

DEFENSE BUSINESS BOARD



Modernizing the Military Retirement System

Task Group

July 21, 2011

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Task Group Overview

Terms of Reference

In order to support the Secretary of Defense's efficiency initiatives, review the current structure and function of the military retirement system. Begin with a review of the current reform thinking on military retirement benefits. This research and analysis will help to provide recommendations for optimizing the Department's military retirement system.

Deliverables

Provide recommendations that will enable the system to be fiscally sustainable and recruit and retain the highest personnel required for our nation's defense.

Task Group Members

Richard Spencer (Chair)

Patrick Gross

David Langstaff

Phil Odeen

Mark Ronald

Bobby Stein

Jack Zoeller

DBB Executive Secretary

Catherine Whittington

Methodology: Interviews

- **Current DoD**
 - Vice Chairman, Joint Chiefs of Staff (VCJCS)
 - Chief of Staff of the Air Force (CSAF)
 - Chief of Naval Operations (CNO)
 - Commandant of the Marine Corps (CMC)
 - Chief of Navy Reserve
 - Chief of Navy Personnel, DCNO, Manpower, Personnel, Training & Education, N1
 - Director, Plans and Resources, Office of the Deputy Chief of Staff of the Army, G1
 - Military Deputy for Budget, Office of the Assistant Secretary of the Army, Financial Management & Comptroller (ASA(F&MC))
 - Under Secretary of Defense for Personnel and Readiness (USD(P&R))
 - Director for Military Compensation (OUSD(P&R))
 - Joint Chiefs of Staff Working Group
 - Members who wrote the 11th Quadrennial Review of Military Compensation (QRMC)
- **Former DoD and Government Officials**
 - HON John Hamre
 - HON Ken Krieg
 - ADM Vern Clark, USN (Retired)
 - HON David M. Walker
 - HON Richard Danzig
- **Defense Ministries**
 - Canada
 - France
- **Institutes and Government Agencies**
 - Institute for Defense Analysis (IDA)
 - Congressional Budget Office (CBO)
 - Center for Strategic and International Studies (CSIS)
 - Center for Strategic and Budgetary Analysis (CSBA)
 - RAND Corporation
 - Office of Thrift Savings Plan
 - OSD Office of the Actuary



Where We Are Today

- The All Volunteer Force has proven to be an outstanding success
- Congress has shown consistent support for the military through increases in both compensation and benefits
- Military compensation is higher than that of average civilians with similar education levels (see **Appendix A**)
 - Enlisted pay ranks in the top quartile of that of high school graduates
 - Officer pay ranks in the top quartile of that of college graduates
- Retiree healthcare (TRICARE) is significantly more generous than civilian programs
- Military retirement exceeds levels in the private sector
- 83% of military personnel receive no retirement benefits

Findings

DoD has maintained the structure of its retirement benefits, which were created prior to the All Volunteer Force

- Retirement plans are an important component of both private and public sector compensation systems
- Over the last few decades, private sector plans have shifted from defined benefit to defined contribution to address longer life spans and unaffordable costs
- The military retirement system has not materially changed for over 100 years
 - The current military retirement system was designed for an era when life spans were shorter,
 - Pay was not competitive with civilian pay, and
 - Second careers were rare since military skills did not transition easily to the private sector
- Military retirement funds are not able to be invested in higher yielding equities and bonds



Findings (Continued)

Military retirement is more generous and expensive compared to the private sector

- DoD pays retirees 40 years of retirement benefits for 20 years of service
 - Military skills are transferrable to the private sector
 - Second careers are now common for those retiring in their 40s
 - Payout after 20 years makes retention difficult – 76% leave between years 20 and 25
 - 20 years of service earns a lifetime of payments of 50%, ramping up to 87.5% for 35 years of service
- Retirement funds accrued for personnel serving less than 20 years are effectively applied to the benefits of those serving more than 20 years
- For those serving more than 20 years, the retirement contribution is 10 times greater than the private sector
 - Average private sector pension contributions range from 4-12% per year; military retirement benefit equates to 75% of annual pay per year for those who retire
 - Immediate payout after 20 years has no comparison in the private sector

For FY11, total government contribution will be \$46B**

**Does not include \$64.1B in unfunded liability amortization payment

Findings (Continued)

“One Size Fits All” has structural disadvantages

- Surveys consistently report that military retirement has little value in recruitment or retention for at least the first 10 years of service
- The current plan is highly inflexible and especially poorly suited for periods of significant change (e.g., when downsizing the force)
 - It will be very difficult to release personnel with 15 or more years of service, yet these age groups are a likely target for downsizing
 - As a result, DoD will likely require special pay to ease transitioning out of the military (as was done in the 1990s), therefore, increasing costs
- The current system does not compensate for those in high risk situations or extenuating circumstances (e.g., combat duty, hardship tour, and separation from family)

Assessment

The Retirement Plan is Unfair

- The military retirement system lacks fairness in several dimensions.
 - Personnel serving 5, 10, even 15 years receive no retirement pay. Those serving 20+ years are endowed with a lifetime benefit.
 - The risky nature of military service is an important justification for the 20-year plan. However, most of the troops engaged in combat serve far less than the required 20 years. (Only 12%-13% of enlisted troops earn retirement pay).
- Retirement is a cost element attributable to each Service member, yet only 17% receive this benefit.
- There is no difference in retirement benefits between those who have served in high risk and low risk positions.

83% of those who serve will receive no retirement benefit

Assessment (Continued)

The Retirement Plan is Unaffordable

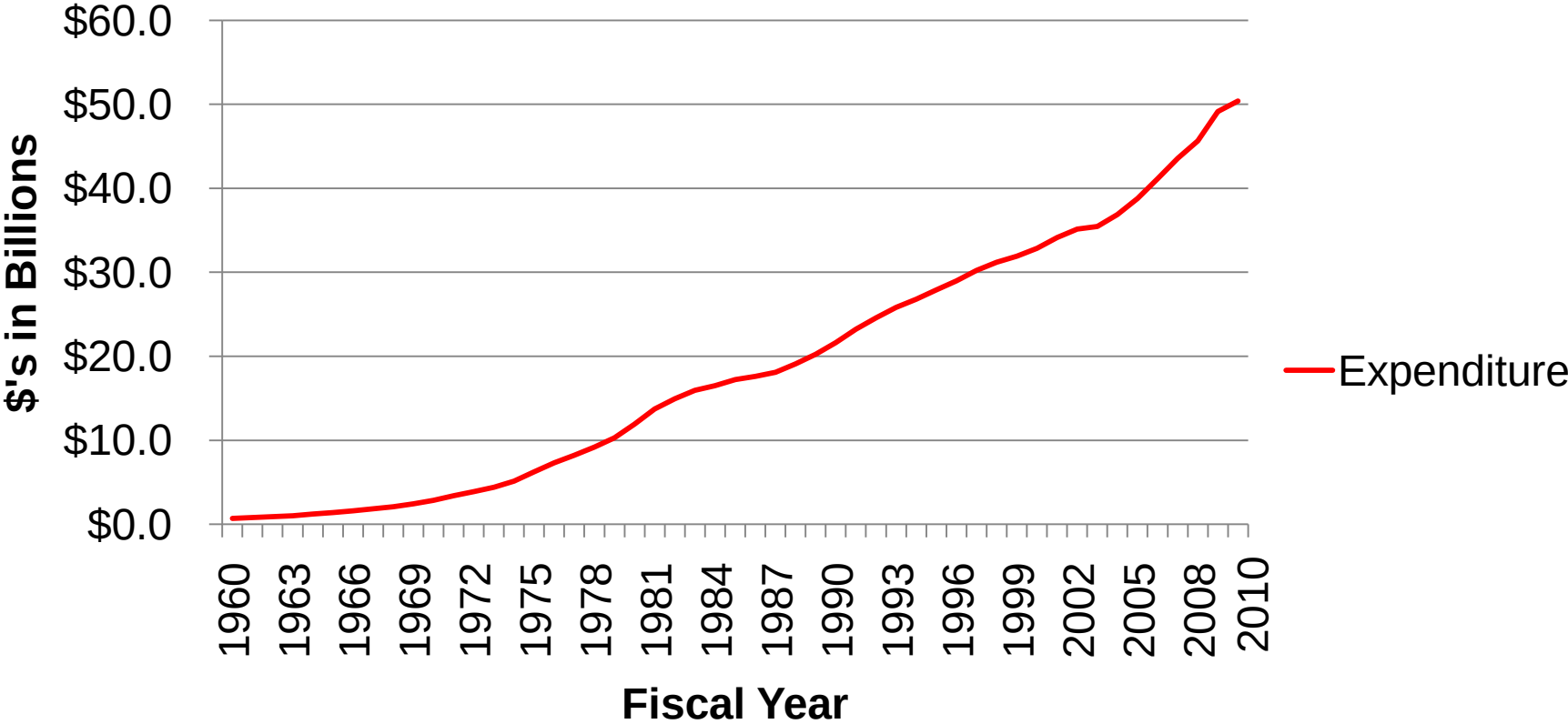
- The costs of military retirement will seriously undermine future military warfighting capabilities
- For each dollar of current pay, the retirement plan accrues 33 cents, for a total of \$24B** in FY11
- Costs are rising at an alarming rate; future liability will grow from \$1.3T (of which \$385B is funded) to \$2.7T by FY34.
- Increases in inflation and life expectancy will further increase military retirement benefit costs
 - +1% inflation increase = \$3.0B military retirement benefit service cost increase
 - +1 year of life expectancy = \$300M military retirement benefit service cost increase

Action must be taken to contain these spiraling costs or they will undermine future warfighting capabilities

**Does not include Treasury interest of \$22B

Military Retirement Trust Fund Payments/Expenditures

Military Retirement Trust Fund Expenditures by Fiscal Year



Military retirement payments continue to increase (\$50B in 2010; \$108B in 2035)

Source: Valuation of the Military Retirement System, September 2009, OSD Office of the Actuary, Dec 10

Assessment (Continued)

The Retirement Plan is Inflexible

- The current system cliff vests at 20 years of active service
- Personnel with fewer years of service earn no retirement
- Only 7% of personnel leave between the 15th and 20th year of service, compared to 76% of those serving 20 to 25 years
- Years served is the only factor in the retirement benefit calculation, regardless of whether the Service member's career risk profile is in an administrative role or a high risk combat role
- Modifying the retirement system would create an effective force shaping tool

Recommendation

A Comprehensive Solution: A New Defined Contribution Plan

- The most flexible and readily available plan would be based on the existing Uniformed Military Personnel Thrift Savings Plan (TSP), but with the government providing annual contributions (see **Appendix C**)
 - Payments into the plan would include an option for military member contributions
 - Plan accounts would be transportable into the private sector and back into the military
- DoD contributions could vary depending on circumstances, such as larger contributions for personnel at risk or on hardship tours
- The Defined Contribution Plan would provide flexibility to assist in force shaping and sizing
- The individual account would provide for rights for survivorship, thereby, eliminating the need for survivor benefits going forward
- Fully disabled participants would qualify for an immediate pension formulated with VA benefits as presently structured

Key Elements of A New Defined Contribution Plan

- Establish a mandatory TSP program for all Military Service Personnel
 - The government contribution, including extra incentives, would be funded at a percentage level comparable to the highest end of a private sector pension plan
 - The plan would vest after 3 to 5 years, payable at age 60 to 65 (or Social Security age)
 - Partial withdrawals (or loans) to cover education, healthcare, or other specified emergencies
- Plan would be risk adjusted to recognize combat roles, family separation, and other unusual duty, for example:
 - Double contributions for years in combat zones or high risk positions
 - Greater contributions for hardship tours
 - Retirement age could be lowered using similar metrics
- Like most private sector severance plans, the option of a time formulated transition payment should be considered to facilitate the change to a new career
- Comprehensive solution would apply to reserve as well as active duty personnel

The new plan would enhance fairness and flexibility, and provide a more affordable cost structure

Attributes of A New Defined Contribution Plan

■ Individual Features

- Uniformed Military Personnel TSP individual account
- Payout options to include: traditional payout, annuity, or lump sum
- Partial payout options to include: education, home ownership, or business acquisition
- Right of survivorship transferability upon death

■ Military Service Features

- Affordable, fair, and flexible solution to current system
- Risk profile multiplier and vesting option provides tool for force management either encouraging or discouraging retention
- Active Duty and Reserves under one plan

■ Coverage

- No impact on existing retired population
- Fully disabled veterans not effected by new plan

■ Transition Alternatives for All Present Active Duty Personnel

- Higher Cost Alternative – No transition (see **Appendix E**)
- Lower Cost Alternative – Immediate transition with no loss of accrued benefits (see **Appendix F**)



Conclusions

- The current military retirement system is out of date.
 - It is unfair, unaffordable, and inflexible.
 - As costs escalate, the continuation of the system will seriously erode future military capabilities.
- A comprehensive alternative that would fix these shortcomings is required.
 - All military personnel earn retirement benefits.
 - Costs are far more manageable in future years.
 - Contributions are flexible and reward longer service, high risk assignments, and family separation.
 - Retired and disabled members would be unaffected. They would still receive current benefits.
- Modifying the existing system to reduce cost would have to be dramatic to address affordability. The system would continue to be unfair and inflexible.
- Implementation should be phased-in to ensure current military personnel are treated fairly with due consideration to cost.

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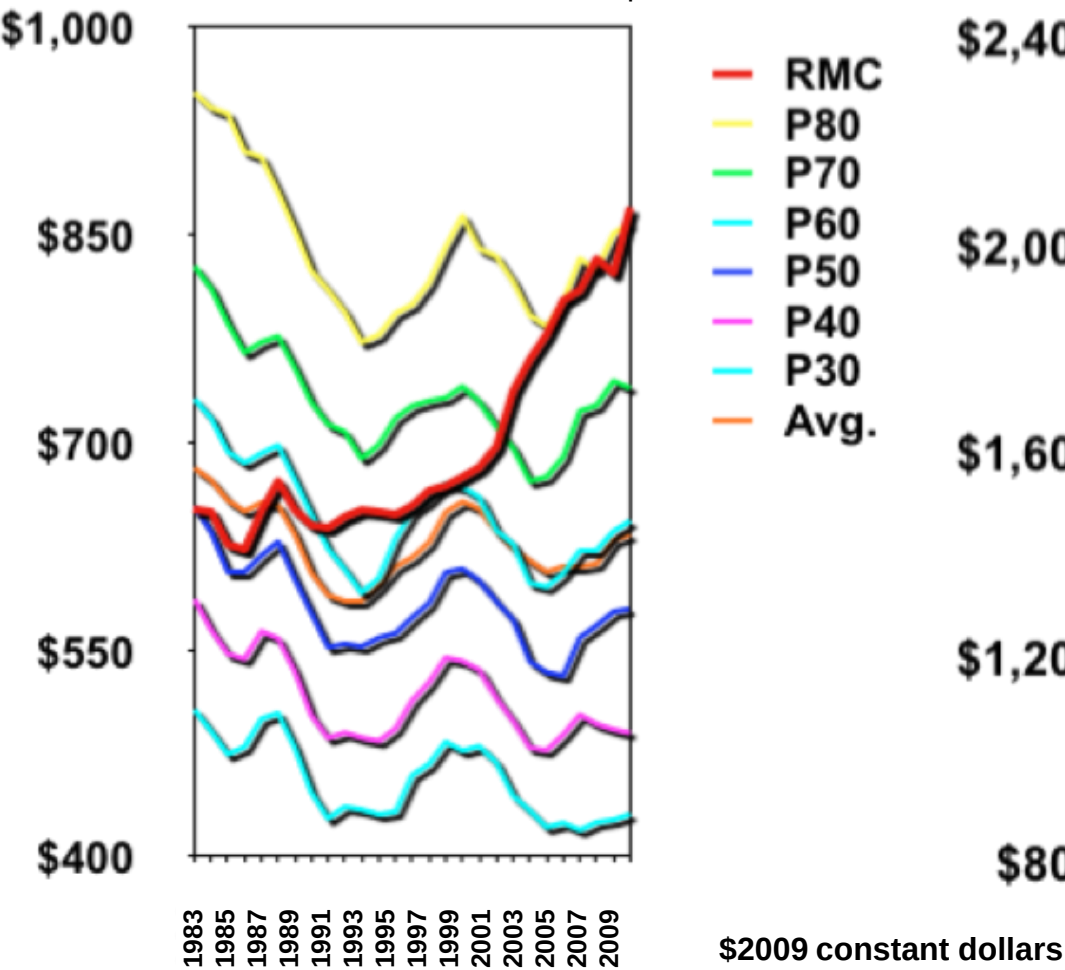
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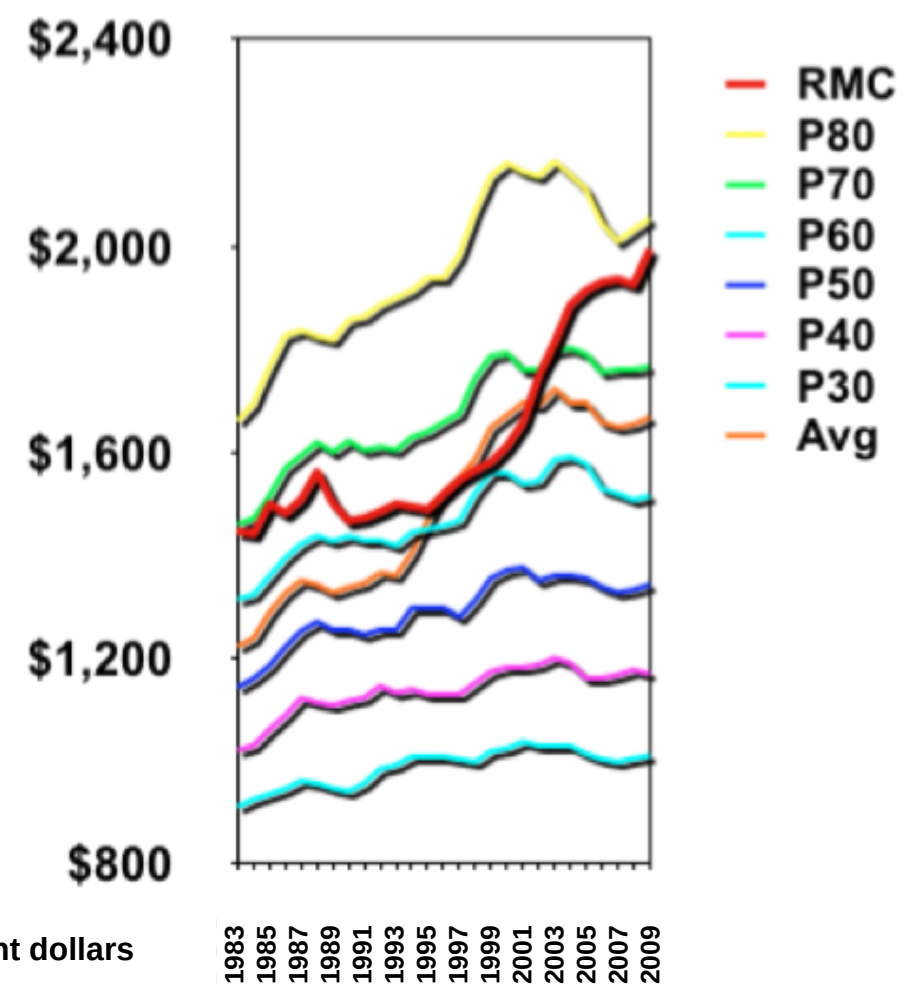
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Appendix A: Regular Military Compensation (RMC) versus Private Compensation

Wage Percentiles of Males, Ages 22-26, with High School Education in Production/Craft Occupations



Wage Percentiles of Males, Ages 32-36, with Four or More Years of College in Professional/Technical Occupations



Source: RAND National Defense Research Institute

Appendix B: Addressing Affordability of the Current System

- Amending the existing system for new entrants can have meaningful impact on sustainability while the volunteer force remains competitive with private markets
 - Index payout of retirement benefits to 67 years of age
 - Propose a one time Transition Payment paid at separation (e.g. one months salary for each year served)
 - Adjust benefit multiplier to 2.0 (40% of base Pay) from present 2.5 (50% Base Pay)
 - By comparison the following are averages of multipliers: private sector 1.1, public and municipal 1.5, and fire and police 2.0
 - Adjust High 3 computation to High 5
- These changes fail to address the inflexibility and unfairness of the current system

Cumulative Savings Over 20 Years				
	Delay Pay	2.0 Multiplier	High 5	Total
FY32	\$193.3*	\$49.9*	\$10.9*	\$254.1*

40% cumulative savings by FY32

*Numbers are in billions

Source: OSD Office of Actuary

Appendix C: 2011 Uniformed Military Personnel Thrift Savings Plan

- \$16,500 annual tax-deferred contribution limit
 - Applies to Member contributions from basic, special, incentive and bonus pays
 - Does not include service matching contributions (for the few service members receiving matching)
- \$5,500 annual tax-deferred “Catch-up” contribution
 - Applies to members who are (or will be) age 50 or older
 - Deducted from taxable basic pay, submitted as tax-deferred to the TSP
 - Catch-up contribution is in addition to the elective deferral and annual additions limit
- \$49,000 annual maximum contribution limit
 - Applies when member contributes while in a designated combat zone depositing tax-exempt contributions to the TSP (which accrue tax-deferred earnings)
 - Limit includes tax-deferred and tax-exempt member contributions from basic, special, incentive and bonus pays (but does not include catch-up contributions)
 - Limit applies to member contributions and any service matching contributions received
 - Does not include amount contributed as catch-up during the year



Appendix D: Trust Fund Under Current Plan

	Today FY11*	Today's Future FY34*
DoD Service Payment	\$19.8	\$42.3
Treasury Service Payment	\$4.8	\$10.2
Treasury Interest Payment	\$21.8	\$149.8
Treasury Unfunded Liability Amortization Payment	\$61.4	\$14.8
Total Federal Government Cost	\$107.8	\$217.1
Fund Liability	\$1,269.9	\$2,720.3

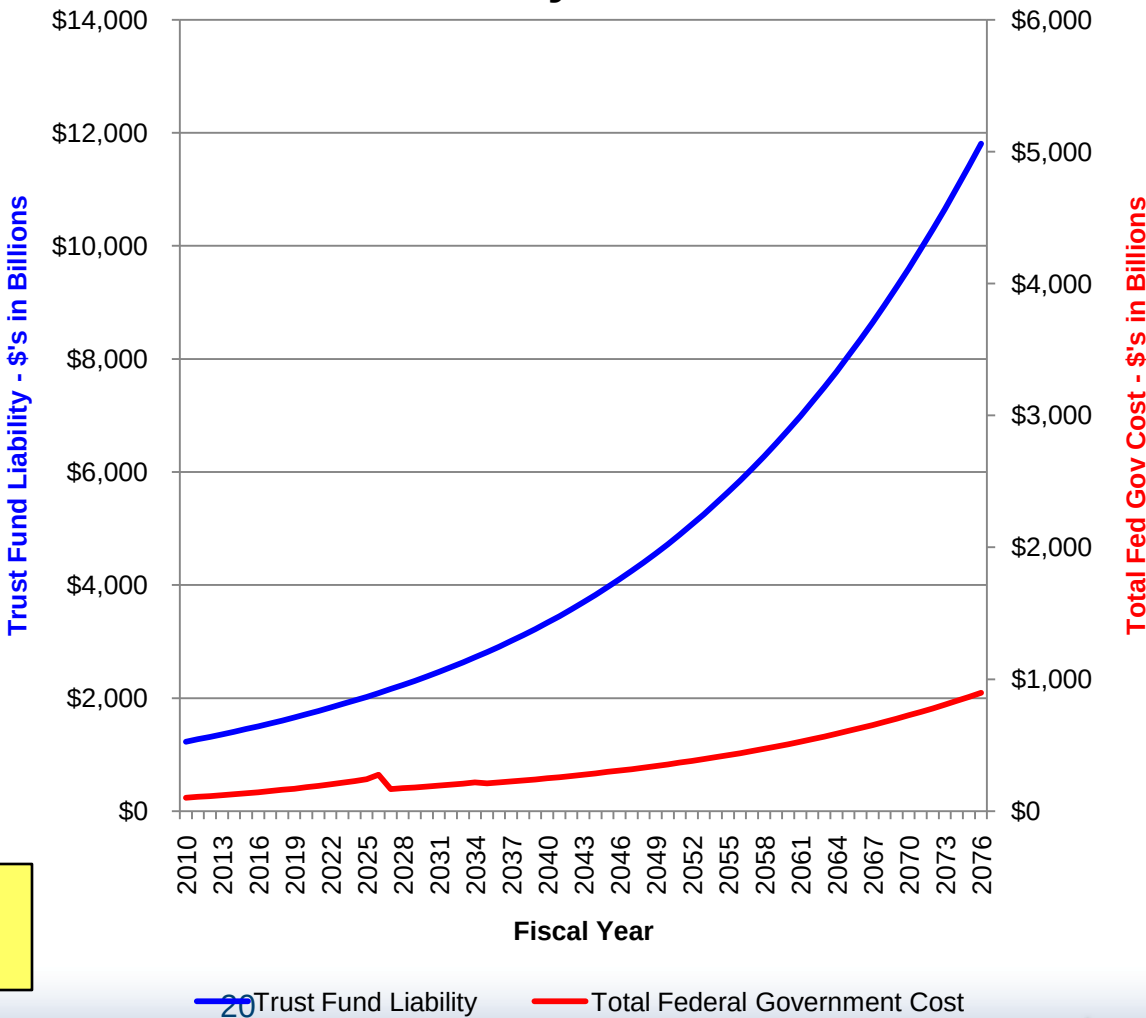
*Numbers are in billions

Assumptions:

- **Vesting year 20**
- **Average contribution is 33% of total payroll**

Source: OSD Office of Actuary

Military Retirement Trust Fund Under Current Plan by Fiscal Year



Appendix E: Trust Fund Under Revised Plan if All Current Active Duty Remain on Current Plan

	Today FY11*	Today's Future FY34*
DoD Service Payment	\$18.9	\$21.0
Treasury Service Payment	\$4.3	\$10.4
Treasury Interest Payment	\$21.7	\$100.7
Treasury Unfunded Liability Amortization Payment	\$61.4	\$14.8
Total Federal Government Cost	\$106.3	\$146.9
Fund Liability	\$1,266.7	\$1,800.0

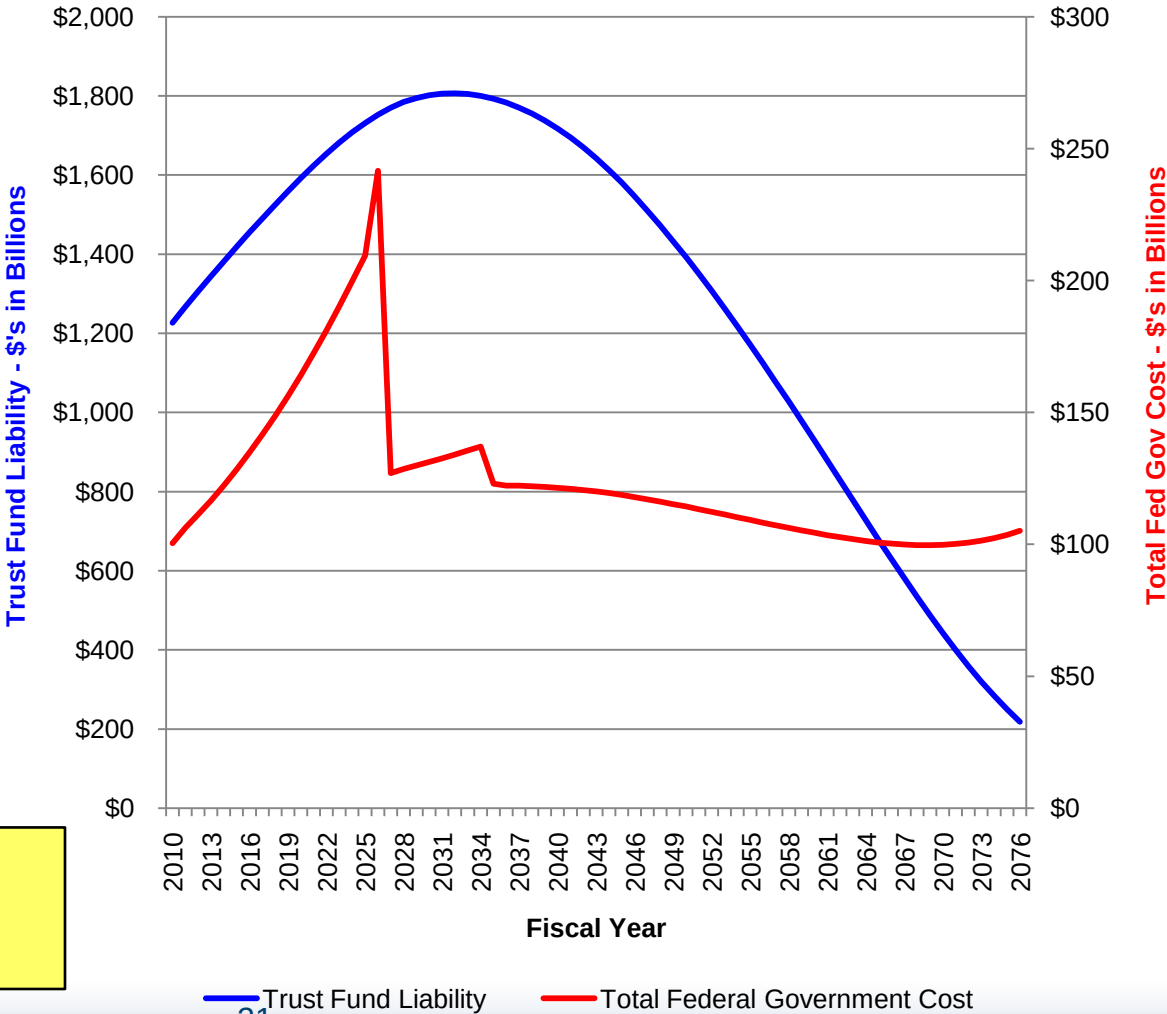
*Numbers are in billions

Assumptions:

- Average vesting year 4
- Active duty remains on current plan
- New recruits go on revised plan

Source: OSD Office of Actuary

Military Retirement Trust Fund Under Revised Plan by Fiscal Year



Appendix F: Trust Fund Under Revised System if All Active Duty Personnel Transition Immediately

- Modeled after private sector approach and yields a viable lower cost alternative
- Rapid transition to new plan for total active force
- Preserve accrued benefit from “old plan” but no further accrual
- For those with less than 20 years – proportional benefit under “old plan” if they stay for 20+ years (example: 10 years of service would result in 10/20 of the old plan benefit at old vesting date or 25% of pay at retirement)
- All active duty personnel start to accrue new benefit for the balance of their service payable under new terms (age 65 nominal)
- Average DoD contribution under revised system includes all extra incentives (16.5% of total pay)

Appendix F : Trust Fund Under Revised System if All Active Duty Personnel Transition Immediately (Continued)

	Today FY11*	Today's Future FY34*
DoD Service Payment	\$27.2	\$20.4
Treasury Service Payment	\$4.3	\$10.4
Treasury Interest Payment	\$21.7	\$68.5
Treasury Unfunded Liability Amortization Payment	\$61.4	\$12.5
Total Federal Government Cost	\$114.6	\$111.8
Fund Liability	\$1,125.0	\$1,217.9

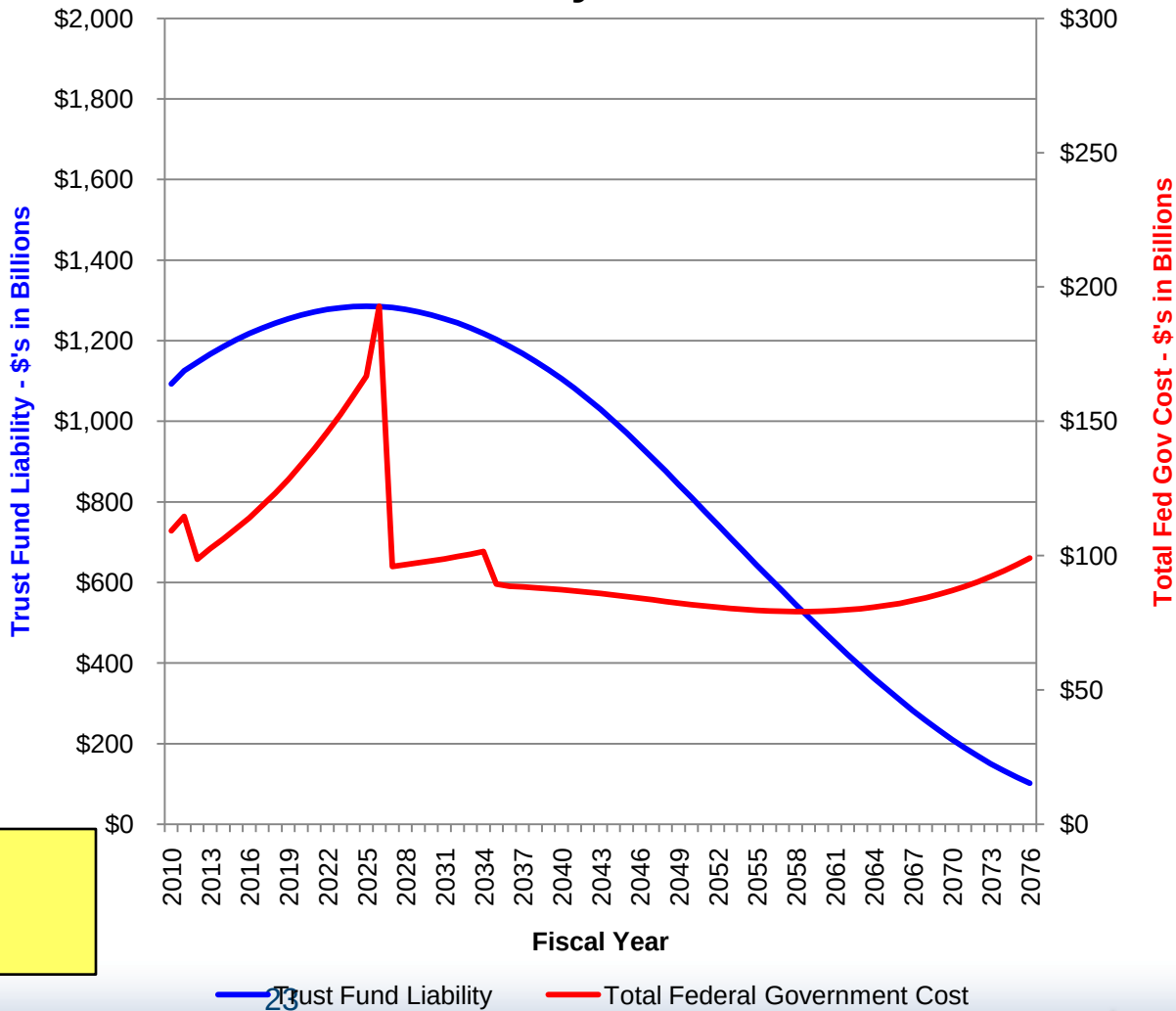
*Numbers are in billions

Assumptions:

- Average vesting year 4
- New recruits on new plan
- Active duty immediately transition

Source: OSD Office of Actuary

Military Retirement Trust Fund Under Transition Plan by Fiscal Year



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Questions?

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