Australian Government
Australian Government Actuary

Ref No.

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Dear

COSTING OF MTAWE INDEXATION OF MILITARY PENSIONS

I refer to your request seeking our advice on the financial impact of indexing military superannuation pensions in line with movements in MTAWE rather than the CPI. This letter replaces my previous letter of 16 July. The previous letter had assumed that the first indexation under the new regime would be on 1 January 2010. Finance have clarified their request and asked for costings assuming the first indexation under the new regime would be on 1 July 2009.

Approach and Assumptions

You requested the costs of two possible changes in approach. The first possible change is MTAWE indexation of all pensions. The second possible change is indexation of pensions at the higher of MTAWE and CPI each 6 months. I note that this differs from the approach currently in place for indexing the Age Pension under the Social Security Act. You have confirmed that this was an intentional request. Note that the improved indexation arrangements only apply to pensions in payment. The unfunded component of MSBS preserved benefits would continue to be indexed in line with CPI. That is, there would be no change to the indexation of unfunded MSBS preserved benefits in deferment.

For costing purposes, we have assumed that MTAWE increases will be the same as general salary inflationary increases at 4% per annum (the rate assumed for the Long Term Cost Report as at 30 June 2005). The use of indexation of the higher of MTAWE and CPI each 6 months significantly increases the long term rate of indexation and we have assumed pension increases of 4.6% pa under this scenario. For reference, the Long Term Cost Report assumed pensions linked to CPI would increase at 2.5% pa

We generally have used the same economic and demographic assumptions as were used for the Long Term Cost Report as at 30 June 2005. In particular, the Long Term Cost Report assumes that the number of serving members of the Defence Forces remains constant and we have retained this assumption for these costings.

We have, however, altered some assumptions from those used for the Long Term Cost Report for these costings. We have assumed that in the MSBS, the more attractive pension terms would lead to a higher take up of pensions. For these costings we have assumed officers take 90% of the employer component in pension form (compared to 75% for the Long Term Cost Report) and other ranks take 80% for the employer component in pension form (compared to 60% for the Long Term Cost Report). This has significant implications for the short term cash flows for the MSBS.

We have also assumed that MSBS remains open and that there are no changes to military superannuation arrangements. In this context, your attention is drawn to the recommendations of the Review of the Military Superannuation Arrangements report.

Data

We have used data as at 30 June 2007 (the latest available) for the costings and assumed that the improvements would be implemented as at 30 June 2009.

For DFRDB, total annual pensions valued as at 30 June 2007 were $1,186m. The total number of contributors valued as at 30 June 2007 was 5,487 with superannuation salaries of $420m.

For MSBS, total annual pensions valued as at 30 June 2007 were $117m. The total number of contributors valued as at 30 June 2007 was 46,218 with superannuation salaries of $2,624m. The total number of preserved members valued as at 30 June 2007 was 66,835.

We have only performed very broad reasonableness checks on the data and these checks did not reveal any significant cause for concern about using this data for the current purpose.

Results

There are a number of measures of the cost of moving to MTAWE indexation. The tables below show the impact on the unfunded liability and the notional employer contribution rate.

Unfunded Liability

The following table shows the projected impact of the various indexation proposals on the projected unfunded liability as at 30 June 2009 if they were to be implemented as at 30 June 2009.

	Unfunded DFRDB Liability ($bn)	Unfunded MSBS Liability ($bn)	Total Unfunded Liability ($bn)
Current arrangement	24.3	12.9	37.2
Full MTAWE indexation	29.9	17.6	47.5
Increase	5.6	4.7	10.3
Higher of MTAWE and CPI	32.7	19.5	52.2
Increase	8.4	6.6	15.0

Notional Employer Contribution Rate

The effect on the notional employer contribution rate from the various indexation proposals is as follows:

	Increase in Notional Employer Contribution Rate (DFRDB) % of superannuation salary	Increase in Notional Employer Contribution Rate (MSBS) % of superannuation salary
Full MTAWE indexation	8.4	8.5
Greater of MTAWE and CPI indexation	12.8	12.1

Additional Cash Expenditure

The table below shows the expected additional cash expenditure over the first 10 years and then at 5 year intervals to 2044/45.

FULL MTAWE INCREASES

	Additional DFRDB Expenditure $m	Additional MSBS Expenditure $m	Additional Total Expenditure $m
2009/10	10	-9	1
2010/11	29	-13	16
2011/12	50	-13	36
2012/13	71	-12	59
2013/14	93	-10	83
2014/15	116	-7	109
2015/16	140	-8	132
2016/17	165	-3	163
2017/18	191	1	192
2018/19	218	4	221
2019/20	245	10	255
2024/25	390	43	433
2029/30	543	242	784
2034/35	686	535	1,221
2039/40	799	920	1,719
2044/45	858	1,551	2,409

GREATER OF MTAWE AND CPI INCREASES

	Additional DFRDB Expenditure $m	Additional MSBS Expenditure $m	Additional Total Expenditure $m
2009/10	14	-9	6
2010/11	41	-12	30
2011/12	70	-10	59
2012/13	100	-7	93
2013/14	132	-4	127
2014/15	165	1	166
2015/16	200	2	201
2016/17	236	10	246
2017/18	273	16	290
2018/19	312	23	335
2019/20	352	33	385
2024/25	570	96	666
2029/30	805	351	1,156
2034/35	1,034	739	1,773
2039/40	1,224	1,271	2,495
2044/45	1,335	2,118	3,453

Note that the figures in the above tables are in nominal dollars and have not been discounted to give a 2009 value and that components may not add exactly to the total due to rounding.

Comments on Results

It can be seen from the results that a move to full MTAWE indexation is an expensive benefit improvement. A move to full MTAWE indexation of pension increases results in about a 20% to 25% increase in the total cost of DFRDB. The equivalent increase in costs for MSBS is about 30% to 35%. The greater percentage increase in MSBS costs is due to the fact that an improvement in indexation arrangements is likely to lead to an increase in the take up rates of the more expensive pension option.

Costs are noticeably higher if indexation is at the greater of MTAWE and CPI on a 6 monthly basis.

Additional Commonwealth cash expenditure in the first few years after any change would be relatively small but the additional amount of cash expenditure would increase and become very noticeable. The short term cash expenditure reductions for MSBS are due to large single lump sum payments being replaced by smaller (but ultimately more expensive) pension payments made over a large number of years due to increased take up of the pension option.

It should be noted that these costings have been done within a very short time so as to be available for the Review into the Indexation of Commonwealth Pensions. As a consequence of this quick turn around, the costings have been subject to a lesser degree of checking than would normally be the case. Nevertheless, the results produced seem reasonable. I have no problem with you providing a copy of this advice in its entirety to the Department of Finance and Deregulation (Finance) for information only. Should Finance want to use information in this letter for some purpose, then Finance should contact us directly. Similarly, I have no problem with this letter being provided to the Review in its entirety on a confidential basis for information only. If the Review wanted to make this information publicly available or wanted to quote information contained in this letter then the Review should again contact us directly.

Should you wish to discuss this letter please contact me on (02) 6263 4126.

Yours sincerely

M. R. Burt

Michael Burt
Actuary