

STAFF SUMMARY SHEET

	TO	ACTION	SIGNATURE (Surname), GRADE AND DATE		TO	ACTION	SIGNATURE (Surname), GRADE AND DATE
1	DFM	sig	<i>[Signature]</i> , Lt Col 2 Jan 14	6			
2	DFER	approve	<i>[Signature]</i> , AID-22, 2 Jan 14	7			
3	DFM	action	Lt Col Brian Payne	8			
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SUMMARY

- PURPOSE.** To provide security and policy review on the document at Tab 1 prior to release to the public.
- BACKGROUND.**
 Authors: Professor William Jennings and Lt Col Brian Payne

 Title: No Easy Day for Military Pensions

 Circle one: Other: Opinion-Editorial Submission

 Description: Wall Street Journal and/or Air Force Times

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 Recommended Distribution Statement:
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- DISCUSSION.**
- VIEWS OF OTHERS.**
- RECOMMENDATION.** Department Head or designee reviews as subject matter expert. DFER reviews for policy and security. Coordination indicates the document is suitable for public release. Suitability is based on the document being unclassified, not jeopardizing DoD interests, and accurately portraying official policy [Reference DoDD 5230.09]. Release is the decision of the originator (author). Compliance with AFI 35-102 is mandatory.

//Signed//

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Tab
1. Wall Street Journal and/or Air Force Times Submission

NO EASY DAY for MILITARY PENSIONS

The financial well-being of the nation's soldiers, sailors, airmen, and marines just suffered a devastating blow. In a surprise move, the budget deal negotiated by Rep. Ryan and Sen. Murray, and subsequently passed by the House and Senate, cut military pensions. We believe much of the subsequent clamor about this cut dramatically underestimates its gravity.

Before this vote, it was reasonable to view military retirement benefits as equivalent to a particular kind of riskless Treasury bonds indexed to inflation—Treasury Inflation Protected Securities, or TIPS. Both military pensions and TIPS were government guaranteed, and both offered full inflation protection.

Under these twin assumptions, we estimate the current value of a military pension at about \$1.7 million for typical officers and \$970 thousand for typical enlisted members, both with 20 years of service. Today's low rates make these numbers quite large—military pensions are undeniably valuable. Knowing this, some servicemembers structured their lives around completing 20 years in the military. (Separating from military service before 20 years earns no pension at all.) They did so anticipating they would be “locking in” a generous inflation-adjusted pension.

Or so they thought. The Ryan-Murray budget deal lowered retirement benefits for retirees under the age of 62 to grow at an annual rate of one percent below inflation. What sounds trivial (a mere one percent change) is actually quite significant. Most investors, indeed most people, are insufficiently wary of the loss of purchasing power due to increasing prices, but careful investors know that even low inflation can have a material impact over retirement-length time horizons. In fact, this one-percent adjustment translates to a four to five percent reduction in lifetime military retirement benefits. Yet the inflation adjustment isn't the end of the story.

More pernicious is that this is the first time in memory that *current* servicemembers and retirees were not grandfathered into the prior, better retirement deal. The 1980 and 1986 retirement reductions cut benefits to *future* warfighters—all currently serving and retired servicemembers retained the benefits they had been promised upon taking their oath of office. The lack of grandfathering is particularly shocking right now. Just two years ago, the corporate-minded Defense Business Board recommended transitioning the military retirement system to a defined contribution plan, like a 401(k). However, their proposal grandfathered current and retired military members into the defined benefit plan promised to them when they volunteered to serve.

Financially speaking, there is a dimension to this change that we haven't seen discussed. Astute readers of this publication know that introducing uncertainty about an investment's returns increases its risk. This uncertainty diminishes the value of the military pension benefit beyond the inflation adjustment. The prospect of a surprise reduction in warfighters' wealth is akin to default risk in credit markets. When an

investor buys a bond, there is a chance that the bond issuer cannot pay it back. Bond buyers demand higher rates to compensate for this potential loss. Similarly, prospective pensioners should include a default risk premium in evaluating their retirement benefit. While the breach of the prior pension promise *directly* reduced retirement wealth by only four to five percent, it is a radical departure from prior practice.

In hindsight, it was perhaps naïve to think the pension benefit inviolable, but for most current military members the Ryan-Murray budget deal was unfathomable—something close to a completely unanticipated “black swan” event. The benefits ambush is particularly surprising since it comes on the heels of the Defense Business Board proposal, which quickly lost traction even with its grandfathering provision.

We estimate this new risk to military pensions merits a risk premium of $\frac{3}{4}$ -1½ percent, which would apply to the whole pension benefit. For twenty-year veterans, the loss in the value of their pension benefits amounts to \$230-370 thousand dollars, with officers taking the larger hit. To put this in perspective, civilian readers should imagine a one-day loss in their retirement portfolio of three to five times their current annual salary.

That is, breaking both the inflation-adjustment and government-guarantee promises on military pensions is equivalent to a one-day loss of 23 percent. Readers will recognize this is similar in magnitude to the stock market’s two Great Crashes. But here the October 1929 or 1987 analog affects only our soldiers, sailors, airmen, and marines. This is a financially devastating assault on what must, almost universally, be these warfighters’ most valuable asset.

Military pensions are unambiguously generous and merit reform. Half pay at twenty years of service is a distinct anomaly, particularly in a world of disappearing corporate defined benefit pensions. Guaranteed inflation adjustments over a 40-50 year remaining life expectancy are incredibly expensive. Personnel costs, including pensions and retirement health care, are crowding out other parts of the defense budget. But shouldn’t we have a national conversation before expropriating a quarter of the wealth of someone who volunteered on September 12, 2001, and has been on freedom’s watch ever since?

William W. Jennings is the civilian Professor of Finance and Investments and Lt. Col. Brian C. Payne, USAF, is Associate Professor of Management, both at the U.S. Air Force Academy. The opinions included are those of the authors and not necessarily those of the U.S. Air Force Academy, the U.S. Air Force, or any other federal agency.