White Paper

The Blended Retirement System: Making it Work for America's Career Military Families

First Command Financial Services, Inc.

One of the most significant changes to military pay and benefits in 70 years is about to become reality for America's career military families – and it's going to transform the way service members think about and plan for their lifetime financial security.

The Pentagon's new Blended Retirement System (BRS) is now law, and in less than one year, all new service members will fall under this new program. While frequently praised as a way to give deserving service members new opportunities to control their own financial futures, the BRS is no reward. It places the weight of increased financial decision making and its attendant risk directly on the shoulders of the active-duty military force. This is particularly true for those service members who want to make the military their career.

Career service members and their families are already challenged by multiple combat deployments since 9/11 and the uncertainties generated by military cuts under sequestration. Financial stress on service member families is further compounded by frequent relocations that limit opportunities for building home equity and securing meaningful employment for spouses. These types of financial concerns are motivating a growing number of career service members to seek professional financial help in the form of knowledgeable investment and retirement advice. But too many active-duty families do not know where to go to find this help. They are challenged in part by outdated governmental policies that artificially stymie healthy competition for the benefit of a limited number of financial industry providers. While designed to protect our nation's service member families, these policies actually threaten their long-term financial stability by limiting options to secure the personalized help they want at a time when they need it most.

How It Works

The BRS is replacing a portion of the traditional military pension, a powerful benefit that has formed the foundation of long-term financial security for generations of service members. The BRS introduces lump sum bonuses and 401(k)-style contributions to the lexicon of active-duty and reserve military. They will be standard issue for service members who join on or after Jan. 1, 2018. Existing service members with less than 12 years of service on Dec. 31, 2017 will stay under the traditional system, or they may choose to transition to the BRS.

BRS reduces the guaranteed income from a military pension by 20 percent. Under the current system, a service member reaching at least 20 years of service is eligible for retirement pay. That pay is arrived at by calculating their average pay from their three highest paying years of service (typically the most recent three) and applying a multiplier of 2.5 percent for each year served. A person serving 20 years receives 50 percent (2.5 percent times 20) of their "high three" average monthly pay. That pay begins immediately upon retirement and lasts for life, with annual cost of living increases. BRS takes that system and slashes the multiplier from 2.5 percent to 2.0 percent, resulting in a huge 20 percent reduction in the multiplier and subsequent annuity.

The reduction in annuity is replaced with two components:

- Automatic and matching contributions to the Thrift Savings Plan (TSP), a defined contribution plan for federal employees and the military offered by the federal government. To earn the full TSP match, service members must contribute 5 percent of their pay.
- A continuation bonus to be awarded between the eighth and 12th year of service. The continuation bonus (intended to manage retention) will be 2.5 or more months of pay.

Proponents praise the new program as a valuable benefit that will give our men and women in uniform new opportunities to control their own financial futures. For those who don't stay long enough to earn the traditional retirement pension (generally 20 years), BRS looks like a fair trade. It will put new dollars in the pockets of service members who today leave the military with no retirement benefits. But for the next generation of 20-year career military families, BRS trades good things for risks that could turn out bad.

BRS is no reward

This new system is no reward for those who make the military their career. The new bonuses and contributions are being paid for through the 20 percent cut in the size of the regular checks that come from a military pension, checks which today begin arriving immediately upon retirement and grow in size through annual cost of living adjustments that continue for the life of the retiree. In essence, the long-term financial security of our service member families under BRS will be built on a cash buy-out. This buy-out reduces the value of the guaranteed pension that has helped support lifetime retirement security for generations of career military families.

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The BRS is intended to save the government money long term, but it's a cost savings heaped on the backs of our service members. Many of them come from lower-income backgrounds with a high school education, making them particularly vulnerable under the heightened financial risks of the new system.

Optional Enrollment for some existing members

The impact of a reduced pension is not limited to those who will be joining the military in the future. The new system gives certain current service members the opportunity to leave behind the old system and opt into the new retirement benefits. That's proving to be an increasingly enticing option. Our marketplace studies through the First Command Financial Behaviors Index® reveal that support for the BRS is strengthening among America's career service members. Our April 2017 survey shows that 31 percent of eligible career military families want to opt in to the new plan. That's up from just 8 percent in August 2016.

Certainly lump sum bonuses and 401(k)-style contributions seem very appealing at first glance. But do these service members understand what they may be giving up? Do they recognize that this decision will likely affect their lifetime financial security? Do they appreciate that the up-front dollars may not be large enough to justify the smaller lifetime pension? The longer a person has served prior to opting into the new system, the less time they have to amass the wealth required to offset the 20 percent reduction in guaranteed retired pay for life.

The historic failure of 401(k)s in America

We must learn from history. We are about to take our military through what the rest of middle class America went through in the 1980s, when the private sector traded the defined benefits of pensions for the defined contributions of 401(k) plans. Certainly it was a successful trade for many employers, who were able to transfer the uncertainty of long-term financial risk from their company balance sheets to the household finances of their employees. But for a good portion of American workers, the trade hasn't worked well. Not only do Americans not participate enough in their retirement planning, lower income Americans are less likely to be able to afford and to participate in their 401(k). Consider the statistics:

- According to the Pew Charitable Trusts, the median account balance for those nearing retirement (ages 55 to 64) is about $76,000– terribly short of what most middle-class Americans will need to maintain their standard of living in retirement.
- Employee participation is highest among higher income workers. A 2011 report by the Government Accountability Office reveals that most of the people contributing as much as they are allowed tend to have incomes of $126,000 or more.
- Those with lower incomes are less likely to participate in a defined contribution plan. According to Vanguard's "How America Saves 2014" report, the median income of participants in 2013 was $75,000. The median income of those who were eligible but did not participate was $48,000.

That last statistic is particularly significant for our career military families. An active-duty service member at a pay grade of E-5 with four years' service earns $32,029 in basic pay in 2017, plus an additional $15,720 in allowances (with dependents) for a total earned income of $47,749 – about the same amount as the median income for non-participants cited in the Vanguard report. Our young E-5 service member example looks very much like the typical American.

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Now we are repeating the history of the private sector, but with government as the cost-cutting employer. Our nation is transferring the uncertainty of long-term financial risk from the public balance sheet to the household finances of the service members who are committed to defending our nation. New service members will embark on their military careers with a smaller guaranteed retirement income stream than those who came before them. They will be compelled to make up the difference by taking on the risks of the financial markets. How likely are our young service members to adequately save for their financial futures? While they are the people most in need of participation, industry statistics tell us they are the least likely to participate. Will career service members succeed where so many other middle-class Americans have failed? The odds are not in their favor.

Leveraging the TSP

Service members already have the opportunity to invest for their retirement through the Thrift Savings Plan. But only 45 percent of eligible service members actually participate, according to the Federal Retirement Thrift Investment Board. Participation is slightly higher, but still poor, among career service members (55 percent for the first four months of 2017, according to our previously-mentioned April 2017 survey).

To ensure TSP participation in the BRS, the program includes an auto-enrollment feature. All BRS participants will be auto-enrolled for a 3 percent contribution into a Lifecycle fund (target-date) in the TSP that most closely corresponds to the year they reach age 67. Anyone who reduces contributions below 3 percent will be re-enrolled at 3 percent in January of each year.

Analyses indicate that replacing the reduction in annuity income will require service members to commit to the full 5 percent contribution, make wise investment choices and invest the full continuation bonus.

Even then, success is highly dependent upon investment returns. This is another area where the odds are not in the favor of career service members. Our research suggests that many TSP participants are missing out on the long-term investment opportunities offered by the stock market. They are stashing their retirement dollars in the G Fund, a low-risk, low-yield government securities fund that offers protection from loss of principal but delivers returns that may not even equal the rate of inflation.

Our monthly Financial Behaviors Index surveys reveal that the G Fund is typically the most popular investment choice of middle-class military families. Participation averaged 32 percent over the four-month period ending in April 2017. Steering away from stocks and toward so-called safe investment options is by no means the safest choice, especially for long-term investors. While the G Fund may feel like a sanctuary from potential stock market losses in the near term, it may not grow enough over time for service member families to meet their future needs.

Success of the BRS for our service members requires education and action.

Education is imperative in order for service members to be able to negotiate the decisions and therefore avoid the pitfalls of the BRS. But as with all American families, education is only the tip of the iceberg. The Department of Defense is required 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 financial readiness training is intended to focus on both career milestones and life events. Some examples of career milestones are:

- Basic Training
- Arrival at First Duty Station
- Promotions
- Subsequent Duty Station Changes
- Pre- and Post- Deployment
- Preparing for Retirement
- Separating from the Service

Life event subjects include:

- Getting Married
- Getting Divorced
- Having a Child
- Enrolling in Thrift Savings Plan

This training is necessary to prepare service members for the decisions they must make. Developing the training and executing at all installations – effectively – will be a monumental task. Each service will need to be accountable for the training and subsequent actions of their personnel. This will require leadership attention at all levels to ensure the training is conducted as required.

Will government education efforts generate successful results? The DoD’s track record is not good.

Results of the sixth annual financial readiness test and survey commissioned by First Command in partnership with the First Command Educational Foundation in January 2017 reveal that 68 percent of career military families were unable to earn a passing grade on a nine-question financial readiness test. That compares to 39 percent of the general population of middle-class families.

Military respondents are significantly more likely than their general population peers to say they completed a financial education program (45 percent versus 21 percent), but the benefits of those programs are not reflected in test scores. Among the subset of military respondents who report completing a financial education program (either through the military or another source), 60 percent were unable to earn a passing grade on the test. That's only slightly better than the overall 68 percent rate.

Sixty-eight percent of career military families were unable to earn a passing grade on a nine-question financial readiness test.

Financial readiness is a particularly important issue in the lives of military spouses. Their unique experience is often one of shouldering the primary responsibility for household budgeting and savings. They must manage family finances during those times when the active-duty spouse is deployed for extended periods and face unique challenges in finding and maintaining meaningful employment because of frequent moves. They carry the burden of knowing that they will face these responsibilities alone in the event of a combat death. And at the end of active-duty service, military spouses play a critical role in navigating the financial complexities of the family's transition to civilian life.

Although education is important, without action nothing happens and their financial future will not improve. The previously mentioned financial readiness test and survey reveals that military families who work with a financial advisor perform better on the test than those without an advisor. Thirty-five percent of them earned a passing grade versus 21 percent of service members who do not work with an advisor.

But the real benefits of professional coaching are in changing behaviors. Career military families who work with a financial advisor are more likely to follow a frugal, long-term approach that focuses on retirement savings than their colleagues who do not work with an advisor.

Our monthly Financial Behaviors Index surveys reveal that 82 percent of middle-class military families who work with a financial advisor contributed to retirement savings during the first quarter of 2017. That compares to 70 percent of their do-it-yourself colleagues. Families with financial advisors contributed more dollars to their retirement accounts, too. Monthly median contributions for the two groups were $500 and $300, respectively.

Service members who work with a financial advisor are also more likely than those without an advisor to contribute to:

- Short-term savings (83 percent versus 77 percent). Monthly median contributions for the two groups were $500 and $300.
- Long-term savings (65 percent versus 47 percent). Monthly median contributions for the two groups were $450 and $250.

Those with a financial advisor report roughly $45,000 more in accumulated savings and retirement funds than their do-it-yourself colleagues. First quarter holdings for the two groups are $158,913 and $113,365, respectively.

Coaching leads to positive action. And yet, the connection between personal financial coaching and financial success is not generally acknowledged in the public debate or provided for in the legislation and training.

Service members who work with a financial advisor are more likely to take advantage of the TSP than their colleagues without an advisor. Our April 2017 survey reveals that during the January-through April period, 60 percent of those with an advisor participate in the TSP versus 32 percent of those without an advisor.

These findings underscore the value of personal financial coaching. The benefit is unmistakable. Coaching leads to positive action. And yet, the connection between personal financial coaching and financial success is not generally acknowledged in the public debate or provided for in the legislation and training.

Military retirement is not enough to retire on

Military retirement benefits under the traditional retirement or BRS are not enough to ensure lifetime financial security. Like all Americans, service members must take an active role in their retirement planning in order to ensure a successful retirement.

For all Americans, success requires behavior change, starting with living on less than they earn and planning for their long-term needs. And this is a key area where financial coaching can bring significant and lasting benefits.

Notably, the correlation of positive financial behaviors and working with a financial advisor is supported by an August 2015 RAND Corporation report:

> "…there is considerable evidence that individuals who receive professional financial advice are more financially healthy than those who do not … and are more likely to have a plan for retirement, more likely to feel confident about their retirement preparations, and more likely to have retirement goals."

The RAND report also notes that "there is considerable research suggesting that those in most need of financial advice are the least likely to receive it."

Working with a trusted financial professional is a time-tested way to pursue positive changes in financial behaviors. Through face-to-face financial coaching, career military families learn to improve their own finances today and pursue a meaningful path to financial security tomorrow.

DoD restrictions on base unfairly limit service members' access to effective financial education and training

Financial coaching can play a key role in the successful pursuit of retirement savings and long-term financial security. Service member families benefit from working with financial professionals who provide personalized, specific advice and encourage and inspire them to follow through with appropriate actions designed to generate the desired result.

What is holding them back? Access.

Many service members are looking for this type of service. The previously mentioned April 2017 survey reveals that 68 percent of career military families say they are extremely or very likely to consult a financial advisor for help in making the opt-in decision. And yet, many continue to report that they do not currently work with a financial advisor. What is holding them back? Access—specifically, access to effective financial education and training that highlights the benefits of financial coaching and that is delivered by expert financial advisory firms. Their options are sorely limited by onerous rules and regulations that benefit a limited number of financial industry providers by effectively shutting the door on the vast majority of their competitors.

The exclusive right to advertising on U.S. military bases enjoyed by on-installation banks and credit unions severely limits the ability of a wider range of financial services to present a more extensive offering of products and services designed to meet the financial and retirement planning needs of career service members. These rules and regulations restrict a variety of activities, even some as seemingly innocuous as advertising at on-installation MWR/MCCS events. These restrictions are typically imposed on financial providers even when they are "paying" commercial sponsors.

Current DoD policy stipulates that off-base financial institutions can act as MWR/MCCS sponsors and advertise at their events as long as the institutions limit their promotions to "product lines and services not offered by the applicable on-installation bank or credit union ("CU")"[1]. Defining these "product lines and services" has proven to be an impossible task, as the on-installation banks and CUs broadly interpret this language. Many request assistance from their JAG and Bank/CU Liaison Officers, whose views are often vastly different from installation to installation. There are also differing interpretations and application among the four Service Departments and the U.S. Coast Guard. As a result, off-base financial institutions are often told they cannot advertise at all (or cannot advertise anything they would deem worthy under a sponsorship agreement). Attempting to resolve these issues is inefficient, time consuming and often futile. The DoD needs to change this policy. Additionally, other outdated DoD and Service Department policies permit on-base commercial banks and credit unions to develop and disseminate information, and provide educational programs, for members of the military services on their personal financial affairs including retirement programs. At the same time, these policies prohibit all off-base financial institutions from disseminating financial information or participating in any on-base financial education programs for members of the military services. On-base banks and credit unions are also required to provide financial counseling services to military personnel as a part of their financial services, but off-base financial institutions are prohibited from doing so on any base.[2]

DoD's current policies noted above have worn out their usefulness. They are unnecessary and unwarranted. They limit financial resources and services available for the benefit of all service members

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[1] (*DoD Financial Management Regulation* ("DoDFMR"), Vol. 5, Chapt. 34). (Encl. 1). This policy is reflected in other DoD regulations and Instructions such as DoDI 1344.07. (Encl. 2). Each of the military services has a policy that mirrors the DoDFMR and DODI policies.

[2] DODFMR, Chapt. 34, paras. 340409; DoDI 1344.07, paras. 6.7.1 and 6.7.5.

and can be a contributing factor to their success or failure at retirement and meeting other financial needs. The policies also limit the dollars available to MWR/MCCS with no benefits to anyone except the on-installation banks and CUs.

With force reductions and restructuring inevitable, and with major changes to the military retirement system, there has never been a greater need for trustworthy financial advice and planning for service members – both for their BRS participation and other financial planning and servicing needs. First Command's long history of working with professional military families and its depth and breadth of services offer service members and their families unique advantages in enhancing their financial readiness, planning for separation or retirement, and transitioning to post-military life. And First Command is but one of many companies that could bring unique advantages to the table.

Given the dire need installations have for corporate sponsorship in these lean financial times, the DoD and the Service Departments should re-think the old and existing policy of granting almost total access and advertising exclusivity to on-installation banks and CUs. The original justification for the policy (i.e., that it was deemed necessary to attract financial institutions to open offices on isolated military bases) is no longer true. Continuation of this policy artificially limits healthy competition. By the mechanism of an old-fashioned regulatory monopoly, the DoD limits the financial resources and services available for the benefit of our military personnel and their families .

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The right and best approach would be for DoD to eliminate, entirely, the policy giving any exclusivity to on-installation financial institutions. A possible result of a fix might be that other off-installation financial institutions may also desire to increase their on-base MWR/MCCS sponsorship/advertising or begin sponsorship programs if they see greater on-installation advertising opportunities. While this might increase First Command's competition for sponsorship activities and programs, and associated costs, it is the right thing to do and would clearly be healthy and helpful for MWR/MCCS programs and our nation's military personnel and their families.

Closing

America’s career military families face real financial challenges, and those challenges are most acute in the area of ensuring adequate financial planning and services, particularly for retirement savings and income.

The guarantees and lifetime financial security offered by the traditional military pension made it a powerful benefit for generations of career service members. While the cash contributions and other benefits of the BRS may seem appealing on the surface, this new system is no reward. It comes with no new dollars. The bonuses and contributions are being paid for through a 20 percent cut in the size of monthly pension checks, which today begin arriving immediately upon retirement and grow in size through annual cost of living adjustments that continue for the life of the retiree. The long-term financial security of U.S. service member families will be built on a cash buy-out – one that transfers risk from the government to the service member.

Whether someone serves until retirement or separates before 20 years of service, the new system will require sound decisions, lifetime action and monitoring. Service members and their families cannot afford to let the BRS turn out the way the first 35 years of 401(k) participation did for the general population. First Command recommends a line of attack that fully considers the importance of shaping savings and investment behaviors, which starts with an effective program for financial education and training on the BRS. To be effective, the program should offer service members on-installation instruction by expert financial advisory firms and should extol the benefits of the type of financial coaching that is already helping many career military families in their long-term pursuit of financial security.

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Compiled by Sentient Decision Science, Inc., the First Command Financial Behaviors Index® assesses trends among the American public's financial behaviors, attitudes and intentions through a monthly survey of approximately 530 U.S. consumers aged 25 to 70 with annual household incomes of at least $50,000. Results are reported quarterly. The margin of error is +/- 4.3 percent with a 95 percent level of confidence. Sentient Decision Science was commissioned by First Command to compile the Financial Behaviors Index®. SDS is a behavioral science and consumer psychology consulting firm with special vertical expertise within the financial services industry. SDS specializes in advanced research methods and statistical analysis of behavioral and attitudinal data.