The Hon Warren Snowdon MP
Minister for Veterans' Affairs
Minister for Defence Science and Personnel

Rear Admiral Ken Doolan AO RAN (Ret'd)
National President
Returned and Services League of Australia
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Dear Rear ~~Admiral~~ Ken Doolan

I refer to your letter of 22 February 2010 to the then Prime Minister, the Hon Kevin Rudd MP, in which you enclosed a submission from the Returned and Services League (RSL) to Government concerning the indexation of military superannuation pensions.

The Government is well aware of the concern of the veteran community about superannuation indexation and in particular, Defence Force Retirement Benefit and Defence Force Retirement and Death Benefits pensions.

Please find attached a response addressing issues you raised in your letter.

Yours sincerely

WARREN SNOWDON

1 3 FEB 2012

Response to Returned and Services League (RSL)
concerning the
Indexation of Military Superannuation Pensions

Superannuation is a key element of the competitive remuneration and conditions of service package for Australian Defence Force (ADF) members. Each of the superannuation schemes set up for ADF members reflect the unique nature of service and provide members with lifetime indexed pensions and also death, invalidity and reversionary benefits.

In respect of the DFRDB pension, it was not intended to provide the sole lifelong income source for those who were still of working age when they ceased service, either through choice or due to rank retirement age (the general trend has been some 75 per cent left under 45 years of age, and 40 per cent left between 35 and 40 years of age). In recognition of the unique nature of military service, there are special provisions allowing military personnel to receive a superannuation pension after only 20 years.

There would be many examples of servicemen and women who completed a successful career in the military, and then went on to further careers and had the benefit of a "top up" superannuation payment over that period of their employment. In comparison, the majority of the community is precluded from accessing superannuation benefits until preservation age is reached, which ranges in age from 55-60 depending on the year of birth.

Furthermore, for those personnel that return to military service to undertake Reserve work on continuous full time service and are in receipt of a DFRDB pension, there can be substantial superannuation pension benefits flowing from their Reserve service where it exceeds 12 months.

The level of DFRDB pension is commensurate with the period of service and the level of income at the time service ceases. For scheme members whose careers were not entirely in the military, it is expected that other employment would provide the opportunity for additional superannuation or savings for retirement. For this reason, the average DFRDB superannuation pension can be misleading as the superannuation pension may not account for the totality of a retiree's retirement income (and assets).

As indicated, the DFRDB superannuation scheme provides for the payment of benefits after 20 years service, irrespective of the age the member ceased service. DFRDB members also had the option to commute a part of their superannuation into a lump sum. This option was exercised by an overwhelming majority of members. These are significant factors regarding the current level of superannuation pensions under the DFRDB scheme.

The RSL submission suggests the nexus between military superannuation schemes and other Commonwealth superannuation schemes for indexation of payments is a policy aberration. Certainly, there should be a specific military superannuation scheme(s) and also military specific provisions in other areas such as compensation and discipline. Further, this special recognition is reflected throughout military service where ADF members have access to service allowances, ADF specific leave, housing, health, and family support. However, it would be difficult to justify not indexing all Commonwealth superannuation payments in the same way.

It should be emphasised that superannuation pensions are different in purpose to other government payments. As the age or service pension is a safety net benefit, the Government has decided that it is appropriate to index these pensions in a different way to superannuation payments it might provide as an employer. The age pension, which is available from 65 years of age, is generally the principal or only source of income for many older Australians who qualify for it. This is not the case for DFRDB superannuants who, depending on other income/assets, are able to access additional financial assistance at 65 years of age through the age pension, or at 60 years of age through the service pension.

Commonwealth superannuation pensions provide a guaranteed level of income and indexation regardless of a person's other income or assets, and are not affected by investment returns. Such a pension is generally not available to the wider community.

A number of individuals and organisations have mentioned the use of the Pensioner and Beneficiary Living Cost Index (PBLCI) as it is considered to apply more directly to senior Australians. The PBLCI, which is a by-product of the Consumer Price Index (CPI), was first introduced as an indexation factor for income support pensions in September 2009. This index is still being refined and was recently updated from the September 2011 quarter. The Government will continue to monitor progress of the use of PBLCI.

Your submissions raised a number of specific issues that are addressed below:

Age pension indexation

In relation to the age pension, there is a misconception that the previous Coalition Government changed the method of indexing the age pension in 1997 to maintain the purchasing power of the age pension.

The 1997 change, which ensured the maximum basic rate of the single adult age pension, after indexation, did not fall below a rate equal to 25 per cent of male total average weekly earnings, was made to honour an election commitment that age pensioners would share in increases in community living standards. This had been a policy objective of successive Governments since the early 1970s. The change was related to the age pension as an income support payment, not superannuation as a condition of employment.

At the time of making the change, the Government acknowledged that indexing the age pension by the CPI ensured that the real purchasing power of the pension was maintained. In his second reading speech for the Social Security and Veterans' Affairs Legislation Amendment (Male Total Average Weekly Earnings Benchmark) Bill 1997, the then Minister for Science and Technology said:

> *Pensions* [that is, single adult age pensions] *are indexed twice a year—in March and September—according to movements in the CPI,* ***ensuring that the real purchasing power of the pension is maintained*** (emphasis added). *However, CPI indexation, by itself, may not enable pensions to keep pace with changes in the living standards of the rest of the community. By legislating to maintain the single rate of pension at 25 per cent of male total average weekly earnings, the government is demonstrating its commitment to ensure that pensioners* ***share in increases in community living standards*** (emphasis added).

Cost of changing indexation arrangements

The submission suggests that 'the cost to the taxpayer of a more equitable indexation measure for military superannuants is small in comparison to that for all Commonwealth funded superannuants – and this should have been acknowledged (in Mr Matthews' Report)'. Clearly, changing indexation arrangements for military pensions alone will incur a lesser cost and the separate costs are reflected in Appendix J of Mr Matthews' Report.

In that Appendix, Mr Matthews estimated the financial impacts of two alternative pension indexation methodologies, namely indexation:

- at the same rate as that for the base rate of the age pension; and
- by the higher of the CPI or the increase in Male Total Average Weekly Earnings.

The estimates in the Matthews Review were based on a commencement date of 1 July 2009.

Updated estimates for a change to indexation arrangements from 1 July 2011 for each of the civilian and military schemes (and in total) are available on the Department of Finance and Deregulation (Finance) website at:

www.finance.gov.au/superannuation/UpdatedEstimates.html

The costing figures on the Finance website have been prepared in line with professional actuarial and accounting standards and have been peer reviewed.

The Government acknowledges that there may be secondary impacts from changes to indexation arrangements (commonly referred to as 'clawback') and these are disclosed on the Finance website. However, these secondary impacts are highly sensitive to assumptions made about the personal circumstances of individuals.

The important work that the RSL undertakes is appreciated and acknowledged. However, the suggested streamlining of processes would not offset the significant additional costs of changing indexation arrangements set out on the Finance website.

In this context, the RSL submission raised the important subject of transition arrangements. The Government is committed to providing the highest quality medical care for our servicemen and women, regardless of whether they are on deployment, at home, or after they have transitioned from Defence. The Government has created a joint Defence/Department of Veterans' Affairs program, called the 'Support for Wounded, Ill and Injured Program', to provide seamless and integrated support to personnel who are wounded, injured or ill.

ADF members separating for medical reasons receive assistance through a transition service managed by the ADF Transition Centres. This service is tailored and includes information on rehabilitation, compensation, income support and health service for service related conditions. Since October 2011, staff of the Department of Veterans' Affairs have been regularly visiting more than 35 Defence bases under the On Base Advisory Service initiative to assist ADF members to access information of their entitlements and this should ultimately improve their transition to civilian life.

Review into Military Superannuation Arrangements (Podger Review)

You mention the Podger Review in the submission. The main recommendation of the Podger Review was that the defined benefit Military Superannuation and Benefits (MSB) scheme close and a defined contribution (that is, accumulation) scheme be established for ADF members. The Podger Review also recommended that if the Government was prepared to go beyond the envelope of current costs, it should consider indexing DFRB/DFRDB pensions for those over 55 on a similar basis to that applying to the age pension.

Any move from a defined benefit arrangement to an accumulation arrangement would effectively shift risk from Government to the member. There has been a significant change in the economic global environment since the report was submitted which would make such a shift difficult. Changing the indexation arrangements for DFRB/DFRDB pensions would also incur a significant additional cost. This additional cost was noted by the Senate Committee that considered the Fair Indexation Bill introduced by the Opposition last year which excluded a quarter of DFRDB members and all Military Superannuation Benefits Scheme members.

The Government has decided not to follow the Podger proposals as a way forward for military superannuation. As you are aware, the previous Coalition Government would not release the Review prior to the 2007 Election.

Commutation of DFRDB pensions

Commuting part of the DFRDB pension means to receive part of the pension benefit early, in the form of a lump sum. When a member commutes part of the pension, that pension is permanently reduced to take account of the fact that part of it has been paid as a lump sum. The factors used for the purposes of calculating the reduction in pension are based on 1960s life expectancy.

Many benefit recipients argue that their pensions should be reinstated to the 'pre-commutation' level when they have reached their life expectancy on the basis they have repaid 'their loan'. The reduction in pension following commutation is not a 'loan' or a 'repayment' of the lump sum.

The lump sum is part of the pension superannuation benefit available to members on retirement, only paid early in a different form. No effort is made to recover the commuted amount if a benefit recipient dies earlier than their life expectancy. Furthermore, the reversionary pensions paid to surviving spouses of deceased benefit recipients are based on the 'pre-commutation' (that is, the full) pension.

The Podger Review examined the operation of the reduction factors and concluded that if any change were to be made, it should be to require a substantially larger reduction in pension in return for the commuted lump sum, not a smaller reduction.

As indicated above, the Government has decided not to follow the Podger proposals as a way forward for military superannuation and has no intention to change the current commutation arrangements.

Taxation of military superannuation pensions

Up until 1 July 1983, people could claim a tax deduction (or in some years tax rebates) for the amount they contributed for superannuation contributions or paid as premiums for an annuity from life insurance cover, subject to a maximum cap. When superannuation contributions/life insurance premiums exceeded the maximum cap in a particular year before 1983, the excess was counted towards the undeducted purchase price (UPP) of the pension/annuity to which those contributions were made.

The UPP was the amount contributed towards the purchase price of a pension or annuity for which the person was not eligible to claim a tax deduction in a particular year. When the pension/annuity became payable, it was subject to tax, but a portion of the UPP could be claimed as a deduction to reduce the pension or annuity income in the person's tax return.

Those DFRB/DFRDB scheme members who retired prior to the introduction of the 'Better Super' tax changes on 1 July 2007 were able to take advantage of the tax laws that applied at the time the benefits were received.

Two of the key taxation elements of the 'Better Super' arrangements are that:

- superannuation benefits, whether paid as a lump sum or a pension, are tax free for people aged 60 and over where the contributions giving rise to those benefits have been subject to income tax in the fund; and

- a tax rebate is provided for people aged 60 and over in relation to superannuation benefits paid where the contributions which give rise to those benefits have not been subject to income tax in the fund.

The employer superannuation contributions for the military superannuation schemes are largely unfunded, that is, the Government pays its employer contributions when the superannuation benefit falls due for payment. This has effectively been the funding arrangement for all Government superannuation schemes since their inception (and both the DFRB and DFRDB schemes relied heavily on the untaxed Consolidated Revenue Fund for paying the bulk of the benefit).

Taxation on employer contributions in the military schemes is recovered when the superannuation benefits are paid (that is, when employer contributions are made). Since 2007, no tax is applied to member funded benefits or to benefits that arise from a member's 'after tax' contributions.

Commonwealth Superannuation Corporation (CSC)

The Government is committed to improving the superannuation outcomes for civilian and military employees. The Government passed a package of legislation through the Parliament in June 2011 to consolidate the trustee arrangements for the Commonwealth civilian and military superannuation schemes. These reforms are intended to improve the superannuation outcomes for many members of the Commonwealth superannuation schemes.

The CSC is the trustee of nine superannuation schemes. Four of these schemes (MSB, the Commonwealth Superannuation Scheme, the Public Sector Superannuation Scheme and the Public Sector Superannuation Accumulation Plan) have a fund that is managed and invested by CSC. The MSB fund has approximately $3.8 billion in funds under management. The other funded CSC schemes have over $19.7 billion in funds under management. The combined funds are over $23.5 billion. The consolidation of these funds will allow members of all schemes to achieve the benefits of scale. The benefits include better access to investment opportunities, lower investment costs and competitive investment returns.

During its first seven months of operation, the CSC has been able to continue managing funds and administering schemes with no disruption to members since the transition to the new merged entity. There has been a smooth changeover to the new CSC Board and it is operating very cooperatively and effectively. The Department of Veterans' Affairs is arranging for a briefing of the Ex-Service Organisation Roundtable at a future meeting by the Corporation.