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How to Work with the New Retirement System

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By Scott Spiker

The new Blended Retirement System (BRS) represents one of the most significant changes to military benefits in 70 years. The BRS, the basics of which are provided later in this article, will be standard for active-duty and reserve military service members who join on or after 1 January 2018. Existing service members with less than 12 years of service on 31 December 2017 will stay under the traditional system, or they may choose to transition to the BRS. For those who do not remain in the military long enough to earn the traditional retirement pension—generally 20 years—the BRS looks like a fair trade, because the automatic contributions put new retirement dollars into the pockets of those who today leave the military with no retirement benefits. For the next generation of 20-year career military families, however, the BRS trades the simplicity and security of a standard pension for risks that, without the type of proper planning that is promoted and detailed here, could result in inadequate preparation for retirement.

Starting on 1 January, the traditional military retirement of the 20-year “cliff vesting” pension system will morph into a new program of smaller monthly pension checks paired with bonuses and matching-fund contributions. Proponents frequently praise the bonuses and contributions as a way to give deserving service members new opportunities to save for and control their own financial futures. Important advantages of the system include the fact that 20 years’ service will no longer be required in order to accumulate a retirement account. This is a major change that must not be dismissed, as it provides security to many who previously had none without serving the full 20 years. Those who remain in the service, however, will need guidance.

The new bonuses and contributions are being paid for through a 20 percent cut in the traditional military pensions, payments that previously began immediately on retirement and grew in size through annual cost-of-living adjustments that continued for the life of the retiree. In essence, families’ long-term financial security under BRS is built on a transition from a simple, predictable benefit with the financial risk assumed by the U.S. government to a complex, option-laden program in which the retiree owns much of the risk. Shrinking the lifetime pension saves the government money in the long term, but the cost savings is made possible by service members’ decreased benefits. Many come from lower-income backgrounds and have just a high-school education, making them vulnerable under the heightened financial risks of the new system.

For those who do stay in the service long enough to collect their full retirement accounts, the BRS buyout will result in lower withdrawal amounts than they would have received under the guaranteed pension that helped support lifetime retirement security for generations of career military families. This is unfortunate, but the negative impact can be moderated with planning.

The new approach comes straight out of the corporate U.S. financial playbook. Decades ago, big employers discovered a new way to cut the cost of an old expense. They made a seemingly generous trade with their workers, replacing promises of guaranteed income in the distant future—old-style pensions—with the more accessible 401(k), offering matching contributions that would be deposited into portable investment accounts. The appeal of this system was and remains that portability, in a workforce that has become far more mobile over the years. The BRS will transform the way career service members must plan for lifetime financial security. Based on the experiences of U.S. workers during the past four decades, we know the questions they will ask: Am I saving enough? What if I pick investments that lose money? How much of my nest egg can I safely spend in retirement?

To help service members navigate the increased complexity of the BRS, which is now law, we must develop methods with better results than those that have to date been realized in the corporate environment.

How It Works

In January 2015, a presidential-appointed Military Compensation and Retirement Modernization Commission (MCRMC) released an in-depth report, with recommendations to modernize the system. A single element of the 15 recommendations was enacted into law as part of the 2016 National Defense Authorization Act (NDAA), which was signed into law on 25 November 2015 and became the BRS.

The changes come in four components:

- **Reduced Multiplier:** The retired-pay multiplier is reduced from 2.5 percent for each year of service to 2.0 percent, resulting after 20 years in a 20 percent reduction in the retirement annuity.
- **Thrift Savings Plan (TSP) Participation:** Military retirement reform depends heavily on service member participation in the TSP. It includes a Department of Defense (DoD) automatic contribution of 1 percent of basic pay, matching contributions applied to a participant’s first 3 percent of contributions dollar for dollar, and 50 cents on the dollar for the participant’s next 2 percent. To earn the full TSP match, service members must contribute 5 percent of their pay. Three percent is automatically deducted from the service member’s pay, but he or she can override that automatic deduction.

- **Continuation Pay:** By offering a continuation pay (which the DoD is calling a bonus), the reform seeks to encourage service members between their 8th and 12th years of service to commit to 4 additional years after the 12th year. Each service independently will determine the number of months of basic pay (2.5 or more months) to be received as a bonus, by either rating or job specialty. If the member does not serve the full four-year extension, he or she will be required to pay back some or all of the bonus. Those additional years, when served, will push service members to within 4 years of retirement. The bonus can be taken as a single lump sum or in not more than four payments. The analysis underpinning the original MCRMC report stated that the Continuation Pay would need to accumulate on a tax-deferred basis in the TSP at 7.3 percent compounded annually, until age 67 if the service member were to achieve a retirement equal to the existing pension. By characterizing this as a Continuation Bonus, the likelihood of these dollars being invested in a retirement account for a prolonged period of time will be negligible.
- **Lump Sum of Certain Retired Pays:** Retiring service members will have the opportunity to receive upfront dollars by forfeiting part of their remaining annuity during their working-age years. The lump-sum payment will be equal to the present value of the additional forgone annuity payments calculated, using a DoD-determined discount factor, which is an annually approved rate that is currently 6.99 percent. They can forgo either 25 percent or 50 percent of their monthly retirement pay. Thus, if a retiree accepts the 50 percent lump sum, he or she will receive only half of the original guaranteed value. The person can choose to take the lump sum as a single payment or in four equal annual installments. Reduced monthly payments from the annuity will continue until full retirement age has been reached, which usually means 67, and then returns to the full amount. Based on a detailed analysis of the future finances of two hypothetical career military members (one enlisted, one officer) who retire at age 42, First Command Financial Services, Inc. (my firm) projects that lump-sum amounts calculated at the 6.99 percent rate would total less than half of all the monthly payments forfeited over a 25-year period.

Prepare Realistically

First Command Financial Services' analysis of BRS consequences for career military members retiring after 20 years, both enlisted and officers, shows that it will be essential to carry out the following steps:

• Save a sufficient portion of basic pay, continuation pay, and all lump-sum bonus payments. Do not accept lump-sum buy-downs, or at least minimize them.

• Invest enough to receive the full match in the fund offerings available through the TSP. Avoid overly conservative investment choices.

Faithfully adhering to these two tenets increases the likelihood of generating retirement pay that equals approximately that of the current pension.

Optional Enrollment

The new system provides certain current service members the opportunity to opt in to the BRS. This is proving to be an increasingly enticing option. First Command Financial Behaviors Index® marketplace studies reveal that support for the BRS is growing, with 27 percent of eligible career military families planning to opt in as of July 2017. In August 2016, only 8 percent believed they would do so.

Certainly lump-sum bonuses and 401(k)-style contributions seem very appealing at first glance. But service members must understand what they may be giving up. This decision likely will affect their lifetime financial security, and the up-front dollars may not be adequate to make up for the smaller lifetime pension. The longer a person has served before opting in to the new system, the less time he or she has to amass the wealth required to offset the 20 percent reduction (over 20 years) in guaranteed retired pay for life. It will be essential for those who opt in to be vigilant in their savings and investing behaviors.

Make Full Use of the TSP

In 2001, service members became eligible to participate in the TSP on a voluntary basis. This is the same 401(k)-style plan available for participation by federal civilians. The significant difference is that, although military families were given the option to contribute, there were no agency automatic or matching contributions. Without an incentive, participation rates have remained relatively low. Today, only 45 percent of eligible service members participate, according to the Federal Retirement Thrift Investment Board. Among those who intend to retire from military service, the July 2017 First Command Financial Behaviors Index shows that participation is slightly higher, at 57 percent.

To ensure TSP participation in the BRS, the new program includes an auto-enrollment feature. All BRS participants will be auto-enrolled for a 3 percent contribution into a Lifecycle fund, meaning their retirement target date will be estimated according to age. The automatic contributions will go to the TSP that most closely corresponds to the year age 67 is reached. Anyone who decides to reduce contributions below 3 percent will be re-enrolled at 3 percent in January of each year, meaning the decision will have to be made every year, with enrollment being the default to avoid costly mistakes for service members.

Our analyses indicate, however, that a full 5 percent contribution will be needed to replace the reduction in annuity income. Even when this strategy is combined with wise investment choices and saving the continuation bonus, success will depend on investment returns. Unfortunately, many TSP participants currently are missing out on the long-term opportunities offered by the stock market—which also comes with risk that too many choose to avoid.

The G Fund is the most popular within the TSP. Many investors put 100 percent of their assets into what they believe is a safe fund. But while the G Fund offers some guarantees, it does not include exposure to stocks. According to Fedweek.com ("TSP G Fund Downside: Low Returns," 10 July 2017 [3]), the result is weak long-term returns. The G Fund does indeed offer sanctuary from potential stock market losses in the near term, however it may not grow enough over time for families to meet their future needs.

Educate Yourself

The DoD is required by Congress to create a financial-readiness program that is available to all personnel at all installations. Although the newest training has focused on the BRS, overall the program is intended to cover both career milestones and life events. The former include:

• Basic training

• Arrival at first duty station

• Promotions

• Subsequent duty-station changes

• Pre- and post-deployments

• Preparing for retirement

• Separating from the service

Life-event subjects include:

• Marriage

• Divorce

• Childbearing

• Enrollment in the Thrift Savings Plan

Developing the training and executing effectively at all installations will be monumental tasks for which leadership attention at all levels will be essential. One of the challenges here will be to improve the DoD’s track record at providing government education with demonstrable success. According to a January 2017 First Command survey, 68 percent of career military families failed a nine-question financial-readiness test, compared with 39 percent of the general population of middle-class families.

Military respondents were significantly more likely than their general-population peers to say they had completed a financial-education program (45 percent versus 21 percent), but the benefits of those programs were not reflected in test scores. Among the subset of military respondents who reported completing a financial-education program (through the military or another source), 60 percent did not earn a passing grade on the test.

Prepare the Whole Family and then Act

Financial readiness is a particularly important issue in the lives of military spouses, who often shoulder the primary responsibility for household budgeting and savings. They manage family finances while the active-duty spouse is deployed for extended periods, and because of frequent moves, finding and maintaining meaningful employment is a challenge. Military spouses also carry the burden of knowing they will face these responsibilities alone in the event of a combat death. And at the end of active-duty service, couples must navigate the financial complexities of the family’s transition to civilian life.

After education comes the time for action. Because military benefits, under both the traditional retirement system and BRS, are often not enough to ensure lifetime financial security, service members must take an active role in planning. Success requires behavior change, starting with living on less than they earned on active duty and planning for long-term needs.

Service members and their spouses need more open access to actionable advice, specifically the type of guidance and counsel that is focused on changing behaviors. They must have knowledgeable coaching readily available, aimed at helping them to take action to follow a frugal, long-term approach. Even though this type of behavioral-based, action-oriented advice is not for everyone, it can be effective for many, as demonstrated by results of the financial-readiness test. Military families who work with a financial advisor performed better on the test than those without an advisor. The failure rate among those who work with a financial advisor is 14 points less than their do-it-yourself counterparts.

Public-Private Collaboration

Services may try to deliver their own versions of this guidance, but shortcomings in the DoD’s educational efforts suggest this is not an area where they should go it alone. For service members to overcome the challenges brought by BRS, both education and advice should be delivered through a new kind of public-private partnership based on the recognition that outcomes are improved through personal engagement, not only readiness training. Personal financial coaching leads to action and success, in the same way as personal trainers can improve physical fitness.

Whether a member serves until retirement or separates before 20 years, the new BRS will require sound decisions, lifetime habits, and monitoring. Service members and their families can learn much from how the first 35 years of 401(k) participation unfolded among the general population. These pitfalls can be avoided. An effective line of attack would consider the importance of shaping savings and investment behaviors. This should begin with an effective program for broad-based financial education, including ongoing training on the BRS and the type of behavioral-based advice that already is helping many families in their long-term pursuit of financial security.

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