's assessment of the funds that would have to be set aside to meet the accumulating liability of the schemes (that will eventually be met by future budget allocations and/or Future Fund disbursements). Despite being 'notional' they are nonetheless paid out of the Defence budget back into Consolidated Revenue. Under the new scheme, the employer contribution rate is mostly real money transferred into the superannuation fund (the provision for death and disability benefits will remain a 'notional' insurance premium as benefits will be funded on a pay-as-you-go basis).

The cash requirements and impact on unfunded liabilities. The shift from mainly unfunded defined benefit schemes to a funded defined contribution accumulation plan will replace the build up of unfunded liabilities to be met in the future with real funding set aside now. The extent of this 'bring forward' will depend upon the extent to which current ADF members and MSBS preservers choose to transfer to the new scheme. The cash required for this current funding is not, in any way, a measure of the costs of the new scheme. After all, there will be a corresponding reduction in future unfunded liabilities as a result of paying for them now.

The transitional impact on accrued liabilities. This is a real cost (or saving) on transition, but is one-off and is not a measure of the underlying or continuing cost. It arises from such things as the choice made by ADF members to transfer to the new scheme, and changes made to the DFRDB or MSBS affecting accumulated entitlements. The one-off cost (or saving) affects the unfunded liability which may not be met until sometime in the future.

The following sections focus firstly on these three financial implications of the proposed new scheme and then on the implications of the recommendations relating to the existing schemes. Estimates of the departmental expenses affecting transitional and ongoing costs are also set out below.

As mentioned in Chapter 1, the Review Team has taken the general approach that its central recommendations should cost about the same as the current arrangements. By this it means that the employer contribution rates should be in line with the current employer contribution rates. As well, if possible, there should be no significant one-off increase in accrued liabilities. Within these cost 'envelopes', the Review Team has developed its central package. The one option (DFRDB indexation – Recommendation 14) that could not be met within these envelopes has been explicitly accorded a lower priority. Because the costs of all the other recommendations do come within these broad envelopes, they are all considered high priority by the Review Team and form a coherent and affordable package.

These cost envelopes do not include consideration of any immediate cash requirements as these requirements do not affect either the underlying long-term costs or any one-off transitional costs arising from the recommendations.

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[8] The notional contribution includes the funded 3% Productivity component.

Employer contribution rates

Figure 10-1 and Table 10-1 compare the employer contribution rate for the current schemes if they continue unchanged and the proposed scheme, as projected by the Actuary.

As demonstrated by Figure 10-1, this measure of the underlying employer cost is projected to be broadly similar under the current and proposed arrangements though with a small increase over the first few years. The employer contribution rates are, however, based on no change to the costs of death and disability benefits. The Actuary has advised that estimating the impact of the proposed changes to these benefits is difficult. The Actuary considers it more likely that the costs in the new scheme will be lower rather than higher than under the current schemes due, in part, to the increased rehabilitation focus. The Department of Veterans' Affairs experience would support this view.

In addition, the existing costs for the current defined benefit schemes are less certain than the costs arising from the proposed defined contribution scheme.

Figure 10–1: Employer contribution rates under current and proposed schemes (including death and disability costs)

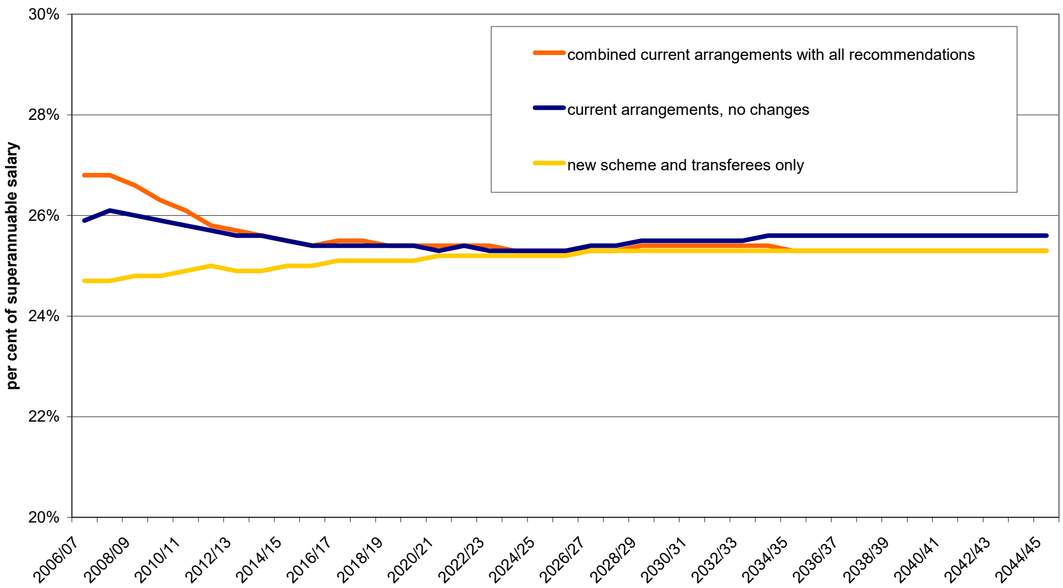


Table 10–1: Employer contribution rates under current and proposed schemes (including death and disability costs)

Financial Year	Current arrangements	Proposed arrangements	
	Combined %	New Scheme %	Combined %
2006/07	25.6	24.7	26.6
2007/08	25.8	24.7	26.5
2008/09	25.7	24.6	26.3
2009/10	25.7	24.6	26.1
2010/11	25.4	24.5	25.8
2011/12	25.3	24.5	25.6
2012/13	25.3	24.5	25.4
2013/14	25.2	24.5	25.3

Cash requirements and impact on unfunded liabilities

The proposed transitional arrangements will bring forward previously unfunded liabilities accrued under the MSBS and DFRDB. This will require an immediate funding on introduction of the proposed scheme of about $7-8bn (based on a 2009 commencement). This funding requirement is likely to be spread over two financial years due to the proposed 12 months window for active and preserved members to choose.

In addition, the Defence contribution for members in the proposed scheme will fund benefits directly rather than notionally. This will have no impact on Defence for which the current 'notional' contribution is an identified expense in its budget, even though the contribution is returned to Consolidated Revenue but it will require additional cash of around $0.4bn per year for a number of years from the Government's overall budget. This additional cash requirement will rise to around $0.7bn (in nominal terms) before falling, and will eventually become negative.

The Review Team notes that the Future Fund is the most obvious source of the initial cash required, it having been established precisely for the purpose of meeting the unfunded liability. In basic economic and financial terms, these cash requirements will not have any real impact if taken from the Future Fund: they will merely bring forward future liabilities and they will transfer funds from the Future Fund's investments to the new superannuation fund's investments.

There will be a commensurate reduction in the unfunded liability that would otherwise continue to grow with the continued operation of the existing schemes. Indeed, as highlighted by Figure 10–2 by 2045 the Actuary's estimates suggest the total unfunded liability will drop from the current $33bn to $19bn instead of growing to $134bn (in nominal dollars).

Figure 10–2: Unfunded liabilities for military superannuation schemes (nominal prices)

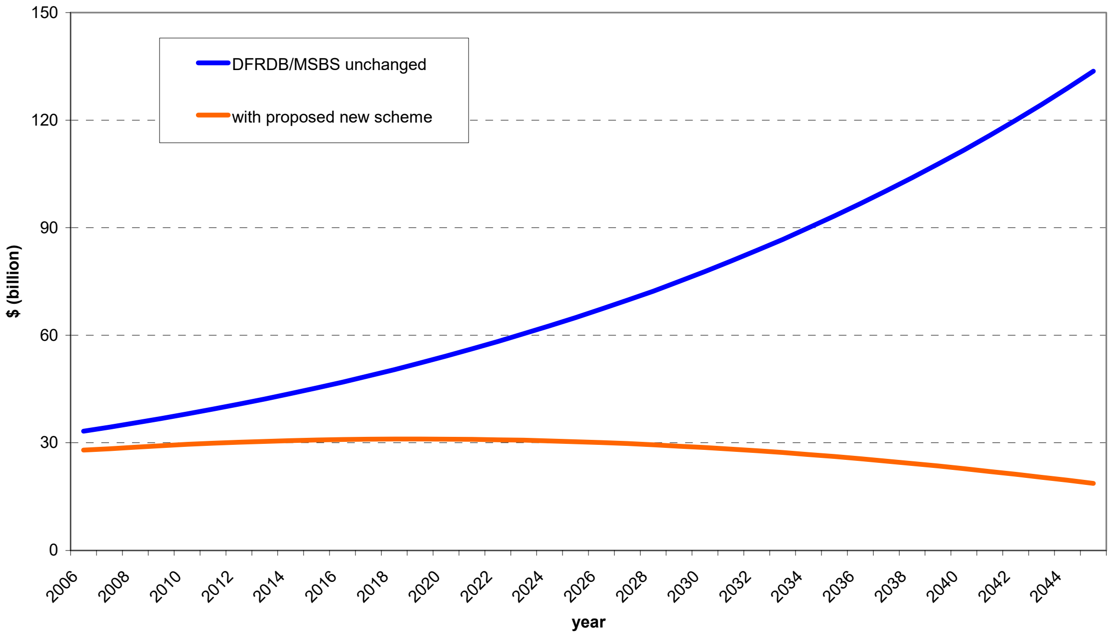


Figure 10–3 shows the impact of the proposed new scheme on the Government's projected total defined benefit superannuation liabilities, including both civilian and military schemes, assuming the recommendations contained in this report (excluding DFRDB pension indexation) are adopted.

It is apparent, again, that the introduction of the new scheme and the proposal for current and preserved members to transfer to the proposed new scheme will not only cap the Government's projected liabilities but also reduce them. Nonetheless, there remains a substantial role for the Future Fund over many years to meet the defined benefit liabilities.

Figure 10–3: Impact of proposed new scheme on unfunded liabilities

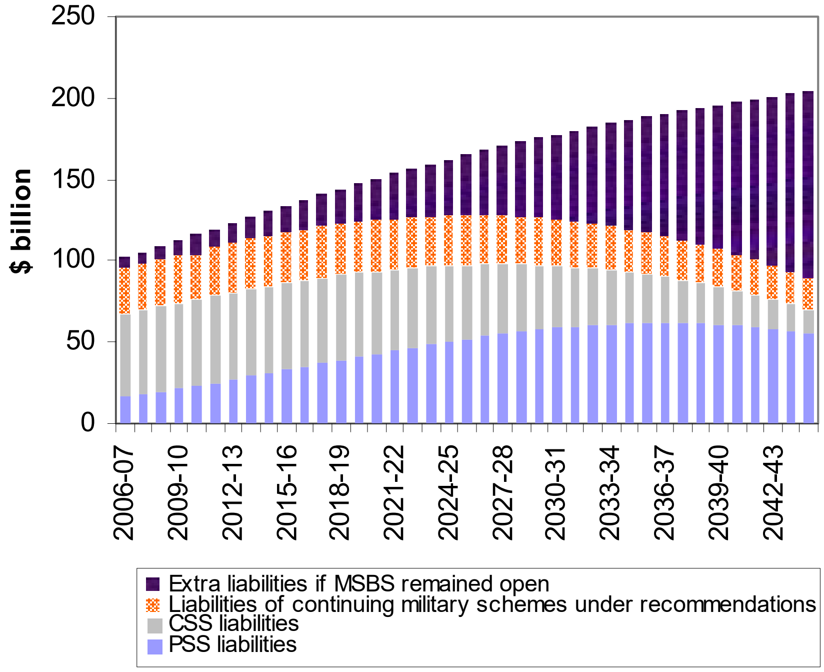
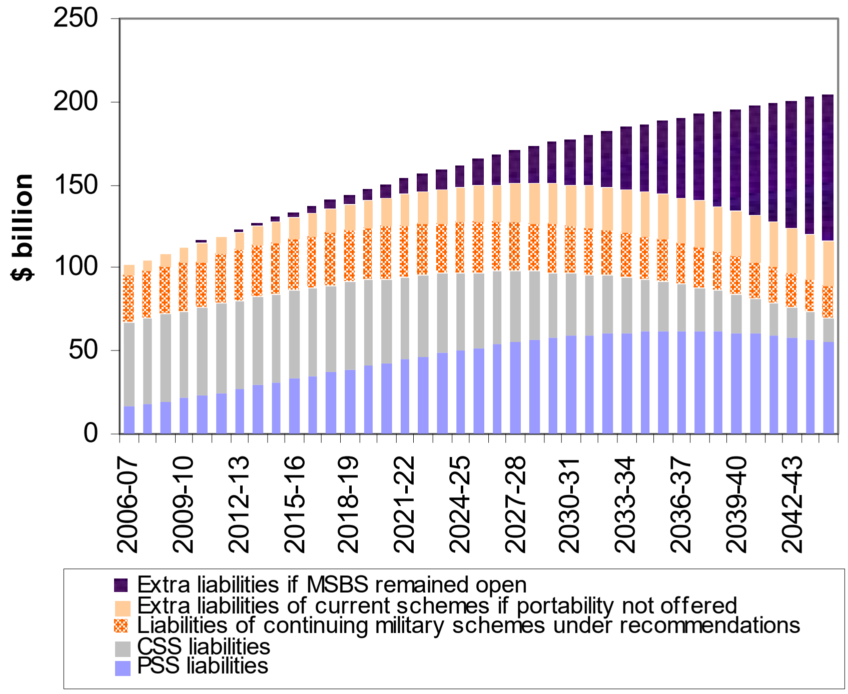


Figure 10–4 shows the effect if the MSBS were closed to new entrants but without offering portability to current and preserved members. A similar effect to that of the Review Team's recommended approach is shown, but the capping is at a higher level and the maximum in respect of the military superannuation liabilities is reached more than ten years later. In effect, a decision not to allow the portability options to the current and preserved members would increase these liabilities each year resulting in an increase of more than $20bn for each year in the projection period after 2023-24. Of course, this reflects the failure under this option to meet these liabilities earlier.

Figure 10–4: Unfunded liabilities where new scheme open only to new members



In other words, the Review Team's firm recommendations to allow current ADF members and MSBS preservers the choice to transfer to the new scheme will reduce the unfunded liabilities somewhat further than if the new scheme were available only to new ADF members, but will only modestly reduce the continuing role of the Future Fund.

Access to the Future Fund is constrained by its legislation, but in 2007 it already holds $51bn and this will increase further from its investment income and when the proceeds of the next stage of the Telstra sale, and any funds from future budget surpluses, are directed into the fund. It is estimated therefore, that the Future Fund will have reached more than 75% of its Target Asset Level by 2009 when it is proposed the new scheme be introduced. The Review Team's recommendations are likely to require about 10% of the Fund to be transferred into the new military superannuation scheme on commencement, if that is to be the source of the funds required.

The Review Team considers that this immediate funding of the benefits for current and preserved members of the MSBS will have a positive effect on recruitment and retention.

Transitional impact – accrued liabilities

The transitional arrangements will have a 'one off' impact on accrued liabilities as members of DFRDB and MSBS choose whether to transfer into the proposed scheme. The Actuary suggests this impact might be a saving on accrued liabilities of around $150-200m, comprising savings as a result of current contributors transferring (around $550m) offset by the costs of MSBS preservers transferring (around $350-400m).

The Actuary has provided estimates of this impact based on considered assumptions of how different demographic groups within the ADF and amongst MSBS preservers would respond to the choice on offer. As explained in the Actuary's Report at Appendix H, the expected saving from transfers by current ADF members relates, in part, to rational choices likely to be made by many young members to take the real funds under the new scheme which keeps their future options open and to forgo possibly higher MSBS benefits in the future in the form of indexed pensions from age 55. After all, these members do not yet know whether they will stay in the ADF for a long period.

The Actuary has also provided estimates based on an alternative set of assumptions involving a lower rate of transfer (essentially, assuming more inertia against change). The two sets of estimates are set out in Table 10–2.

Table 10–2: One-off cost impact on accrued liabilities

	Base Estimate $m	Alternative Estimate $m
Cost of current ADF members choosing to transfer	-550	-500
Cost of preserved MSBS members choosing to transfer	350 to 400	250 to 300
TOTAL Costs	**- 150 to - 200**	**- 200 to - 250**

In summary, while there is considerable uncertainty about these estimates, it is likely that they will involve a net saving of over $100m in reported accrued liabilities.

Additional technical measures

Table 10–3 identifies the estimated costs, both in terms of the employer contribution rate and any one-off impact on accrued liabilities, of the Review Team's recommendations on the additional technical issues set out in Chapter 9.

Table 10–3: Costs of additional technical measures

Item	Impact on employer contribution rate % of total ADF salary base	One-off Impact on Accrued Liabilities $m
Abolition of MSBS Maximum Benefit Limits	Negligible[1]	60
Interdependent Relationships	Negligible[2]	Negligible[2]
Changing Final Average Salary to Final Salary for MSBS death and disability benefits	Negligible[1]	Negligible
Wages indexation of DFRDB pensions		
- for those over 55	0.8[3]	4,200
- for those over 65	0.5[3]	2,600

1. These impacts on the employer contribution rate have been included in the estimates in Figure 10–1 and Table 10–1.

2. These estimates do not include any costs should the Government decide to recognise Interdependent Relationships under the existing schemes.

3. These will decline rapidly as DFRDB contributors leave the ADF.

Leaving aside the option to change DFRDB indexation arrangements, the costs of these recommendations both in terms of ongoing employer contribution rates and in terms of accrued liabilities can be met within the current broad cost envelopes along with the new scheme and the recommended transitional arrangements.

Changes to DFRDB indexation could not be met within the envelopes of current costs and existing unfunded liabilities, and has therefore been accorded a lower priority than the other recommendations. The Review Team also recognises there would be flow-on pressure for such a change to apply to the Commonwealth Superannuation Scheme for public servants. Nonetheless, the large one-off increase on the unfunded liability would be paid out over many years with only a modest budgetary impact in the first few years, as illustrated below:

Table 10–4: Budget Impact of DFRDB indexation options

	DFRDB pensions for over 55 year olds $m	DFRDB pensions for over 65s only $m
1st year's impact	3	1
2nd year's impact	14	7
3rd year's impact	27	13
4th year's impact	41	21
5th year's impact	55	28
35th year's impact	702	458
40th year's impact	721	480
Total impact on future unfunded liabilities	4,200	2,600

Departmental expenses

Implementation costs

The introduction of the proposed accumulation plan and the proposal that the defined death and disability arrangements be administered by DVA will require additional resources over about three years for a range of agencies.

Table 10–5 sets out preliminary estimates by the agencies affected of the transitional costs involved, on the basis of introduction of the new scheme in early 2009.

Table 10–5: Departmental expenses for transition

	FY 2007-08	FY 2008-09	FY 2009-10	Total
Department of Defence	\$5.0m	\$8.9m	\$4.5m	\$18.4m
ComSuper	\$4.3m	\$4.0m	\$0.0m	\$8.3m
Board of Trustees	\$0.5m	\$1.5m	\$1.0m	\$3.0m
Department of Veterans' Affairs	\$1.1m	\$1.3m	\$0.6m	\$3.0m
Total	**\$10.9m**	**\$15.7m**	**\$6.1m**	**\$32.7m**

Note Due to the cap on Defence's civilian staffing numbers, Defence may need to seek additional staff coverage for the implementation of any recommendations.

Ongoing costs of administration

Overall, the new scheme should require no net increase in administrative costs: there may be some savings over time due to the simpler scheme design and a heightened rehabilitation focus (that should return injured individuals to the workforce earlier than current arrangements). The Review Team has not developed estimates of the costs or savings for individual agencies, but notes that there will be some additional ongoing costs in relation to the emphasis on rehabilitation (Recommendation 4b), the proposed education and awareness program (Recommendation 11), and as a result of an increase in the number of trustees for military superannuation (from five to seven), and their on-costs (Recommendation 9b). These increased costs are likely, in the medium to long term, to be outweighed by savings in relation to:

- the administration of a simpler scheme design;
- some injured individuals returning to the workforce earlier;
- the requirement for fewer overall medical assessments; and
- efficiencies from having only one agency dealing with both compensation and superannuation medical assessment regimes and appeals processes.

Glossary and acronyms

Glossary

Accrued Benefit	The amount of a benefit in a superannuation scheme that has accrued to a member on the basis of completed years of service and/or membership at a particular date.
Accumulation Scheme	A superannuation scheme where all members have defined contributions (accumulated benefits). The assets of the fund are invested and any earnings (or losses) are credited (debited) to the member's account less any charges such as administration fees and insurance premiums. Members bear the full effect of fluctuations in investment earnings. Under the new proposed scheme there will be no administration fees or insurance premiums charged to the accounts of serving ADF members.
Better Super	Measures announced in the May 2006 Federal Budget to simplify superannuation taxation arrangements, most of which took effect from 1 July 2007. These measures included tax-free benefits from age 60 and the introduction of contribution limits in respect of taxed funds.
Commutation	Conversion of all or part of a pension or annuity benefit to a lump sum.
Commutation Factor	A multiple applied to an annual pension benefit to achieve a lump sum equivalent. An actuarially determined commutation factor takes account of: ▪ life expectancy of the member; ▪ life expectancy of the member's spouse; ▪ the percentage of the member's pension to which the spouse is entitled in the event of the member's death; and ▪ the indexation factor.
ComSuper	Commonwealth Superannuation Administration, the Australian Government agency responsible for the administration of the principal occupational superannuation schemes for the Australian Government's public sector employees and Defence Force members.
Defined Benefit Scheme	A superannuation scheme where the member's benefit is calculated on a specified formula. Usually the member's final benefit depends on years of service, level of salary near retirement and the benefit scale.
DFRB	Defence Forces Retirement Benefits Scheme. The superannuation scheme for members of the ADF from 1948 until 30 September 1972. In this report, reference to DFRDB pensions is also taken to include DFRB pensions.
DFRDB	Defence Force Retirement and Death Benefits Scheme. The superannuation scheme for ADF members from 1 October 1972 until 30 September 1991. In this report, reference to DFRDB pensions is also taken to include DFRB pensions.
ESO / Ex-Service Organisation	An organisation dedicated to the welfare of members and former members of the ADF, includes the Returned and Services League, the Regular Defence Force Welfare Association and others.
Final Average Salary (FAS)	The average of remuneration received by the member in the years prior to exit, as defined in the relevant trust deed or legislation. In the MSBS, FAS is the average superannuable salary over the last three years.

Funded Scheme	A superannuation scheme in which contributions (either member or employer or both) are held in a fund from which benefits are paid.
MGYS	Military Gap Year Scheme, a 12-month scheme to enable young Australians to experience ADF training and the Service lifestyle.
Re-entered Recipient	For DFRDB purposes is a person receiving a DFRDB pension who rejoins the ADF. If rejoining for more that one year, retirement pay is cancelled and contributions re-commence.
Preservation	From 1 July 1999, all contributions made by, or on behalf of members must be preserved on entry to a superannuation fund or Retirement Savings Account. All earnings from that date must also be preserved until the member meets a condition of release. The general condition of release is retirement from the workforce after reaching Preservation Age.
Preservation Age	The Preservation Age for individuals depends on the person's date of birth as follows: **Date Of Birth** — **Preservation Age** Before 1 July 1960 — 55 1 July 1960 – 30 June 1961 — 56 1 July 1961 – 30 June 1962 — 57 1 July 1962 – 30 June 1963 — 58 1 July 1963 – 30 June 1964 — 59 After 30 June 1964 — 60
Superannuation Salary	The salary used for superannuation purposes (i.e. both contributions and benefits) as defined in the relevant trust deed or legislation. In the DFRDB, superannuation salary is the maximum rate of pay for rank and pay level plus Service Allowance. In the MSBS, superannuation salary is currently the sum of base salary, Service Allowance and any Higher Duties Allowance. In the proposed new scheme, superannuation salary will be base salary plus Service Allowance.
Uhrig Report	Review of the Corporate Governance of Statutory Authorities and Office Holders.
Unfunded Scheme	An unfunded super scheme is one where neither the employer nor the member pay contributions into a fund to cover future benefits payable.

Acronyms

ADF	Australian Defence Force
ADFFSCC	ADF Financial Services Consumer Council
AFSL	Australian Financial Services Licence
AGA	Australian Government Actuary
APRA	Australian Prudential Regulation Authority
ATO	Australian Taxation Office
CPI	Consumer Price Index
CSS	Commonwealth Superannuation Scheme
DFRB	Defence Forces Retirement Benefits Scheme
DFRDB	Defence Force Retirement and Death Benefits Scheme
ILO	International Labour Organisation
MBL	Maximum Benefit Limit
MRCA	*Military Rehabilitation and Compensation Act 2004*
MSBS	Military Superannuation and Benefits Scheme
OECD	Organisation for Economic Co-operation and Development
PSS	Public Sector Superannuation Scheme
PSSap	Public Sector Superannuation accumulation plan
RDFWA	Regular Defence Force Welfare Association
RSL	Returned and Services League of Australia
SG	Superannuation Guarantee
SIS	*Superannuation Industry (Supervision) Act 1993*
The Actuary	The Australian Government Actuary (AGA)
TORs	Terms of Reference
TTR	Transition to Retirement

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Appendix A. Support to the Review Team

Departmental Secretariat

The Review Team is particularly grateful to the Departmental Secretariat established to support the Review Team. It included members of the RAAF, Navy and APS employees.

Membership of the Secretariat changed over the course of the review. The following people were all part of the secretariat:

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Additional Technical Support

The Review Team was also ably assisted by:

The Australian Government Actuary, Mr Michael Burt, Ms Susan Antcliff, Mr Peter Martin

ComSuper, Mr Max Staples and Ms Ann Finlay

MSBS Board, Board Chair Mr Charles Kiefel and CEO Mr John McCullagh

Department of Veterans' Affairs, Mr Mark Travers and Mr Mark Johnson

Defence's Director-General of Occupational Health, Safety and Compensation, Mr Mal Pearce, Mr David Cooke, Ms Michelle Glanville and Mr Barry Hutchins

Appendix B. People and organisations consulted and submissions received

Formal submissions were received from the following organisations:

Australian Labor Party (submitted by Mr Alan Griffin MP, Shadow Minister for Veterans' Affairs and Shadow Minister for Defence Science and Personnel and Senator Nick Sherry, Shadow Minister for Superannuation and Intergenerational Finance, Banking and Financial Services)

Australian Special Air Service Association, National Executive (submitted by LTCOL David Lewis (Rtd))

Australian Veterans' and Defence Services Council Incorporated (submitted by RADM Ian Crawford (Rtd))

Chief of Navy (submitted by VADM Russ Shalders)

Chief of Air Force (submitted by AM Geoff Shepherd AO)

Defence Families of Australia (submitted by Ms Nicole Quinn)

DEFCREDIT (submitted by CEO Mr Jon Linehan)

Defence Reserves Association, Queensland Branch (submitted by COL G Bulow (Rtd))

Defence Reserves Association, South Australia Branch (submitted by LTCOL Murray Alexander (Rtd))

Defence Reserves Association Victorian Branch (submitted by LTCOL Ian George (Rtd))

Defence Reserves Support Council (submitted by Chair DRSC Superannuation Group, Mr Bill Thompson)

Director General Navy Personnel and Training (submitted by CDRE David Letts)

Director General Personnel – Army (submitted by BRIG Paul Symon)

Director Personnel Capability Management – Air Force (submitted by GPCAPT David Richardson)

Fiducian Financial Services (submitted by Mr Cameron Darrow)

Head Personnel Executive (submitted by MAJGEN Mark Evans)

Injured Service Persons' Association (submitted by President, Mr Ray Brown)

Legacy Co-ordinating Council (submitted by Chairman, David Grierson)

Military Superannuation and Benefits Board of Trustees (submitted by Chairman, Mr Charles Kiefel)

Naval Association of Australia (submitted by CMDR (Rtd) Peter Cooke Russell)

OzVeteransForce (submitted by LTCOL John Graham (Rtd) and LTCOL John Graham (Rtd))

Regular Defence Force Welfare Association (submitted by National President, Mr H.J. Adams)

Regular Defence Force Welfare Association, New South Wales Branch (submitted by Mr Bryan Wilson)

Returned & Services League of Australia – National Headquarters (submitted by MAJGEN (Rtd) Bill Crews)

Royal Australian Air Force Association National Council (submitted by Air Vice-Marshall (Rtd) Roxley McLennan)

Royal Australian Air Force Association Victorian Division (submitted by President, Mr Peter Colliver & Executive Director Mr Gordon Caley)

Royal Australian Air Force Engineer Officers' Association (submitted by Mr Richard Orr)

Royal Australian Army Ordnance Corps Association Western Australia (submitted by President, LTCOL (Rtd) Warren G Evans)

Royal United Service Institution of New South Wales (submitted by BRIG (Rtd) P.R. Carey)

Sea Change Implementation Team (submitted by CDRE Clint Thomas)

Superannuation Complaints Tribunal (submitted by Chairperson, Mr Graham McDonald)

The Royal Australian Regiment Association (submitted by MAJGEN (Rtd) Jim Connolly)

Vietnam Logistical Support Veterans' Association Queensland (submitted by DFRDB Project Officer, Mr Rodney Nott)

Vietnam Veterans' Federation (submitted by President, Mr Tim McCombe)

War Widows' Guild – Victoria (submitted by Ms Patricia Medaris)

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PTE (ARES) Timothy Bennett

WO1 Kelvin Bennett-Paterson

PTE (ARES) Andrena Berran

SGT Brendan Berry

MAJ Bruce Blain

TPR (ARES) Rodney Bourke

LCDR Ross Bowden

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LTCOL Gerard Sharkey (Rtd)
WGCDR Rohan Sharples
CPL Clayton Sharrett
MAJ David Siggers
Mr Andrew Slatter
WO2 Alex Smith
Mr Ben Smith
Mr D. A. Smith
PO Glenn Smith
SGT (RAAF) Mark Smith
LCDR Andrew St John-Brown (Rtd)
Mr Jim Staats
LCDR Tim Standen
CAPT Michael Stark
Mr Joe Straczek
MAJ Helen Stransky
CMDR Kerry Stephen, AM (Rtd)
Mr Grant Stuart
WO2 (ARES) Greg Summers
Mr Patrick Sumner
Mr Nick Sverdloff
Mr Peter Tait
WO1 Stephen Targett
Mr Don Tate
PO Aaron Taylor
Mr Hamish Taylor
LTCOL Robert Taylor (Rtd)
Mr Harold Vincent Tebbit
Mr Dean Tetley
LCDR Peter Thompson
CAPT (ARA) Dragon Tucic
Mr Paul Ugrinic
Mr R.A. Unger
Mr Michael Voss
Mr Colin Wade
Mr Darryl Wagstaff
CAPT Stephen Ware
CPL Jean Warwick

CPO Benjamin Wastell

Mr Charles Watson OAM

Mr Malcolm Webb

CAPT Peter Wertheimer (Rtd)

Mr Benjamin White

TPR (ARES) Daniel Wilce

WO2 Brett Wild

Mr Jason Williams

LTCOL Paul Wilmot (Rtd)

FLTLT Daniel Wilson

CPL Trent Wiseman

MAJ Franz Wolber (Rtd)

Mr Morgwn Wood

Mr Brad Woodland

SGT (RAAF) Benjamin Wright

Mr A. Wright

LCDR Bernard York

CPL (ARES) Adrian Younger

CAPT Sandy Zalstein

Note: An additional 42 submissions were received from authors who chose to remain anonymous

In addition to the people and organisations at Appendix A who supported the Review Team, the Review Team consulted with representatives of the following organisations:

Australian Defence Force Financial Services Consumer Council

Australian Prudential Regulation Authority

Australian Veterans' and Defence Services Council

Directorate Reserve Support Council

Defence's Finance Officer

Chief of Defence Force

Chiefs of Service Committee

The Navy, Army and Air Force Personnel Branches

Regular Defence Force Welfare Association

Returned and Services League of Australia

Appendix C. Key issues raised in submissions

The Review Team received 381 submissions. Many, particularly those from Ex-Service Organisations, canvassed multiple issues. The numbers of submissions addressing issues from the Terms of Reference are provided in the following table:

Issues (as outlined in the Terms of Reference)	Number of Submissions in which issue was raised	
	Individuals	Organisations
Wider remuneration for permanent and reserve members of the ADF	104	7
—Reservists superannuation	79	5
—DFRDB (general)	7	
—Salary Sacrifice	4	
—Allowances superannuated	3	
The Contemporary legislative and regulatory framework within which superannuation benefits are provided in Australia	75	19
—Simply Super	19	6
—Tax arrangements for DFRDB	22	4
—DFRDB Reclassified as funded	11	1
—MSBS Reclassified as funded	4	1
—Tax arrangements for MSBS	3	2
Indexation of military superannuation pensions	64	16
Portability arrangements	69	5
The operation of the Maximum Benefit Limits	32	7
The Review Team's evidence based assessment of the links between military superannuation and ADF recruitment and retention rates	38	6
The operation of life expectancy factors	19	11
The current and likely future demographic profile of the ADF	14	6
The impact of the Compulsory Retirement Age given the role of preservation ages the 2006-07 Budget superannuation proposals	15	4

State, national and international best practice in the provision and funding of occupational superannuation, invalidity and death benefits in comparable military and civilian public and private sector organisations whose members are subject to relatively early retirement	11	5
Preservation arrangements	11	2
Need to manage unfunded liabilities	8	2
The appropriateness of, and potential for, the MSB Fund to be accorded public offer status	7	2
The calculation of final salary for retirement, invalidity and death benefits	6	2
The implications of the complexity of the military superannuation schemes for members and the administrator	6	0
Superannuation splitting	2	4
The appropriateness of the three-tiered invalidity classification system	8	2

Appendix D. Contemporary ADF attitudes to superannuation

Defence Attitude Surveys

Defence conducts a census of all ADF personnel every four years and attitude surveys of a 30% sample of ADF personnel each year. The 2003 Your Say Survey by McKinnon & Gorny (2003), was themed 'What Motivates You' and provided definitive data on the importance of various features of military service and the level of satisfaction with each feature. Table D-1 sets out the top 15 influences on retention (out of 97 listed elements) for various age groups in the ADF. Superannuation scheme, together with retirement benefits and employer contributions, were influential factors for members over 30 years of age. The survey was repeated in 2006 but the results have not yet been released. Nevertheless, initial indications are that the influence of superannuation scheme and the employer contribution level have increased.

ORIMA Research results

ORIMA Research was commissioned in late 2006 to conduct a survey with current full-time members of the Australian Defence Force (ADF) about their superannuation scheme. In light of the Review of Military Superannuation announced on 27 February 2007, the original survey methodology / questionnaire were reviewed before commencing fieldwork.

The purpose of the survey was to target current serving full-time members of the ADF in peak discharge years to find out:

- to what extent military superannuation influences members' decision to join, remain in or discharge from the ADF;
- members' level of knowledge of their scheme;
- scheme features members consider to be most important;
- perceptions of military schemes compared to civilian schemes; and
- members' preferences on retirement.

A selection of results that address each of the survey areas are presented on the following pages. In general, results show both overall ADF attitudes and the influence of years of ADF service on outcomes.

Key results

- Just over one quarter of respondents were aware of military super and its benefits before they enlisted in the ADF.
- Around one third of respondents were confident that they have a 'very good' or 'good' understanding of the benefits provided by their military scheme, however an almost equivalent proportion felt their understanding was 'poor' or very poor.
- Superannuation had little influence for most respondents on their decision to join the ADF, however membership of military super has a greater influence on respondents' decision to remain in the ADF.
- MSBS respondents felt that the most important features of their scheme were the employer benefit, that no administration fees or charges were payable, and the insurance cover.
- The two main features which encouraged MSBS respondents to remain in the ADF were pension benefits on retirement, and the ability to choose how to invest the member benefit.
- Around two thirds of respondents indicated they would prefer a pension at retirement over a lump sum payment.
- Respondents generally felt their scheme provided higher benefits than civilian schemes for death, invalidity, and retirement, however views were mixed about benefits for resignation.

Table D-1: 15 most influential aspects of ADF employment

Rank	24 years and below	25-29 years	30-34 years	35-39 years	40-44 years	45-49 years	50 years and over
1	Medical Benefits	Job enjoyment	Job enjoyment	Job enjoyment	Job enjoyment	Job enjoyment	Job enjoyment
2	Dental Benefits	Job security	Job security	Job security	Job security	Job security	Challenging Work
3	Opportunity to travel	Ability to balance work and personal time.	Base Pay	Ability to balance work and personal time.	Superannuation scheme	Superannuation scheme	Team environment
4	Job security	Dental Benefits	Medical Benefits	Base Pay	Support from partner spouse	High level of responsibility	Job security
5	Job enjoyment	Medical Benefits	Support from partner spouse	Superannuation scheme	Challenging Work	Base Pay	Ability to balance work and personal time.
6	Access to leave entitlements	Base Pay	Dental Benefits	Support from partner spouse	Ability to balance work and personal time.	Support from partner spouse	Serving your country in uniform
7	Involvement in peacekeeping/ humanitarian operational deployments	Access to leave entitlements	Future job opportunities	Future job opportunities	Team environment	Challenging Work	Job diversity
8	Base Pay	Future job opportunities	Superannuation scheme	Medical Benefits	Base Pay	Superannuation employer contributions	High level of responsibility
9	Deployment allowances	Service Allowance	Access to leave entitlements	Dental Benefits	High level of responsibility	Job diversity	Support from partner spouse
10	Mateship	Challenging Work	Ability to balance work and personal time.	Access to leave entitlements	Retirement benefits	Opportunity to lead	Mateship
11	Quality of co-workers	Nationally recognised qualifications	Opportunity to travel	Quality of co-workers	Opportunity to lead	Ability to balance work and personal time.	A different work experience
12	Involvement in combat operational deployments	Professional training-development	Superannuation employer contributions	Retirement benefits	Superannuation employer contributions	Team environment	Opportunity to lead
13	Future job opportunities	Quality of co-workers	Mateship	Superannuation employer contributions	Mateship	Retirement benefits	Superannuation scheme
14	Nationally recognised qualifications	Opportunity to travel	Service Allowance	Challenging Work	Job diversity	A different work experience	Trust in CO
15	Provision of rental allowance	Access to long service leave	Challenging Work	Team environment	Trust in CO	Mateship	Base Pay

Note The table shows the 15 most influential aspects of ADF employment (out of 97 elements), by age group, in a survey conducted in 2003.
Source Adapted from The Defence Personnel Environment Scan 2025, July 2006.

Awareness of military superannuation scheme benefits

Figure D.1. Were you aware of military superannuation and its benefits before you enlisted in the ADF? Base: All respondents (n=739)

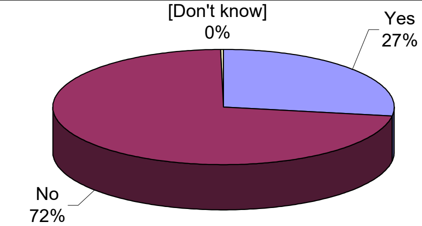


Figure D.2. Overall, how would you rate your understanding of the benefits provided by your military superannuation scheme? Base: All respondents (n=739)

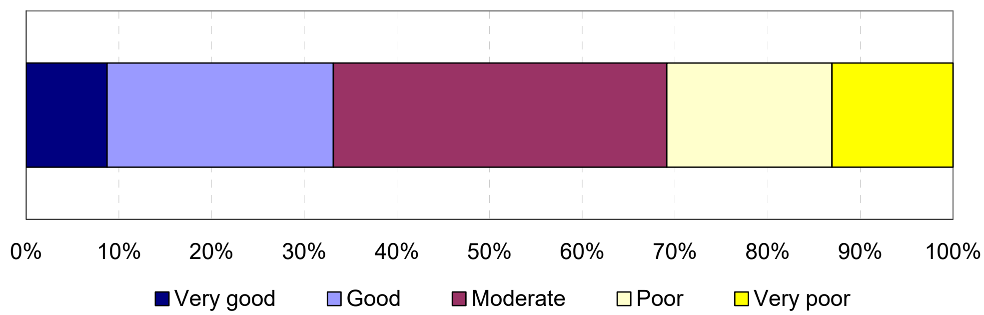
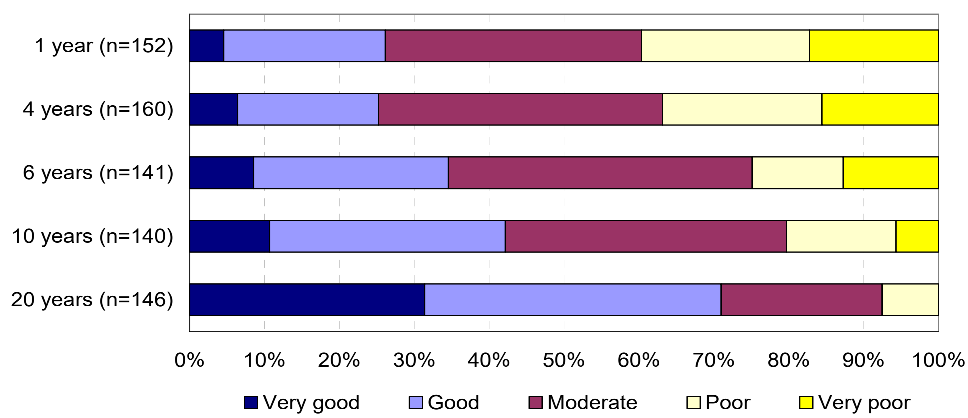


Figure D.3. Overall, how would you rate your understanding of the benefits provided by your military superannuation scheme? [By years of service] Base: All respondents



Influence of superannuation scheme benefits on job

Figure D.4. To what extent did your knowledge of military superannuation and its benefits influence your decision to join the ADF?
Base: All respondents (n=739)

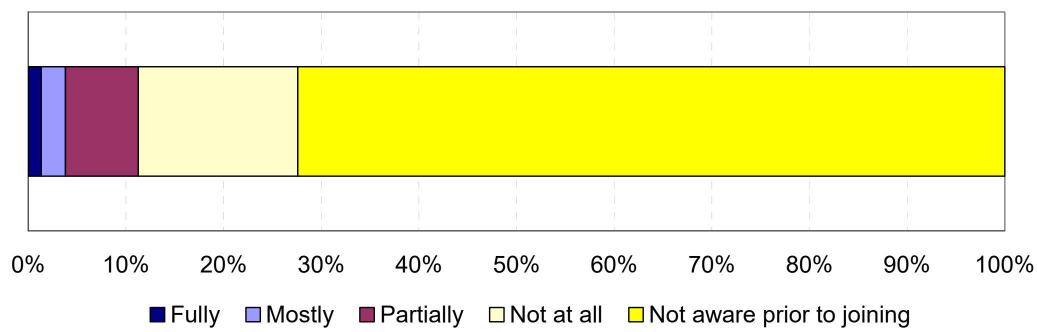


Figure D.5. To what extent does your membership of your military superannuation influence your decision to remain in the ADF?
Base: All respondents (n=739)

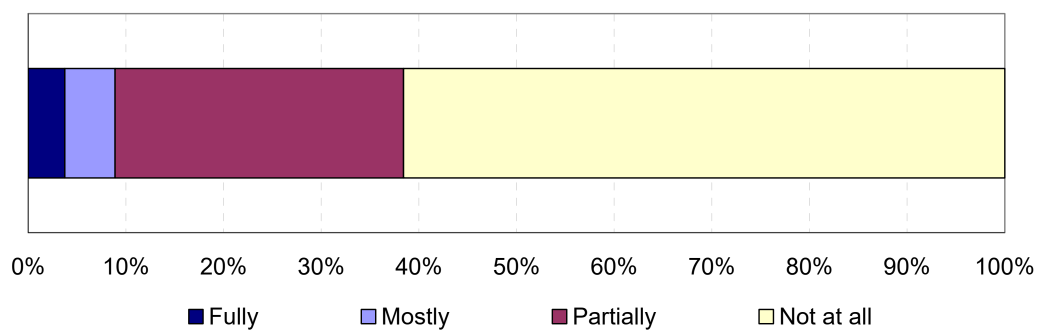
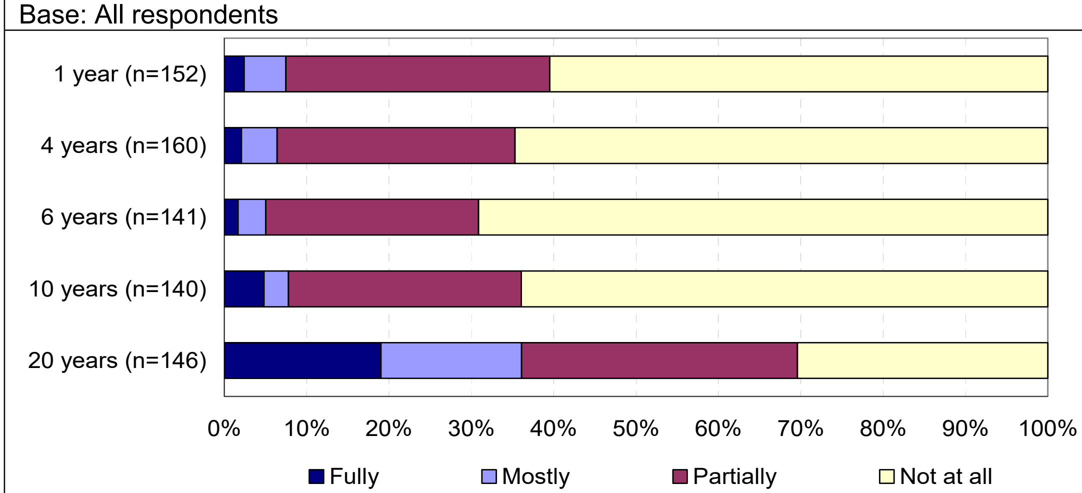


Figure D.6. To what extent does your membership of your military superannuation influence your decision to remain in the ADF? [By years of service]
Base: All respondents



Preferred features of their Scheme

Figure D.7. Most important features of MSBS
Base: All MSBS respondents

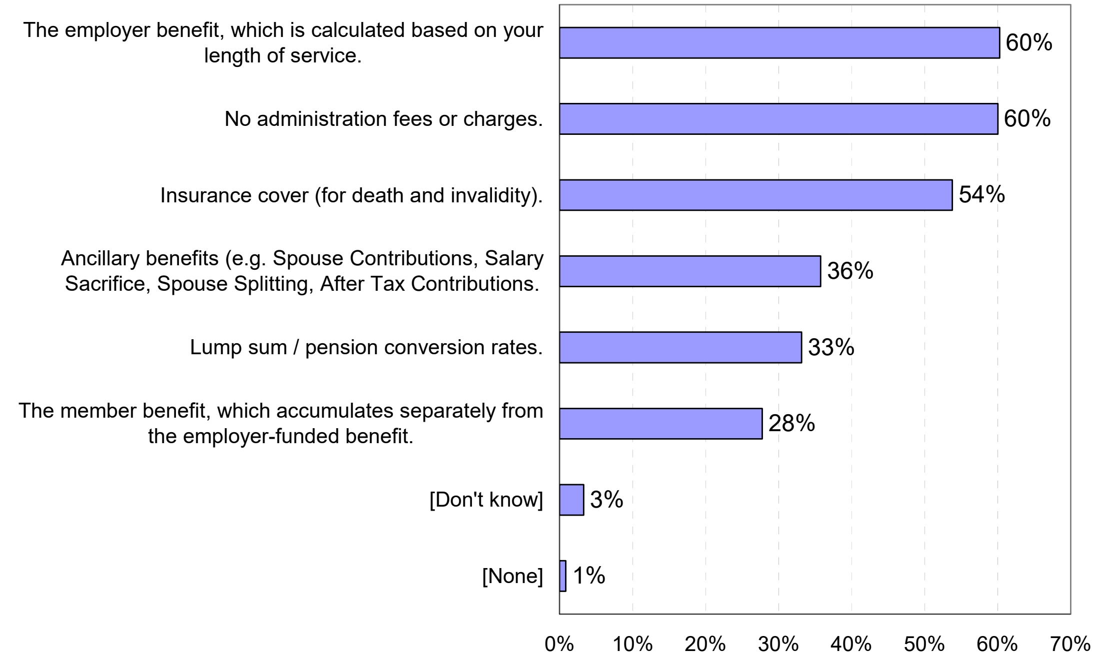


Figure D.8. MSBS features which influence remaining in ADF
Base: All MSBS respondents

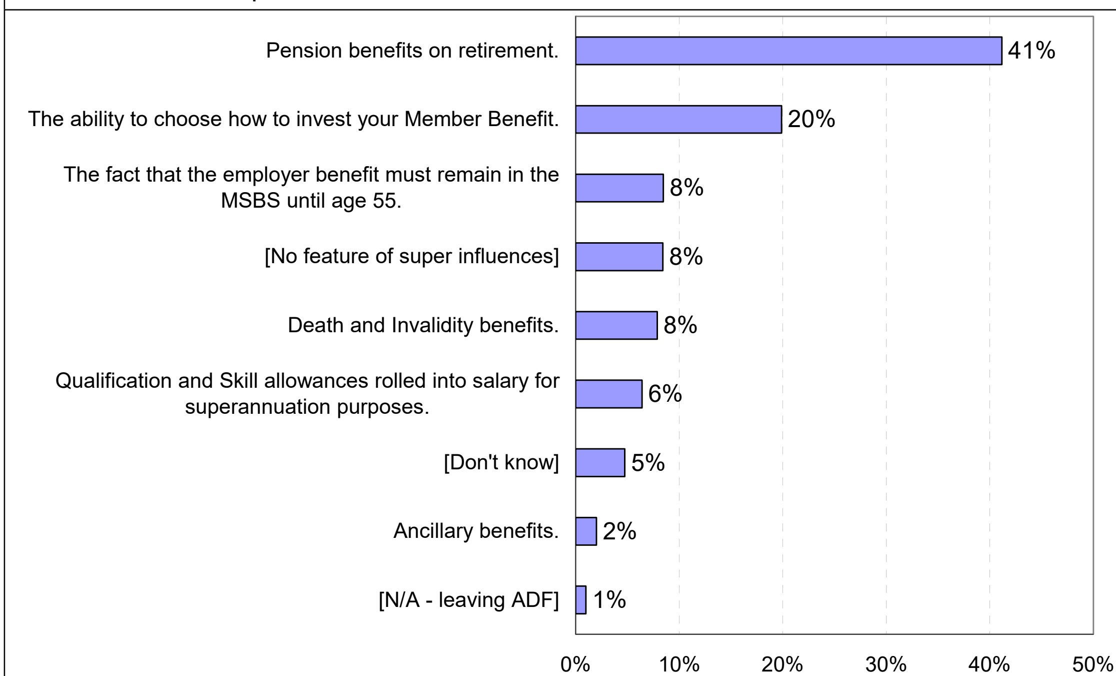
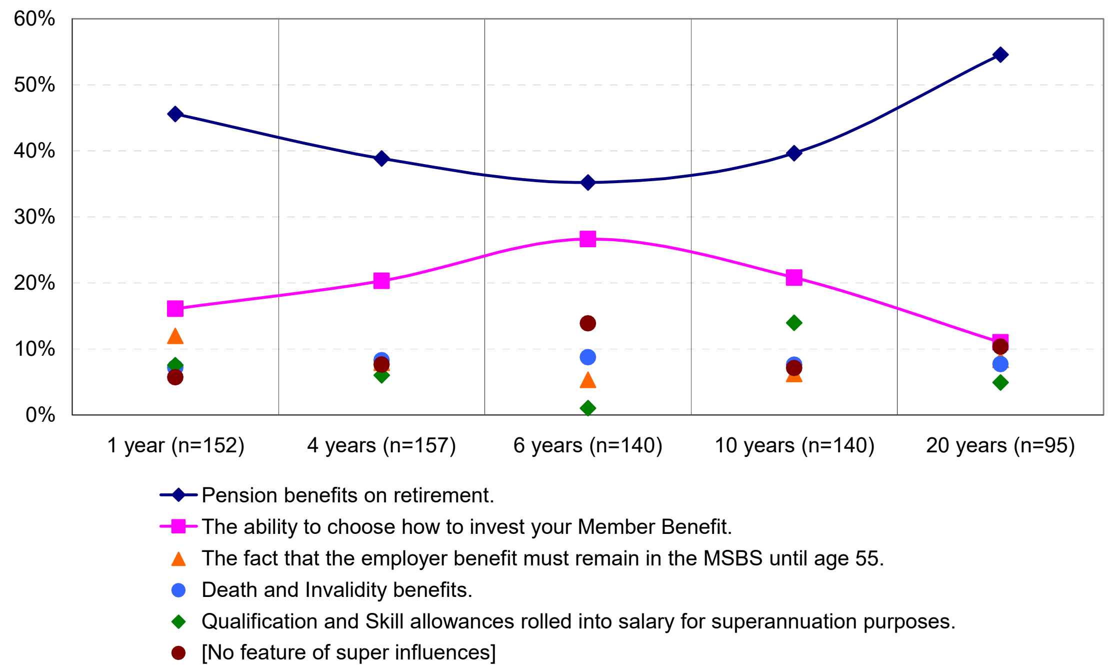


Figure D.9. MSBS features which influence remaining in ADF [By years of service]
Base: All MSBS respondents



Preferences on retirement and perceptions of scheme

Figure D.10. From your current viewpoint, which benefit would you prefer at retirement?

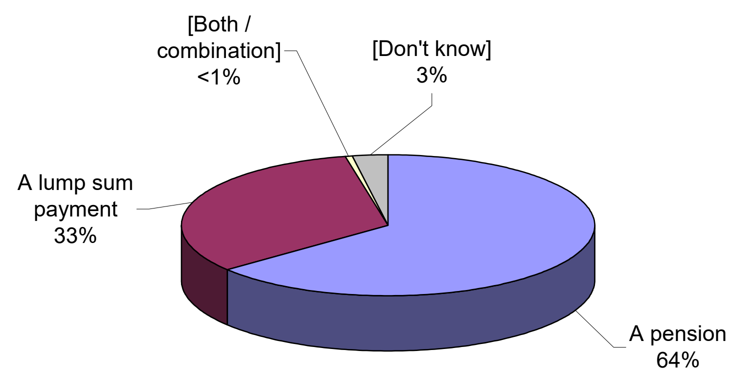


Figure D.11. From your current viewpoint, which benefit would you prefer at retirement? [By age]

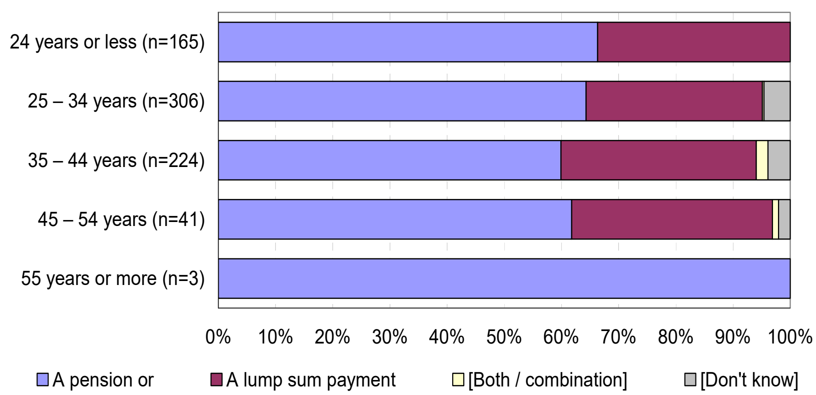
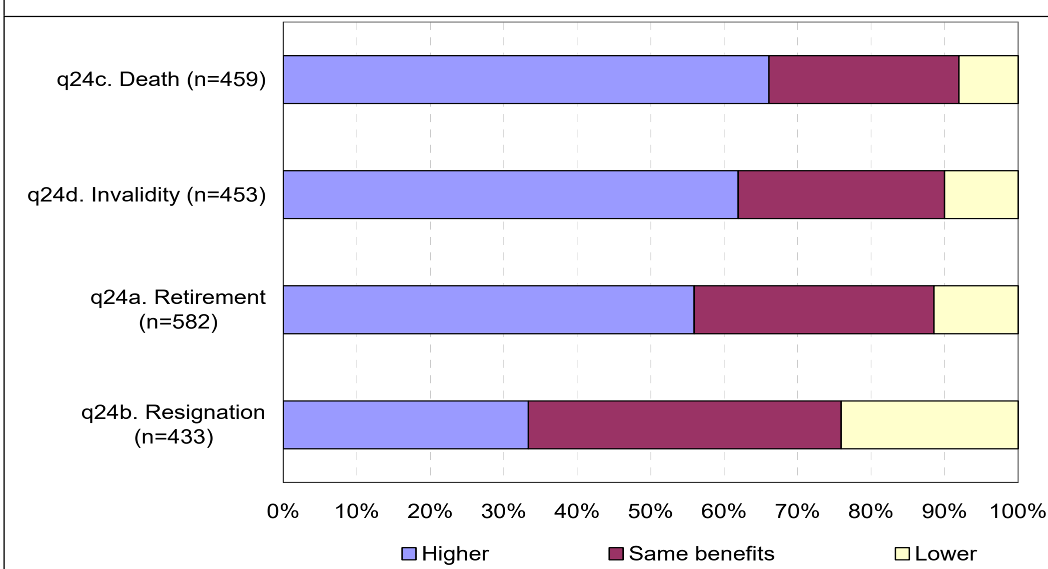


Figure D.12. Do you believe that your military scheme provides higher, the same or lower benefits than contemporary civilian schemes?



Focus Group results

The Review Team tested attitudes towards current and potential superannuation features with small groups of ADF personnel in Sydney, Canberra and Wagga Wagga late in the Review process. Each focus group comprised approximately ten members of various ranks but within targeted ADF years of service bands – three focus groups with members less than seven years of service, three focus groups with 8-22 years of service and two focus groups with more than 22 years of service. While members could raise any issues, the following topics were used to generate discussion and opinions:

- a comparison of defined benefit and defined contribution schemes;
- the need for compulsory member contributions;
- the trade-off between employer provided salary and superannuation;
- the level and structure of employer contribution rates;
- the impact of superannuation on recruitment and retention;
- the importance of military superannuation membership for family and post ADF service;
- the necessary level of disability benefits and work tests; and
- the relative importance of post retirement options such lump sums and indexed pensions.

Key Results - Less than seven years of service (generally less than 25 years of age). Several stated initially that the old DFRDB scheme was a good retention tool, and they favoured the scheme, but, when questioned, none of them were aware that the majority of ADF members (who completed less than 20 years of service) did not receive any benefit. Following discussion, the consensus view was that an accumulation plan provided the flexibility and portability that this age group desired. The transfer of investment risk to members, at a reasonable level, was not a concern, and defined contribution schemes were seen to be more in keeping with the arrangements applying to friends and family outside the ADF.

The majority of this age group said that superannuation was important but did not trust themselves to voluntarily contribute now. Most wanted some strong encouragement for member contributions, some preferring compulsory contributions to continue.

The majority of this age group did not know what the employer superannuation contribution currently is – some thought that it was the 9% Superannuation Guarantee. When the MSBS rates were explained, members expressed more positive views on their conditions of service and said it could be an influence (albeit not major) on their decision to continue in service. A more transparent and clearly defined employer contribution would have a greater impact.

In all cases, an indexed pension was seen as an important feature. While some of these members did not fully understand the concept of an indexed pension, it was a considerable influence on their parents who had encouraged them to join the Services.

Overall, these focus groups were strongly in favour of the proposed new scheme as outlined, believing it would enhance retention, provided members were educated on the benefits. The portability features and ability to have control over contributions and investments were welcomed, as was the suggestion of extending membership to spouses without an administration fee.

Key Results - 8-22 years of service (generally 25–40 years of age). Members in these focus groups were more knowledgeable on superannuation and more diverse in their views and opinions than the younger age group. While one or two initially said they would prefer to keep a defined benefit scheme where the employer looked after their interests, the others firmly favoured the choice and flexibility of a defined contribution scheme. Several highlighted how they might tailor a defined contribution scheme to their own family situation.

While some supported compulsory member contributions both for themselves and for younger members of the ADF, most favoured choice so long as there was some form of duty of care, to ensure that it was an informed decision.

Members of the group expressed the view that the availability of the pension option in the MSBS was very important, and most indicated that they would take a mix of pension and lump sum. The availability of the indexed pension was considered to be a significant retention factor. When the stepped-up contribution rates were explained, these members indicated that the 23%and 28% employer contribution rates would significantly influence a decision to separate or remain in the ADF, so long as the steps were at relevant stages of their careers.

There was strong support for extending membership to spouse and children, with no administrative fees. Several spoke of having small sums in many accounts with significant administrative fees.

Key Results - Over 22 years of service (generally over 40 years of age). Members of these focus groups represent some 13% of the ADF. Most were MSBS members, though some belonged to the DFRDB. The current scheme knowledge was generally greater than amongst the younger groups. The group was split between members who were strongly paternalistic (eg "soldiers are only interested in the end result not the journey", "young members aren't able to make the complex decisions so leave it as it is") and those who believe the modern generation wants choice and flexibility and should be expected to take more responsibility for their outcomes. Almost all thought that, at this point in their own career, they would probably choose to stay in their current scheme (either DFRDB or MSBS), but most considered that a defined contribution scheme made more sense for new ADF members.

Superannuation was a retention factor for most, though they were not sure of the value of their current employer contribution.

Almost all considered that there should be compulsory member contributions, and all strongly favoured indexed pensions.

Outcomes of the Focus Groups

The Review Team concluded that there would be general support for a funded and taxed accumulation plan. The current MSBS was poorly understood although recognised as having many good features once they were explained. The greatest deficiencies identified in the current schemes were the inability to accurately measure the value of the employer contribution and the inability of members to exert any control over their entitlement.

While confirming the general direction of the Review Team's proposals, the focus group discussions contributed to the Review Team revising its recommendations to:

- introduce the concept of a default opt-out member contribution;
- change the indexed pension qualification point from 20 years to 15 years; and
- reduce the initial employer contribution step from the start of the eighth year of service to start of the seventh year.

Appendix E. History and description of current schemes

The DFRDB

The DFRDB Scheme was implemented with effect from 1 October 1972 following the Joint Select Committee Review of Defence Forces Retirement Benefits Legislation, chaired by Mr J D Jess MP. This Committee was established in view of the concerns of private members and Senators with the operation of the *Defence Forces Retirement Benefits Act 1948*, particularly the very high contribution rates required of certain pre-1959 entrants to the scheme, delays in completing statutory actuarial reviews and the ever growing complexity of the legislation.

The DFRDB arrangements replaced the DFRB Scheme for all serving members and existing DFRB contributors were transferred to the DFRDB Scheme under no detriment provisions.

The key features of the DFRDB Scheme (as introduced from October 1972 under the legislation passed in 1973) are:

- a flat contribution rate of 5.5% of military salary, with member contributions being paid into and all benefits paid from the Consolidated Revenue Fund;
- retirement pay (i.e. pension) eligibility after 20 years of contributory service (35% of retiring salary, rising to a maximum of 76.5% after 40 years service);
- notional retiring age penalties for officers who voluntarily resigned below specified ages for their rank;
- indexation of pension amounts by a wage based index although this was replaced in 1974 by annual movements in the Consumer Price Index (CPI);
- an option to commute up to four times the annual retirement pay benefit to a lump sum payment, with an associated reduction in the retirement pension amount;
- a simple refund of member contributions (with no indexation or interest) for those who took voluntary separation before becoming eligible for a pension at 20 years; and
- a three-tiered system of invalidity benefits based on the maximum retirement pay rate and a member's incapacity for relevant civilian employment.

The scheme effectively replaced the funded arrangement under the DFRB. The Jess Committee had recommended the move to pay benefits from Consolidated Revenue but, in first announcing the Government's decision to introduce the new scheme, the then Prime Minister, Mr W McMahon MP, stated that the fund would continue. The legislation passed under the Whitlam Government, however, reflected the original Jess Committee recommendation.

The maximum commutation factor was progressively increased from four to five times annual retirement pay over 1982 to 2002 to offset the impact of the 1983 concessional tax increases on lump sum eligible termination payments. The original intent of the commutation feature (in the DFRB Scheme) was to allow retiring ADF members to buy a home and the proposed use of the commutation funds had to be approved by the (DFRB) Authority. However, over time this requirement was dropped.

While those discharging with less than 20 years of service were ineligible for pensions and only received a refund of their contributions, they could also receive a small lump sum gratuity based on length of service.

The 1991 Cole Review, which led to the introduction of the MSBS, also led to a number of enhancements to the DFRDB scheme. These involved:

- formalisation of arrangements for accrual of the three 3% Productivity Benefit introduced from January 1988;
- annual CPI indexation for the lump sum component of orphans' and children's benefits;
- the introduction of a commutation option for dependent spouses on the death of a contributing member;

- changes to the calculation of benefits for re-entered DFRDB pensioners and a choice between resuming DFRDB membership or joining MSBS; and
- the cessation of DFRDB contributions on completion of 40 years service.

The DFRDB is a totally unfunded scheme. The compulsory member contribution of 5.5% of military salary is paid to Consolidated Revenue. The final defined benefit is paid out of Consolidated Revenue with the notional member contribution and the notional 3% Productivity benefit considered tax-paid for superannuation purposes. However, the majority of the benefit is considered untaxed and precludes members from receiving all the benefits of the new Better Super arrangements such as tax-free benefits after age 60.

The DFRDB scheme is closed to new members but currently has some 5500 contributors in service.

The MSBS

In May 1989, the then Minister for Defence Science and Personnel (Mr David Simmons) announced a review of the DFRDB Scheme. As part of the announcement, the Minister gave an 'ironclad guarantee' to serving members that existing DFRDB benefits would continue to be available to be taken up when they left the Services. A Review of the DFRDB Scheme was subsequently undertaken by a small team led by Sir William Cole and their report of 25 June 1990 (which became known as the Cole Report) concluded that the DFRDB Scheme was no longer appropriate for the majority of ADF members, particularly younger personnel, and did not adequately meet the ADF's personnel management objectives.

The Cole Report noted that the DFRDB Scheme was designed in a superannuation environment markedly different to that existing in 1990. Since 1983, major changes had been made to the regulatory system governing superannuation and taxation to encourage people to fund their own retirement and ease future demands on the social security system. These changes sought to establish the prime purpose of superannuation as providing for genuine retirement income. Additionally, DFRDB arrangements failed to meet the requirements of the Occupational Superannuation Standards (OSS) Act 1987 in several key areas such as returns on member contributions, the payment of commutable retirement pensions before age 55 and the structure of the DFRDB Authority.

The Cole Report's rationale for a totally new ADF superannuation and benefits scheme was based on the following deficiencies in the DFRDB Scheme with respect to OSS compliance:

- members who served for less than 20 years received no employer-financed benefit (unless they had reached retiring age for rank with at least 15 years service);
- the lack of any investment return on member contributions;
- payment of an employer benefit (pension) well before the age of 55 (in some cases retirement pay could commence at age 36 for former trade apprentices); and
- the substantial cost (and scheme design changes) required to overcome these compliance issues unless the Minister's 'ironclad guarantee' regarding the continuation of the extant DFRDB benefit structure were abrogated.

Cole also identified a problem with separation rates linked to the DFRDB Scheme design in that the retirement pension provision tended to cause very low separation rates in the 12-20 year service bracket, but created a dramatic peak after the 20 year point. This resulted in many experienced members leaving after 20 years service to access the lump sum available through commutation.

All DFRDB contributors had a one year window from 1 October 1991 to elect to transfer to the MSBS after the new scheme's introduction. On transfer, they received an (unfunded) member-financed benefit based on their contributions and notional interest at the long term bond rate. A notional employer-financed benefit was also determined based on their average salary and length of service.

95% of DFRDB members serving at the time made an election and 38,355 personnel (or 59% of electees) chose to transfer to the MSBS. This transfer figure represented 81% of (former DFRDB) members with less than ten years service, 41% in the 10-15 year bracket, 23% with 15-20 years service and 17% of members with more than 20 years.

MSBS became the compulsory superannuation scheme for all members joining the ADF from 1 October 1991. The scheme remains in force and is essentially a hybrid accumulation/defined benefit arrangement with the following key features:

- Compulsory member contributions (a minimum of 5% and maximum 10% of after tax salary) are invested in the MSBS accumulation fund with regular contributions and investment earnings added to the member balance via a unitised account system. Members may choose from a range of investment options.
- The member-financed benefit is payable only as a lump sum and all contributions and earnings from 1 July 1999 are subject to superannuation preservation requirements.
- The employer-financed benefit is a totally separate (largely unfunded) defined benefit which is calculated on a member's discharge according to length of service (based on multiples of 18% for the first seven years, 23% from 8-19 years and 28% for more than 20 years) and final average salary.
- The MSBS employer-financed benefit is subject to the preservation rules and can be taken either as a pension (indexed at CPI), a lump sum or a combination of both from the age of 55. The pension option is favourably priced.
- The death benefit for a contributory member is an immediate lump sum of the member component and an employer-financed lump sum based on prospective service to age 55. This lump sum can be converted on generous terms to an indexed pension to a surviving spouse with additional benefits for dependent children.
- The MSBS features a three-tiered invalidity benefit structure which is similar to the DFRDB arrangements.

The MSBS member contribution and consequent earnings are fully funded and taxed and may be withdrawn after preservation age and will now be tax-free after age 60. The employer component of the scheme is unfunded and untaxed except for the notional value of the 3% Productivity element. This increases at the MSBS default investment choice earning rate. The employer-financed defined benefit is paid out of Consolidated Revenue with the 3% Productivity benefit element considered to be a taxed benefit. However, the majority of the benefit is considered untaxed and precludes members from receiving all the benefits of the new Better Super arrangements such as tax-free benefits after age 60.

Appendix F. International military scheme comparison

High level summary of Foreign National Military superannuation arrangements*

Scheme design features	USA	UK	Canada	NZ
Defined Contribution or Defined Benefit	DB	DB	DB	DC
Funded	No	No	No	Yes
Compulsory Membership	Yes after 15 years of service	Optional. Automatic member unless opt-out, with one opportunity to re-join.	Yes	Yes
Member Contribution	No	No	4.6% of pensionable earnings, rising to 6.4% by 2013. Reduces by 1% after age 35.	7.6% of annual salary
Employer Contribution	N/A	N/A	N/A	17.9% of salary
Retirement Pay	No benefit for less than 15 years of service (social security payable only). After 20 years of service, up to 75% of average basic pay (for highest 36 months of member's career) payable without preservation with a limited commutation option.	Indexed pension from age 55 equal to 1/70th times years of service times FAS plus a tax-free lump sum of 3 times annual pension (convertible to additional pension).	Indexed pension from age 60 equal to 2% times pensionable service times average earnings. Non-indexed pension to age 60 is also payable after 25 years of service.	Lump sum amount payable on leaving the NZDF or in the event of death or TPD.
Indexation	Cost of living adjustment.	Retail Price Index adjustment.	Consumer Price Index adjustment.	N/A

* Not including death and disability provisions

Appendix G. Australian 'Uniformed Bodies' scheme comparison

High level summary of selected Australian 'Uniformed Bodies' superannuation schemes

Name	DB/DC Name of Plan	Taxed	Funded	Member contributions	Employer contributions for DC plans	Defined benefit scale for DB plans	Additional employer sponsored insurance	Choices
Australian Federal Police	DC - PSSap	Yes	Yes	Optional	15.4%	N/A	Nil	Investment and insurance
NSW Police	DC – Police Blue Ribbon Superannuation (re-badged FSS)	Yes	Yes	Optional	9%	N/A	Nil – other benefit paid outside superannuation	Investment and insurance
Vic Police	DB – ESSS defined benefit	Yes	Yes	Optional (rates of contribution 0%, 3%, 5%, 6% and 7%)	N/A	8.5% to 25% depending on level of member contribution	Based on DB	Member contributions rate only
Qld Police	DB – QSuper defined benefit account or	Yes	Yes	Compulsory (rates of contribution 3%, 4%, 5% and 6%)	N/A	14% to 24.5% depending on level of member contribution	Based on DB	Choice of DB or DC and member contribution rate only
	DC – QSuper accumulation account	Yes	Yes	Compulsory (rates of contribution 3%, 4%, 5%, and 6%)	Between 12% and 18% depending on level of member contribution	N/A	Nil	As above, and investment and insurance

Appendix H. Financial implications

Australian Government

Australian Government Actuary

MILITARY SUPERANNUATION REVIEW - ACTUARIAL REPORT

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INTRODUCTION

The Australian Government Actuary (AGA) has been asked to prepare a brief report on the costs associated with changes to military superannuation arrangements as recommended by the Military Superannuation Review Team (Review Team). This report has been requested by the Review Team for inclusion in their report putting forward their recommended changes.

The time allocated to the Review Team to consult and recommend changes was fairly tight. We have provided the Review Team with information and costings as required over the last three months to assist the Review Team in forming an in principle approach and then reaching a final position. This report does not seek to cover the full range of advice that was provided. Rather, it summarises most of the elements of our advice which are relevant to the final position reached by the review team. As costings have been provided over a period of time, the costs provided in this report do not tie in exactly with the final recommendations. However, the differences are minor and commentary has been provided on the extent of the differences.

I believe that the advice that we have provided to the Review Team is such that the Review Team can make properly informed decisions about their recommendations. However, it should be noted that given the fairly tight time frame allocated to the Review Team, the Review Team has concentrated on the major structural changes, benefits and conditions that would apply to the vast majority of Defence personnel. If a decision is made to proceed with some or all of the Review Team's recommendations, many decisions on the detailed implementation of the recommendations will still need to be made. Examples include the treatment of individuals that have been subject to a Family Law superannuation split and the detailed design, implementation and pricing of the 'actuarially fair' pension option.

The costings were based on data as at 30 June 2006 and it was assumed that changes were implemented as at 30 June 2006. It is not known what date, if any, will be the implementation date for some, or all, of the recommended changes. However, given that a decision needs to be made on major structural changes followed by many decisions on detailed implementation which would then be followed by changes to legislation, changes to administrative systems, preparation of individual transfer offer material and associated communication material, I consider an implementation date of 1 January 2009 optimistic but achievable if everything goes smoothly. The main features disclosed by our costings would still be present if the implementation date were in 2009. We have included further commentary in the report on a later implementation date.

While this report will form part of the Review Team's report, its presence should not be taken as our endorsement of the Review Team's recommendations or otherwise. The recommendations of the Review Team are theirs and theirs alone. We know that the Review Team has consulted with many parties in forming their recommendations and these parties include the AGA.

PROPOSED NEW ACCUMULATION ARRANGEMENT, PRIORITY CHANGES TO MSBS AND DFRDB AND TRANSFER TERMS FROM MSBS AND DFRDB

- *Proposed new Accumulation Arrangement*

A brief summary of the main elements of the proposed new accumulation arrangement is set out below:

- Employer contributions

  16% of superannuation salary for the first 6 years
  23% of superannuation salary for the next 9 years
  28% of superannuation salary thereafter.

Superannuation salary is the same salary definition as is currently used for MSBS.

In addition to the contributions referred to above, the employer:

- will cover the administration costs of the new accumulation arrangement;
- provide separate death and invalidity cover.

Members will be able to choose the level (if any) of their contributions. There will be a default contribution rate of 5% of superannuation salary for those who do not nominate a contribution level.

- *Priority Changes to DFRDB and MSBS from the Superannuation Review*

The Review Team recommended a central package of what it termed priority changes. This package does not include any changes to the DFRDB. There is, however, a lower ranking recommendation to improve indexation of DFRDB (including DFRB) pensions. This has not been included in our main costings but has been considered separately.

With the MSBS, there are no substantial priority changes to benefits and conditions. The first significant priority change contemplated is to abolish the MBLs. The costings assume this improvement applies retrospectively to serving members at the implementation date.

The second significant priority change is to the salary definition used for death, invalidity A and invalidity B benefits. The change is that these benefits will be calculated using final superannuation salary rather than final average superannuation salary. This change has not been included in any costings that incorporate changes. If this change went ahead there would be a very small increase in accrued (and unfunded) MSBS liabilities and an increase in the MSBS notional employer cost of about 0.2% to 0.3% of MSBS superannuation salaries. Given that few MSBS contributors are likely to remain after the transfer offer, the impact on the overall notional employer cost is likely to be small.

- Transfer Arrangements for MSBS and DFRDB

Non-pensioner members of DFRDB and MSBS would be offered a one off opportunity to transfer to the new accumulation arrangement.

A brief summary of the recommended transfer terms for MSBS members is set out below:

- *Preserved Members*

The transfer value would be the nominal (or face) value of the Preserved Benefit. This would include any member component and the employer component.

- *Contributors*

The transfer value for contributors would be the nominal (or face) value of the accrued benefits in MSBS. That is, it would be:

- Member account; plus
- Accrued employer multiple X Final Average Salary.

In brief, the conceptual approach taken for DFRDB contributors is to assume a 'de facto' transfer to MSBS in 1991 followed by a transfer to the accumulation arrangement. This results in a transfer value of:

- Member contributions plus interest at the 10 year Commonwealth Bond rate; plus
- Accrued MSBS multiple X Final Average Salary (FAS).

The accrued MSBS employer multiple would be calculated assuming the individual had transferred to the MSBS, that is, 18% for the first 7 years, 23% for the next 13 years and 28% thereafter.

Note that the terms would be different where special situations are involved, for example, for re-entered recipients or where benefits have been subject to a Family Law split.

DATA

The data used for the costings is data as at 30 June 2006. Rough checks against the data used for the Long Term Cost Report as at 30 June 2005, along with Defence payroll information and ComSuper pension payroll information at 30 June 2006 indicate that it is suitable for the current costings.

A summary of the data as at 30 June 2006 is set out below:

Contributors	Number	Superannuation Salary $m
MSBS	45,151	2,442
DFRDB	6,265	452
Preserved Members		**Nominal Value of Benefits $m**
MSBS	61,818	3,647
Pensioners		**Annual Pension $m**
MSBS	5,915	105
DFRDB	56,557	1,150

CURRENT POSITION

We have prepared projections to 2045 on the same assumptions as were used for the Long Term Cost Report as at 30 June 2005. The projected outlays and unfunded liabilities have been calculated in the same way as for the Long Term Cost Report as at 30 June 2005. In particular, we have assumed unaltered MBLs for MSBS. These projections assume that combined contributory membership of DFRDB and MSBS stays constant. That is, every contributor exit from DFRDB and MSBS is replaced by a new member of MSBS. A copy of the Long Term Cost Report as at 30 June 2005 can be accessed at www.aga.gov.au/publications.

The table below shows projected Commonwealth cash outlays and the notional employer cost for each year until 2009/10 and then for every fifth year thereafter. The notional employer cost is the cost as a percentage of total superannuation salaries of benefits accruing each year to serving Defence Force personnel.

PROJECTED COMMONWEALTH OUTLAYS AND NOTIONAL EMPLOYER COSTS (CURRENT ARRANGEMENTS)

Year	MSBS ($'m)	DFRDB ($'m)	Total ($'m)	Notional Employer Cost %
2006/07	264	1,314	1,578	25.6
2007/08	252	1,347	1,599	25.8
2008/09	276	1,384	1,659	25.7
2009/10	292	1,416	1,708	25.7
2014/15	469	1,532	2,001	25.2
2019/20	752	1,608	2,360	25.1
2024/25	1,226	1,636	2,861	25.1
2029/30	1,801	1,621	3,423	25.2
2034/35	2,576	1,577	4,153	25.3
2039/40	3,607	1,473	5,079	25.3
2044/45	4,769	1,304	6,074	25.4

* Note that components may not add up to total due to rounding.

It should be noted that the projections are in nominal dollars. That is, they have not been discounted to give a 2006 value.

The table below shows projected unfunded liabilities for each year to 2010 and every fifth year thereafter.

PROJECTED UNFUNDED LIABILITIES (CURRENT ARRANGEMENTS)

Year ending 30 June	MSBS ($'m)	DFRDB ($'m)	Total ($'m)
2006	9,637	23,623	33,261
2007	10,548	23,824	34,372
2008	11,569	23,997	35,566
2009	12,669	24,130	36,799
2010	13,864	24,223	38,088
2015	21,149	24,166	45,315
2020	30,877	23,305	54,182
2025	43,161	21,790	64,951
2030	58,057	19,701	77,758
2035	76,216	17,077	93,293
2040	97,645	14,019	111,664
2045	122,906	10,748	133,654

* Note that components may not add up to total due to rounding.

The projections of cash flows and unfunded liabilities are similar to those from the Long Term Cost Report as at 30 June 2005. This is to be expected.

TRANSFER ASSUMPTIONS

The take up rates of the transfer offer are subject to significant uncertainty. Past experience with the closure of DFRDB and its civilian equivalent, the CSS, where there were options to transfer to MSBS and its civilian equivalent, the PSS indicated that most individuals made sensible decisions about whether to transfer or remain. That is, most individuals made the decision that was to their advantage. However, it appears that there were some individuals who, with the benefit of hindsight, made decisions that were not to their eventual advantage. Some individuals also seem to have made poor decisions, possibly related to apathy or mistrust of the Commonwealth's motives.

In setting transfer assumptions we have had regard to the following:

- MSBS pension option. The ability to convert the MSBS employer component into pension on very favourable terms is an argument for remaining in MSBS.

- Member contributions. The new accumulation arrangement does not require the payment of member contributions whereas MSBS and DFRDB do. If no member contributions are paid there would be a significant increase in take home pay and this is an argument for transferring.

- MSBS Preserved Benefit. The current MSBS preserved benefit is widely disliked because the majority of the benefit is only indexed in line with CPI and it cannot be transferred to another superannuation scheme. Given that most MSBS contributors leave well before age 55 and hence will be preserved beneficiaries for an extended period, this is likely to result in more transfers.

- Future investment returns. The estimated cost of the new accumulation arrangement is at a similar level to the assessed cost of the MSBS. The assessed cost of the MSBS was derived using an interest rate of 6% per annum. To the extent that future investment returns could be expected to be greater than 6% per annum, the expected benefits from the new accumulation arrangement could be expected to be higher. There is a reasonable expectation that future investment returns will be higher than 6% per annum and this will make transferring more likely to be attractive. The recent history of very good investment returns may play a part in individuals' decisions.

- Death and invalidity cover. The new arrangements have a very different structure from the current arrangements. Existing contributors may have trouble understanding all the implications of the new arrangements and may treat them with suspicion. This makes transferring less attractive.

- Tax status. With the new 'simpler super' arrangements, benefits from the new arrangements will be tax free after age 60 and this may be attractive. However, it should be noted that the unfunded part of the transfer will be subject to 15% contribution tax on transfer.

- Inertia and suspicion of Commonwealth's motives. These factors will be present.
- Comprehension and community norms. The accumulation part of the arrangement is easier to understand. Accumulation arrangements are now the community norm and the new arrangements are well in excess of the 9% standard employer contribution rate. This may make transferring more attractive.
- Different accrual patterns. The jumps in contribution rates occur earlier with the new accumulation arrangement than the corresponding jumps in the MSBS accrual rates. This may make transferring more attractive.

\- *Contributor Assumptions*

The decision to transfer or remain will depend on individual circumstances and preferences. However, overall, I believe that the transfer offer will be very attractive to younger MSBS contributors. The transfer offer will be far less attractive to older contributors intending to take the MSBS pension.

I believe that the transfer option for DFRDB contributors will only be attractive in very limited circumstances and there will be a very low take up rate.

We have prepared costings on two different sets of assumptions for MSBS. The first assumes that decisions are mainly based on rational factors and that inertia and suspicion only plays a small part in the process. This results in a high level of transfer. These (high transfer) assumptions are set out below:

Age	**Other Ranks**			**Officers**		
	Short %	**Medium %**	**Long %**	**Short %**	**Medium %**	**Long %**
To 24	90	90	90	90	90	90
25 – 29	90	90	90	90	90	90
30 – 34	90	90	90	90	90	90
35 – 39	85	85	75	75	75	50
40 – 44	60	60	50	40	40	40
45 – 49	40	40	40	25	25	25
50 or more	40	40	40	25	25	25

Short service is up to 10 years; medium service 10 to 18 years; long service is 18 years or more

Following the transfer offer any individual remaining in the MSBS is assumed to convert all the employer component into pension on eventual retirement at age 55.

The second set assumes that inertia and suspicion plays a greater role in the process. This results in a lower level of transfer. These (low transfer) assumptions are set out below:

Age	Other Ranks			Officers		
	Short %	Medium %	Long %	Short %	Medium %	Long %
To 24	70	70	70	70	70	70
25 – 29	70	70	70	70	70	70
30 – 34	70	70	70	70	70	70
35 – 39	65	65	60	55	55	45
40 – 44	50	50	45	30	30	30
45 – 49	30	30	30	20	20	20
50 or more	30	30	30	20	20	20

Short service is up to 10 years; medium service 10 to 18 years; long service is 18 years or more

Following the transfer offer any individual remaining in the MSBS who was aged 40 or more at the transfer offer date is assumed to convert 90% of the employer component into pension on eventual retirement at age 55 and take the remainder in lump sum form. An individual remaining in the MSBS who was aged 39 or less at the transfer date is assumed to convert 60% of the employer component into pension.

- *DFRDB Contributors*

I believe that the transfer option will be unattractive to virtually all DFRDB contributors. We have assumed that only 5% of DFRDB contributors transfer. It definitely would not surprise me if this assumption turned out to be too high.

- *MSBS Preserved Members*

As with MSBS contributors, we have used two sets of assumptions. The first set is deliberately conservative, assuming sensible decision making, and results in high transfer levels which leads to higher costs. This set of assumptions is set out below:

Transfer Assumptions (High)		
Age	Other Ranks %	Officers %
34 and under	100	100
35 – 39	100	100
40 – 44	100	100
45 – 49	30	20
50 and over	30	20

All of those that remain in the MSBS are assumed to take the employer component in pension form on retirement at age 55.

The second set of assumptions assumes considerable inertia and lower take up rates. These assumptions are set out below:

Transfer Assumptions (Low)		
Age	Other Ranks %	Officers %
34 and under	65	65
35 – 39	60	45
40 – 44	45	30
45 – 49	30	20
50 and over	30	20

The assumed pension take up rates for the employer component for those who remain in MSBS are:

- Transfer age 39 or less 60% pension, 40% lump sum.
- Transfer age 40 or more 90% pension, 10% lump sum.

IMMEDIATE IMPACTS OF THE TRANSFER OFFER

If the transfer offer had taken place as at 30 June 2006, then, on the assumptions made, there would be a number of significant immediate impacts which are set out below:

- *Membership*

Membership numbers in MSBS and DFRDB would be expected to fall.

		High Transfer Assumptions		Low Transfer Assumptions	
	Number at 30 June 2006	Transfer	Remain	Transfer	Remain
MSBS contributors	45,151	37,424	7,727	29,121	16,030
MSBS preserveds	61,818	57,878	3,940	35,448	26,370
DFRDB contributors	6,265	313	5,952	313	5,952

- *Commonwealth Cash Expenditure*

Significant Commonwealth cash expenditure would be required because the DFRDB and MSBS are largely unfunded. This is particularly the case in respect of the MSBS where transfer option will be attractive for many individuals.

	High Transfer Assumptions	Low Transfer Assumptions
	Unfunded Component $bn	**Unfunded Component $bn**
MSBS contributors	2.5	1.9
MSBS preserveds	2.5	1.5
DFRDB contributors	0.1	0.1
Total	**5.1**	**3.5**

Thus, immediate additional Commonwealth cash expenditure associated with the transfer is estimated to be of the order of $4bn to $5bn. Note that the Commonwealth would get a taxation receipt associated with this due to the 15% tax on the unfunded component of the transfer value when it is paid.

- *Accrued (unfunded) Liability Impacts*

The immediate impact on the accrued liability (and unfunded liability once a decision is made but before funding for the transfer values occurs) is as follows:

	High Transfer Assumptions	Low Transfer Assumptions
	Increase in Accrued Liability $m	**Increase in Accrued Liability $m**
MSBS contributors	-483	-448
MSBS preserveds	378	268
DFRDB contributors	-60	-60

Overall, there is a decrease in accrued liabilities of around $200m.

Some care needs to be taken in interpreting these figures. Other things being equal, it would be expected that if it is attractive to transfer then the benefit being paid on transfer would be higher than the actuarial value of the existing accrued benefit. That is, individuals would be expected to choose the option which benefits them most, which is normally the one that costs the employer most. Thus, the total liability would be expected to be higher after transfer. For MSBS preserved beneficiaries, this is the result. For MSBS contributors, however, the liability has reduced.

I regard part of the reduction shown for MSBS contributors as being a genuine feature. This is because many individuals will make sensible decisions to transfer based on factors other than actuarially assessed costs of the two alternatives.

I also regard part of the reduction as being what could be argued to be a change in 'accounting treatment'. The current actuarial valuation method for the MSBS calculates accrued employer benefits on a pro rata basis. To explain this, consider an individual who currently has 5 year membership and a retirement benefit that is expected to be payable after 20 years membership. The MSBS employer multiple after 20 years is calculated as

$$7 \times 18\% + 13 \times 23\% = 4.25 \times \text{Final Average Salary}$$

Using the pro rata approach the accrued amount is:

$$\frac{5}{20} \times 4.25 = 1.0625 \times \text{Final Average Salary}$$

When calculating the transfer value, a scheme multiple accrual approach is used. Under this approach the transfer value for the employer component would be calculated as

$$5 \times 18\% = 0.90 \times \text{Final Average Salary}$$

POSITION AFTER TRANSFER OFFER

We have prepared projections to 2045 following the changes.

The projected unfunded liabilities are set out below:

PROJECTED UNFUNDED ACCRUED MSBS AND DFRDB LIABILITIES (NEW ARRANGEMENTS)

	High Transfer Assumptions			Low Transfer Assumptions		
Year ending 30 June	**MSBS ($'m)**	**DFRDB ($'m)**	**Total ($'m)**	**MSBS ($'m)**	**DFRDB ($'m)**	**Total ($'m)**
2006	4,523	23,417	27,940	6,042	23,417	29,460
2007	4,774	23,607	28,380	6,454	23,607	30,060
2008	5,043	23,769	28,812	6,891	23,769	30,661
2009	5,314	23,893	29,207	7,335	23,893	31,228
2010	5,589	23,978	29,567	7,790	23,978	31,768
2015	6,907	23,892	30,799	10,089	23,892	33,981
2020	8,014	23,019	31,033	12,312	23,019	35,330
2025	8,826	21,500	30,326	13,873	21,500	35,373
2030	9,275	19,412	28,687	14,764	19,412	34,176
2035	9,377	16,798	26,174	15,095	16,798	31,893
2040	9,050	13,762	22,811	14,568	13,762	28,330
2045	8,180	10,526	18,706	13,337	10,526	23,863

* Note that components may not add up to total due to rounding.

The projected Commonwealth cash flows are set out below for the high transfer assumptions. The notional employer cost as a percentage of total Defence superannuation salaries is also given.

PROJECTED COMMONWEALTH CASHFLOWS AND NOTIONAL EMPLOYER COSTS (NEW ARRANGEMENTS – TRANSFER OPTION) HIGH TRANSFER ASSUMPTIONS

Year	MSBS ($'m)	DFRDB ($'m)	New Accumulation ($'m)**	Total ($'m)	Notional Employer Cost %
2006/07	154*	1,306*	488	1,949*	26.6
2007/08	146	1,339	527	2,012	26.5
2008/09	153	1,374	571	2,097	26.3
2009/10	159	1,405	616	2,181	26.1
2014/15	222	1,518	859	2,599	25.3
2019/20	306	1,592	1,125	3,024	25.1
2024/25	401	1,619	1,410	3,430	25.1
2029/30	491	1,604	1,733	3,828	25.1
2034/35	564	1,558	2,116	4,238	25.1
2039/40	638	1,452	2,572	4,663	25.0
2044/45	697	1,283	3,130	5,110	25.0

* 2006/07 figures do not include transfer values of $5.1 billion.

** includes an allowance of 3.8% of superannuation salary for new accumulation members for death and invalidity cover. (MSBS and DFRDB figures include death and invalidity benefits.)

Note that components may not add up to total due to rounding.

The projected Commonwealth cash flows are set out below for the low transfer assumptions together with the notional employer cost as a percentage of total Defence superannuation salaries.

PROJECTED COMMONWEALTH CASHFLOWS AND NOTIONAL EMPLOYER COSTS (NEW ARRANGEMENTS – TRANSFER OPTION) LOW TRANSFER ASSUMPTIONS

Year	MSBS ($'m)	DFRDB ($'m)	New Accumulation ($'m)**	Total ($'m)	Notional Employer Cost %
2006/07	178*	1,306*	382	1,866*	26.0
2007/08	168	1,339	422	1,928	25.9
2008/09	177	1,374	466	2,016	25.6
2009/10	183	1,405	513	2,101	25.3
2014/15	256	1,518	770	2,545	24.7
2019/20	372	1,592	1,053	3,018	24.6
2024/25	627	1,619	1,359	3,606	24.8
2029/30	741	1,604	1,705	4,050	25.0
2034/35	892	1,558	2,103	4,552	25.0
2039/40	1,037	1,452	2,570	5,059	25.0
2044/45	1,052	1,283	3,130	5,465	25.0

* 2006/07 figures do not include transfer values of $3.5 billion.

** includes an allowance of 3.8% of superannuation salary for new accumulation members for death and invalidity cover. (MSBS and DFRDB figures include death and invalidity benefits.)

Note that components may not add up to total due to rounding.

The tables above incorporate an allowance of 3.8% of superannuation salaries for the new accumulation arrangement for the employer provided separate death and invalidity cover. It is intended that the invalidity cover arrangements would be integrated with workers compensation arrangements. The 3.8% allowance is the cost of current MSBS death and invalidity insurance cover if it applies to the combined MSBS and DFRDB contributors.

We tried to estimate the costs of the new combined superannuation and workers compensation cover compared to the existing combined superannuation and workers compensation cover. We found that the data available was not sufficiently reliable to enable robust costings to be made. However, rough reasonableness type checks and general logic suggest that the combined costs of the new arrangements would be less than the combined cost of the existing arrangements. The difference could be of the order of about 0.5% of superannuation salaries for the individuals covered by the new arrangements but is highly uncertain. We thus believe that the use of a 3.8% allowance is conservative and probably slightly overstates costs for comparison purposes.

The details of the death and invalidity cover arrangements are still to be decided, including the financing mechanism. For the projections we have assumed that the equivalent element to the existing MSBS cover is pre-funded using an employer contribution of 3.8% of superannuation salaries of the individuals in the new accumulation arrangement. If the arrangement is not pre-funded (that is, operates on an unfunded or pay-as-you-go basis) then Commonwealth cash outlays will be lower, particularly in the early part of the projection period, but Commonwealth unfunded liabilities will be higher.

COMMENTS ON THE PROJECTIONS INCORPORATING PROPOSED NEW ARRANGEMENTS

Note that the projections have only looked at the direct costs of the schemes. We have not attempted to incorporate tax and social security effects. These are very difficult to incorporate as they depend on individual circumstances, tax rates and social security rules over a long time frame. However, given that the Commonwealth has broadly tried to maintain consistency of tax impacts and social security impacts between unfunded and funded superannuation arrangements, it would be expected that tax and social security effects should roughly even out in the long term between the two types of arrangements. Accordingly, considering the notional employer costs of the respective arrangements is probably the best cost comparison available.

The new arrangements have little effect on projected employer cashflows and unfunded liabilities for DFRDB. This is mainly because most of these are locked in as they are attributed to current pensioners who will not be offered any option to transfer. I expect the transfer offer made to DFRDB contributors will not appear attractive and I anticipate a low take up rate of the offer.

There is a substantial reduction in projected unfunded liabilities for MSBS. This is partly due to the initial transfer. Going forward, the level of ongoing accruals for MSBS contributors is also greatly reduced as there will be far fewer contributors following transfer. The remaining MSBS contributors will gradually exit over the next thirty to forty years. The employer cashflows for MSBS are noticeably reduced in the short term with the reductions becoming much more significant as time goes on.

Overall employer cashflows are much higher. This starts with the initial transfers of about $4bn to $5bn. In the near to medium term, employer cashflows are about 15% to 25% larger than currently which is about $300m to $400m per annum in the near term. This relative increase in employer cashflows only starts reducing after about 15 years and it takes about 30 to 35 years before the annual employer cashflows are similar to those projected for the current arrangements. Thereafter, annual employer cashflows are lower than for the current arrangements.

Overall, when the accrued liability position and projections of notional employer cost are taken into account, I am of the view that the assessed cost of the current arrangements and the proposed new arrangements are not dissimilar.

The figures in this report have been based on data as at 30 June 2006 and assume that any transfers from MSBS and DFRDB happen on 30 June 2006. I believe that they are appropriate to enable decisions to be made. In practice, the transfer will not take place for some time, quite possibly not until 2009. The key features disclosed by the projections using a transfer date of 30 June 2006 will still be present if the transfer date were in 2009. These key features are:

- the notional employer cost under the proposed new arrangements is similar to the current arrangements. The current annual superannuation cost to Defence for accruing benefits is of the order of $750m (26% of $2.9bn superannuation salaries);
- unfunded liabilities initially fall somewhat, but decline dramatically towards the end of the projection period;
- annual Commonwealth cash expenditure is about 15% to 25% higher for about 15 years, with the margin reducing to be about breakeven after 30 to 35 years before moving to some savings relative to the current position after that;
- accrued liabilities will be of the same order; and
- there is a large amount of immediate Commonwealth cash expenditure associated with the transfer.

The most noticeable change associated with deferral of the transfer date to, say, 2009 is that the immediate cash expenditure will be larger. I estimate that it will have grown to approximately $7bn to $8bn compared to around $5bn as at 30 June 2006 on the high transfer assumption. There are two main reasons for the increase. The first and more significant is that serving MSBS contributors will accrue further unfunded benefits during this period. The second effect is that the transfers will be in 2009 dollar terms not in 2006 dollar terms. That is, inflation means that the amount expressed in nominal dollars will be higher.

CLOSURE OF MSBS TO NEW MEMBERS WITH NO TRANSFER OFFER

For reference, we have prepared projections to 2045 assuming the MSBS was closed to new entrants as at 30 June 2006. Existing members of the MSBS and DFRDB would not be offered the opportunity to transfer to the new accumulation arrangement. That is, these individuals would remain in the MSBS and DFRDB respectively.

The recommended changes to the MSBS MBL arrangements have been incorporated in these projections. The recommended changes to the MSBS salary definition used for death, invalidity A and invalidity B benefits have not been incorporated into these projections. If this latter recommendation is implemented, the cost shown in the projections will be slightly understated.

The projected unfunded liabilities are set out below:

PROJECTED UNFUNDED ACCRUED MSBS AND DFRDB LIABILITIES (CLOSURE OF MSBS TO NEW ENTRANTS – NO TRANSFER OPTION)

Year ending 30 June	MSBS ($'m)	DFRDB ($'m)	Total ($'m)
2006	9,718	23,623	33,342
2007	10,632	23,824	34,456
2008	11,599	23,997	35,596
2009	12,582	24,130	36,712
2010	13,596	24,223	37,820
2015	18,868	24,166	43,034
2020	24,386	23,305	47,691
2025	29,602	21,790	51,392
2030	33,677	19,701	53,378
2035	36,322	17,077	53,399
2040	36,692	14,019	50,711
2045	35,205	10,748	45,953

* Note that components may not add up to total due to rounding.

The projected Commonwealth cash flows and the notional employer costs as a percentage of total Defence superannuation salaries is set out below:

PROJECTED COMMONWEALTH CASHFLOWS AND NOTIONAL EMPLOYER COSTS (CLOSURE OF MSBS TO NEW ENTRANTS – NO TRANSFER OPTION)

Year	MSBS ($'m)	DFRDB ($'m)	New Accumulation ($'m)**	Total ($'m)	Notional Employer Cost %
2006/07	266	1,314	3	1,583	25.7
2007/08	246	1,347	44	1,637	25.1
2008/09	262	1,384	92	1,738	24.5
2009/10	268	1,416	145	1,830	24.1
2014/15	391	1,532	458	2,381	23.6
2019/20	592	1,608	802	3,003	23.8
2024/25	943	1,636	1,184	3,762	24.2
2029/30	1,326	1,621	1,608	4,556	24.7
2034/35	1,791	1,577	2,058	5,426	25.0
2039/40	2,280	1,473	2,561	6,313	25.0
2044/45	2,414	1,304	3,130	6,848	25.0

** includes an allowance of 3.8% of superannuation salary for new accumulation members for death and invalidity cover. (MSBS and DFRDB figures include death and invalidity benefits.)

Note that components may not add up to total due to rounding.

AWOTE INDEXATION OF DFRDB PENSIONS

The Review Team has recommended AWOTE indexation (or something similar) of DFRDB pensions. This is a lower priority recommendation. The main lower priority recommendation is AWOTE indexation of pensions after age 55 but with only CPI indexation applying before age 55. A possible variation is AWOTE indexation of pensions after age 65 but with only CPI indexation applying before age 65. The impacts of these improvements are set out below.

- *Unfunded Liability*

The following table shows the impact of the various AWOTE indexation proposals if they had been implemented as at 30 June 2006.

	Unfunded DFRDB Liability ($bn)	**Increase in Unfunded Liability ($bn)**
Current arrangement	23.6	0.0
AWOTE indexation from age 65	26.2	2.6
AWOTE indexation from age 55	27.8	4.2

- *Notional Employer Contribution Rate*

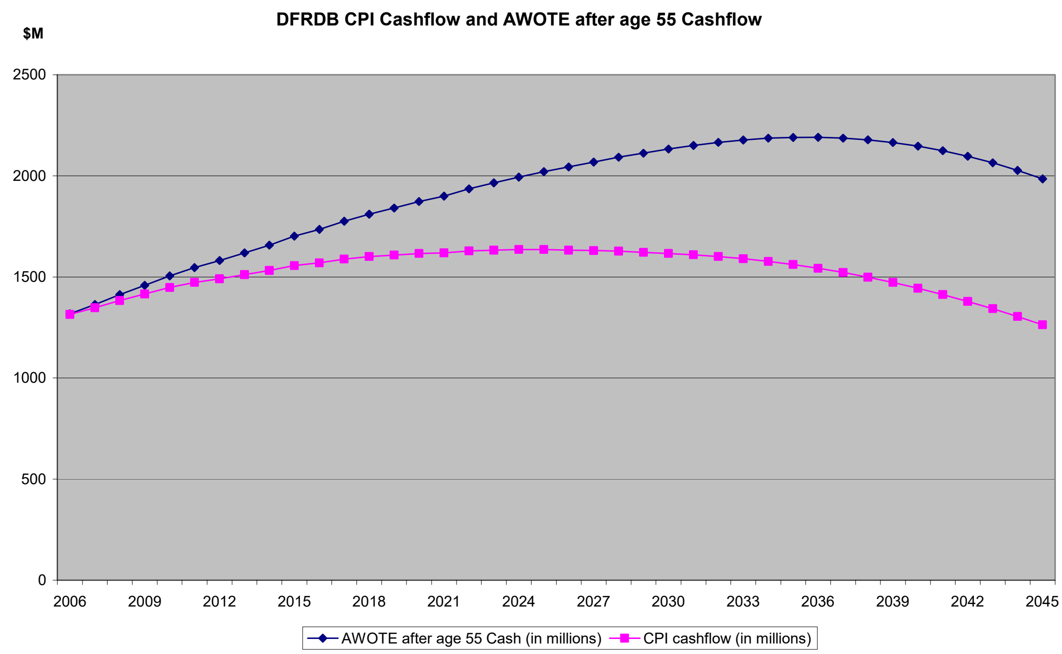
The effect on the notional employer contribution rate from the various AWOTE indexation proposals if they had been implemented as at 30 June 2006 is as follows:

	DFRDB Notional Employer Contribution Rate %	**Increase as a Percentage of DFRDB Superannuation Salaries %**
Current arrangement	33.5	0.0
AWOTE indexation from age 65	36.7	3.2
AWOTE indexation from age 55	38.9	5.4

If the age 65 AWOTE indexation proposal had been implemented as at 30 June 2006, the additional notional employer cost in 2006/07 would have been about $14m which is about 0.5% of total Defence superannuation salaries. If the age 55 AWOTE indexation proposal had been implemented as at 30 June 2006, the additional notional employer cost in 2006/07 would have been about $23m which is about 0.8% of total Defence superannuation salaries. These costs as a percentage of total Defence superannuation salaries would quickly diminish as DFRDB contributors exited service.

- *Additional Cash Expenditure*

The chart below shows the expected additional cash expenditure had the age 55 AWOTE changes been introduced with effect from 2006/07.



- *Comments on Results*

It can be seen from the above that any move to AWOTE indexation for DFRDB is an expensive benefit improvement. While additional Commonwealth cash expenditure in the first few years after any change would be relatively small, the additional amount of cash expenditure would continue to increase for a long time and become very noticeable. Extra cash expenditure would peak in about 40 years time in nominal dollars. The peak extra annual expenditure in nominal dollars would be about $700m (at that stage, around 50% higher than current projected outlays) for the AWOTE from age 55 improvement and about $500m for the AWOTE from age 65 improvement.

A deferral of implementation to 2009/10 would slightly reduce the additional Commonwealth cash expenditure and costs in real terms.

SUPERANNUATION GUARANTEE ARRANGEMENTS – ORDINARY TIME EARNINGS

Defence has to ensure that it complies with the minimum Superannuation Guarantee (SG) requirements in relation to its employees. For the new scheme, this requirement extends to the use of Ordinary Time Earnings (OTE) for the purposes of assessing SG compliance.

At the present time, the existing schemes are deemed to have 'protected earnings bases'. This means that compliance with SG can be assessed in relation to superannuation salary. From 1 July 2008, protected earnings bases will be removed for all defined benefits funds and compliance will be assessed in relation to Ordinary Time Earnings (OTE). Changes to the SG regulations and, consequently, updating of Institute of Actuaries of Australia Guidance Notes in relation to SG compliance are still to occur.

The use of OTE for SG compliance has the potential to cause significant compliance issues for Defence as well as possibly requiring benefit improvements in some circumstances. This is despite the fact that the overall level of employer superannuation support is, by community standards, generous.

In undertaking these costings, we have assumed that compliance will be achieved without any substantial increase in costs (either direct or administrative costs). The following discussion sets out the issues.

The first issue is that there is no real concept of Ordinary Time for Defence Force personnel. Technically, Defence Force personnel are on duty 24 hours a day.

The second issue is that Defence Force pay and allowances are complex and cover a myriad of situations. We have received advice from the Australian Taxation Office (ATO) that many of the special payments for military personnel which do not fall under the current definition of superannuation salary will form part of OTE. While the ATO's views may be technically correct, I would regard some of the items included in OTE being far from ordinary from a common sense perspective. For instance, according to ATO advice, deployment allowances paid tax free are regarded as being part of OTE.

The third issue is that special payments can be large and lumpy (only payable for a relatively short period of time or in a single lump sum) and, as a result, they could cause the standard employer contribution to the new accumulation arrangement to be insufficient to meet minimum SG requirements from time to time. In many cases, the top up contributions are likely to be small because there is a maximum salary that is used for measuring SG compliance. For 2007/08 the maximum quarterly earnings base for SG is $35,470. Note that although the individual may have received significantly in excess of the minimum SG requirements for most of the period of employment, those excesses cannot be used to offset the requirement to pay more in financial quarters where large amounts of special payments are made.

Given the complexity of Defence arrangements, it would be very helpful for there to be some form of guidance (which may need to be legislated) to clarify what constitutes OTE for Defence Force personnel. For a sensible outcome, it will be important that this guidance takes a common sense approach. For example, the Government could deem that the schemes automatically meet minimum SG requirements given the overall generous level of benefits provided.

M. D. Burt

Michael Burt
Fellow of the Institute of Actuaries of Australia
30 July 2007

Attachment: Letter from Minister Assisting the Minister for Defence

THE HON BRUCE BILLSON MP
Minister for Veterans' Affairs
Minister Assisting the Minister for Defence

Mr Brian Paule
Director General Defence Superannuation
1 Thynne Street
BRUCE ACT 2617

Dear ~~Mr Paule~~ Brian,

Recent legislative changes have been introduced into Parliament that seek to enhance and streamline the consideration of the granting or continuation of Department of Veterans' Affairs (DVA) Service Pensions for individuals remanded in custody by Federal or State/Territory authorities. In essence, provision currently exists for the suspension or refusal of such pensions once individuals are convicted.

As discussed, the applicability of similar provisions to benefits payable under Defence superannuation legislation has been a matter of public interest for some time. Particular concerns have arisen from publicity associated with Mr Derek Ernest Percy.

Accordingly, I ask that the Review Team consider and report on the application of such provisions within the Defence context as part of the deliberations of the Defence Superannuation Review. This should include, without being exclusive, the application to the Defence Forces Retirement Benefits (DFRB), Defence Force Retirement and Death Benefits (DFRDB) and Military Superannuation and Benefits (MSB) Schemes. Particular advice and recommendations are requested in relation to the cessation of payments (in full or in part) under particular circumstances, any distinctions, discretions or duties that may apply to employee and employer contributions and scope for the recovery of payments already made.

I look forward to your advice.

Yours sincerely,

Bruce Billson