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United States Government Accountability Office
Washington, DC 20548

July 26, 2006

The Honorable John Warner
Chairman
The Honorable Carl Levin
Ranking Minority Member
Committee on Armed Services
United States Senate

The Honorable Duncan L. Hunter
Chairman
The Honorable Ike Skelton
Ranking Minority Member
Committee on Armed Services
House of Representatives

Subject: *Financial Management: Implications of Significant Recent and Potential Changes for the Actuarial Soundness of the Department of Defense Survivor Benefit Plan Program*

This report responds to a legislative mandate to report on the effects of certain program changes on the actuarial soundness[1] of the Survivor Benefit Plan (SBP) program, which is part of the Department of Defense's (DOD) Military Retirement Fund (Fund). The primary purpose of the SBP is to provide benefits to the surviving dependents of deceased members or retirees of the armed forces. In certain cases, individuals other than dependents can be designated recipients of survivor benefits. The Fund accumulates financing resources in order to fund, on an actuarially sound basis, the liabilities of the military retirement and SBP programs.

The SBP was created by legislation enacted on September 21, 1972,[2] and has been modified various times by subsequent legislation. The fiscal year 2006 National

[1] The term actuarial soundness is widely used but not clearly defined for public retirement systems. For purposes of this report, we used the following definition: A retirement system is considered actuarially determined if a professionally qualified actuary (1) calculates the present value of the liabilities for future benefits for current participants and their beneficiaries, (2) determines the normal cost and amortization payments for the unfunded actuarial accrued liability over a reasonable period, and (3) has established a method for determining and amortizing experience gains and losses. If, in addition, the plan sponsor has indicated that it has the willingness and sufficient fiscal capacity to pay those ongoing costs, the plan may be considered actuarially sound.
[2] Pub. L. No. 92-425, 86 Stat. 706 (Sept. 21, 1972) (*codified*, *as amended*, *at* 10 U.S.C. §§ 1447-1455).

Defense Authorization Act[3] requires that we report to you on

(1) the effect of recent significant SBP program changes on the actuarial soundness of the program,
(2) the effect of these significant SBP program changes by the various categories of participants and in total on (a) DOD normal cost payments for the program[4] and (b) Department of the Treasury (Treasury) payments to amortize the unfunded liability amounts,[5]
(3) the potential effects to Treasury and DOD payments that would result from the following two legislative changes: (a) the enactment of a law permitting participants in the program to designate an insurable interest if a previously designated beneficiary dies and (b) the enactment of a law repealing the Dependency and Indemnity Compensation (DIC) offset (10 U.S.C. § 1450(c), 1451(c)(2)) for beneficiaries, and
(4) the effect that each of the two potential legislative changes would have on the actuarial soundness of the SBP.

To accomplish the above objectives, we met with the DOD Office of the Actuary (OOA) staff to identify legislative changes to the SBP that occurred within the last 7 fiscal years and that had a significant effect on SBP annual costs, the related long-term liabilities, or both. We determined that while the DOD OOA was able to provide us with information on SBP changes to DOD normal cost payments by participant categories, that same level of detail is not maintained for Treasury amortization payments because participant level breakout is not required for such payments. We discussed this limitation with your offices, and they agreed that, for purposes of this report, Treasury payments could be reported in total.

As we stated in communications with your offices, the SBP is a part of the Fund, and it is not practical to report on the actuarial soundness of the SBP separately. Therefore, our review had to consider how SBP changes affected the actuarial soundness of the Fund as a whole. We also brought to your attention the fact that information related to the ongoing SBP open season enrollment period[6] will not be fully estimable for at least 2 years, and therefore, current cost estimates may be subject to significant changes once the enrollment period has ended on September 30, 2006. As agreed with your offices, for open season changes, we reviewed the reasonableness of preliminary estimates made by the DOD OOA using current participant and cost information and certain assumptions considered likely by actuarial staff. Finally, we performed procedures to assess the reliability of the data used by the DOD OOA in calculating the cost estimates for the various enacted and potential legislative changes. Because the SBP is part of the Fund, the systems, data,

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[3] Pub. L. No. 109-163, div. A, tit. VI, § 666, 119 Stat. 3136, 3318-19 (Jan. 6, 2006).
[4] Normal cost payments reflect the percentage of basic pay that must be contributed over the entire active career of a typical group of new entrants to pay for all the future retirement benefits of that group.
[5] Unfunded liability amounts include liabilities that were present at the inception of the plan for prior service and any actuarial gains or losses that arise because of such things as experience that deviates from what was assumed, changes in plan benefits, or changes in actuarial assumptions.
[6] Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005, Pub. L. No. 108-375, § 645, 118 Stat. 1811, 1962 (Oct. 28, 2004).

and assumptions used by the DOD OOA are subject to testing as part of the Fund's annual financial statement audit. To determine the extent of testing related to the DOD OOA process used to estimate SBP benefit program costs as well as the Fund's pension liability, we interviewed the Fund's independent auditors and reviewed relevant fiscal year 2005 financial statement audit test documentation. Although auditors have given the Fund an unqualified opinion on its financial statements for the past 10 years because audit tests have shown the reported information to be reliable, the SBP program is such a small component of the Fund that auditors are unlikely to test many specific SBP program data elements.[7] Therefore, the unqualified opinion that applies to the Military Retirement Fund as a whole cannot be separately applied to the SBP as a stand-alone program. More details on our scope and methodology and the limitations related to this review are presented in enclosure I.

We requested comments on a draft of this report from the Secretary of Defense or his designee. We were provided a number of technical suggestions, which we have incorporated as appropriate. Separately, we received a written response provided by the Deputy Under Secretary of Defense for Program Integration and presented in enclosure II.

We conducted our work from February 2006 through June 2006 in accordance with generally accepted government auditing standards.

Results in Brief

The significant statutory SBP program changes implemented within the past 7 fiscal years that we reviewed have resulted in increased DOD normal cost payments and annual Treasury amortization payments to the Fund in order to maintain the actuarial soundness of the Fund. When changes are made to SBP coverage or benefits, the DOD OOA calculates the necessary DOD and Treasury contributions to ensure that sufficient moneys are available to make all benefit payments to eligible recipients each year, and that sufficient Fund assets will be available in the future to liquidate all current unfunded liabilities.

According to the DOD OOA estimates, the significant SBP program changes[8] we reviewed have resulted in the following:

- Eliminating the reduction in surviving spouses' SBP benefits when such spouses are also eligible for Social Security benefits at age 62 and thereafter increased the SBP liability by an estimated $25.2 billion as of September 30, 2004. Of this amount, Treasury and DOD will be responsible for an estimated $23.7 billion and $1.5 billion, respectively. DOD's $1.5 billion liability includes $1.3 billion in normal costs for current active duty and full-time reservists (full-

[7] For fiscal year 2004, only 13 percent of total Fund participants were part of the SBP program and only 6 percent of Fund expenditures and obligations related to the SBP.

[8] The DOD OOA estimates the cost of each significant SBP program change as of a specific valuation date. Subsequent to that date, the costs of each SBP program change become part of the baseline actuarial model and are not separately identified. According to the DOD OOA, there have been no significant cost reestimates after the valuation date for the three program changes we reviewed.

time employees) and $0.2 billion in normal costs for current part-time reservists (part-time employees).

Periodically, Congress has allowed an open season for SBP enrollment, the most current one being during fiscal year 2006. Although the total effects of the SBP open season cannot be fully estimable for at least 2 years, the estimated increase in the SBP liability will likely range from $31 million to $86 million.

- Eliminating further SBP premiums to be paid by retirees who are aged 70 or older and who have paid such premiums for 30 years increased the SBP liability by an estimated $2.5 billion.[9] Of this amount, Treasury will be responsible for an estimated $2.4 billion, and DOD will be responsible for $0.1 billion in normal costs related to current full-time employees.

- Extending SBP surviving spouse or child benefits for all personnel who are killed in the line of duty and are not eligible for retirement at the time of their deaths increased the SBP liability by an estimated $72 million as of September 30, 2001. Of this amount, Treasury will be responsible for an estimated $28 million, and DOD will be responsible for $44 million in normal costs related to current full-time employees.

The two potential changes to SBP benefits mentioned in Section 666 of the National Defense Authorization Act for Fiscal Year 2006 would likely also result in increases to the DOD normal cost payments and the annual Treasury amortization payments to the Fund as follows.

- Currently, an unmarried DOD retiree without dependent children may elect to have another person with an insurable interest as the SBP beneficiary; however, if that beneficiary dies, designation of another insurable interest is not allowed. Using conservative assumptions, the DOD OOA calculated that the SBP liability would increase by an estimated $2.2 million if retirees were allowed the option of choosing a second insurable interest. Of this increase, Treasury would be responsible for $2 million and DOD for $231,000. Of DOD's $231,000, $211,000 would be for normal costs related to current full-time employees and $20,000 for normal costs related to current part-time employees.

- The survivors of veterans who die because of complications resulting from a service-connected disease or injury are entitled to DIC benefits from the Department of Veterans Affairs (VA).[10] Under current law, SBP benefits for survivors of retired veterans are offset by any DIC payments received. The DOD OOA calculated that eliminating the current offset requirement would increase the SBP liability by an estimated $12.9 billion. Of this amount,

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[9] The liability estimate for this legislative change was determined as of September 30, 2001, and will be effective on October 1, 2008.

[10] VA's DIC was established in 1956 by the Servicemen's and Veterans' Survivor Benefits Act, Pub. L. No. 84-881, 70 Stat. 857, 862 (Aug. 1, 1956) (*codified*, *as amended*, *at* 38 U.S.C. ch. 13).

Treasury and DOD would be responsible for $12.3 billion and $645 million, respectively. Of DOD's $645 million, $617 million would be for normal costs related to current full-time employees and $28 million for normal costs related to current part-time employees.

Enactment of these legislative changes would require the Board of Actuaries and the DOD OOA to adjust DOD and Treasury payments, subject to future appropriations, by amounts necessary to offset any increased costs related to expanded benefits; for this reason, enactment of these changes should not negatively affect the actuarial soundness of the Fund.

In responding to a draft of this report, DOD did not have any objections or substantive comments. DOD separately provided some technical suggestions, which we incorporated as appropriate.

Background

Under the SBP program, a military retiree can have a portion of his or her monthly retired pay withheld in order to provide, after his or her death, a monthly survivor benefit to a surviving spouse or other eligible recipient(s). The cost of this benefit is shared by the retiree (in the form of reductions from monthly military retired pay after retirement) and the government. The original intended purpose of the SBP was to "insure that the surviving dependents of military personnel who die in retirement or after becoming eligible for retirement will continue to have a reasonable level of income."[11] In 2001, coverage was expanded to active duty personnel as well.[12]

Six separate types of coverage are available under the SBP for military members retired from a military career, characterized according to the relationship of the beneficiary or beneficiaries to the military retiree:

- spouse only,
- spouse and child(ren),
- child(ren) only,
- persons with an insurable interest,
- former spouse, or
- former spouse and child(ren).

Total SBP costs are shared by the federal government and the retiree, so the reductions in retired pay, which represent the SBP premiums, are only a portion of the total cost of the SBP program.[13] The type of coverage and the amount of coverage provided are factors used in determining the cost to the military retiree. A retiree

[11] Department of Defense, Office of the Secretary of Defense, Military Compensation Background Papers, *Compensation Elements and Related Manpower Cost Items: Their Purposes and Legislative Backgrounds*, 6th edition (Washington, D.C.: April 2005), 902.
[12] National Defense Authorization Act for Fiscal Year 2002, Pub. L. No. 107-107, § 642, 115 Stat. 1012, 1151 (Dec. 28, 2001).
[13] In most cases, the SBP premiums are fixed by law or regulation and do not cover the total cost of the SBP program.

with an eligible spouse is automatically enrolled in the SBP upon retirement at the maximum level of coverage for his or her current spouse, unless the retiree elects not to participate, elects to participate at a lesser level of coverage, elects other than spousal coverage with spousal consent, or is ordered by a court to provide such benefits to a former spouse. The maximum SBP benefit for most retirees is 55 percent of retirement pay. If the retiree chooses less coverage, the SBP benefit is calculated as 55 percent of an amount less than full retired pay.

Although participants must decide whether to enroll in the SBP at the time of retirement, Congress may authorize an open enrollment season for retirees to make or change their SBP election. The current open season, established by the Defense Authorization Act for Fiscal Year 2005, runs throughout fiscal year 2006, and over 1.3 million retirees are eligible to elect or change their SBP participation. If retirees elect to participate in or increase coverage under the SBP program, they will have to pay a prospective monthly premium and a onetime, buy-in premium, which can be paid over a 2-year span.

The SBP program is part of the Fund, which was established by the Department of Defense Authorization Act, 1984.[14] This law also established an independent three-member DOD Retirement Board of Actuaries (Board) appointed by the President. Members of the Board must be qualified professional actuaries who are members of the Society of Actuaries, and they serve for 15 years. The Board is required to approve the actuarial assumptions for and review valuations of the military retirement system, to determine the method of amortizing unfunded liabilities, to report annually to the Secretary of Defense, and to report to the President and Congress on the status of the Fund at least every 4 years. The law also states that reports should include recommendations for changes that in the Board's judgment, are necessary to protect the public interest and maintain the Fund on a sound actuarial basis.

The DOD OOA provides all technical and administrative support to the Board. Among other duties, the DOD OOA performs annual valuations of the military retirement system, which include (1) projecting personnel, pay, and benefits; (2) calculating annual DOD contribution costs; and (3) determining program unfunded liabilities and their amortizations.

In general, the Fund's liabilities are funded by three sources: (1) monthly normal cost payments from DOD to pay for the future benefit costs of current service members,[15] (2) annual payments from Treasury to cover the costs related to amortizing the initial unfunded liability of the Fund and subsequent actuarial gains and losses, and (3) investment income. The Fund receives investment income from a variety of Treasury-based instruments, all of which are debt obligations of the U.S. government and are backed by the "full faith and credit" of the federal government.[16] The Fund receives

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[14] Pub. L. No. 98-94, tit. IX, § 925, 97 Stat. 614, 634, 644 (Sept. 24, 1983) (*codified, as amended, at* 10 U.S.C. §§ 1461-1467).

[15] Normal cost amounts are transferred from the DOD military pay appropriations.

[16] The Treasury-based instruments are not cash; they are a claim on the general fund of the Treasury for future spending. Federal trust funds, such as the Fund, typically invest their excess annual receipts over disbursements in federal securities. These securities constitute future obligations of the Treasury

management oversight from the DOD Investment Board established in September 2003. The members of the Investment Board are the Director, Defense Finance and Accounting Service; the Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller); and a senior military member, currently the Vice Chief of Naval Operations.

Effect of Recent Changes to the SBP Program on Actuarial Soundness of the Fund

When changes are made to the SBP program that result in more people being eligible for benefits or higher benefit payments to survivors, the DOD OOA is responsible for determining the amounts, which are to be approved by the Board, that must be contributed annually to the Fund to maintain the Fund on an actuarially sound basis. According to the DOD OOA, this means that there must be sufficient funds contributed to make all benefit payments to eligible recipients each year, including survivors, and that the Fund balance is projected to eventually equal the actuarial liability, that is, all unfunded liabilities will be liquidated. In order to accomplish this, DOD normal cost payments are calculated to fully fund the current year projected liability for active duty members and reservists. In addition, Treasury amortization payments are calculated to fund liabilities that were present at the inception of the plan (the initial unfunded liability) and any actuarial gains or losses that arise because of such things as experience that deviates from what was assumed, changes in plan benefits, or changes in actuarial assumptions. Treasury payments to cover the costs related to amortizing the initial unfunded liability are being made over a 50-year period and should be completed in 2033, while payments to amortize all subsequent gains and losses will be made over a 30-year period from the date of the change that caused a gain or loss.

According to the DOD OOA, it is not practical to separate the assets and liabilities of the SBP program from the whole of the Fund and it is not necessary to do so. The DOD OOA stated that all of the Fund's assets are available to pay any and all of the Fund's liabilities, including those of the SBP.

Effect of Significant Recent SBP Program Changes on SBP Liabilities

The three recent SBP program changes have increased the liabilities of the Fund and will therefore require increases in DOD and Treasury payments to the Fund. As shown in table 1, for the significant SBP program changes that have been implemented during the past 7 fiscal years, the DOD OOA estimated that the SBP liability would increase by about $27.8 billion. Of this increased liability, Treasury and DOD would be responsible for approximately $26.1 billion and $1.7 billion, respectively.

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since the Treasury must provide cash to redeem these securities in order for the Fund to pay benefits as they come due. When this occurs, if sufficient cash surpluses are not available to redeem the securities, the federal government would need to obtain cash through increased taxes, spending cuts, increased borrowing from the public, retiring less debt (if the unified budget is in surplus), or some combination thereof.

Table 1: Summary of Significant Recent Changes to the SBP Program

Dollars in millions			
Significant SBP change	**Estimated total increase in SBP liability**	**Estimated unfunded liability increase**[a]	**Estimated normal cost increase**[b]
Elimination of the age 62 benefit reduction	$25,205	$23,677	$1,528
Enactment of the paid-up provision	2,506	2,374	132
Extension of benefits for spouses and children of personnel killed while on active duty	72	28	44
Total effect of significant recent changes to the SBP	**$27,783**	**$26,079**	**$1,704**

Source: GAO analysis of DOD Office of Actuary information.
[a]Treasury is responsible for the annual amortization of the unfunded liability.
[b]DOD is responsible for the normal cost. Amounts shown reflect the increased normal cost payments on behalf of current employees and do not include the increases on behalf of future entrants.

Elimination of the Age 62 Benefit Reduction

Elimination of the reduction in surviving spouses' SBP benefits when such spouses are also eligible for Social Security benefits at age 62 and thereafter[17] has increased SBP liabilities by an estimated $25.2 billion. Of this amount, Treasury and DOD will be responsible for an estimated $23.7 billion and $1.5 billion, respectively. Of DOD's increased funding responsibility, $1.3 billion is for normal costs related to full-time employees and $0.2 billion is for normal costs related to part-time employees.

When the SBP was enacted in 1972, survivor benefits for those spouse annuitants 62 and over were reduced through use of a formula to reflect the availability of Social Security to the survivor. In 1985, the reduction formula was changed so that all annuitants 62 and over received 35 percent, rather than 55 percent, of the retiree's base amount.[18] Those whose annuities had been reduced by the original Social Security offset formula were grandfathered under the new law and allowed to choose whichever of the formulas was most advantageous. The National Defense Authorization Act for Fiscal Year 2005[19] phased out by April 1, 2008, the reduction in the survivor benefit that occurs at age 62 for all current and future survivors. Specifically, on October 1, 2005, the minimum SBP benefit for those surviving spouses age 62 and older was increased from 35 percent to 40 percent, and on April 1, 2006, the minimum benefit was increased to 45 percent. The benefit amount will increase to 50 percent on April 1, 2007, and to 55 percent on April 1, 2008.

[17] Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001, Pub. L. No. 106-398, tit. VI, § 656, 114 Stat. 1654, 1654A-166 (Oct. 30, 2000); Ronald W. Reagon National Defense Authorization Act for Fiscal Year 2005, Pub. L. No. 108-375, § 644, 118 Stat. 1811, 1960 (Oct. 28, 2004).
[18] Department of Defense Authorization Act, 1986, Pub. L. No. 99-145, § 711, 99 Stat. 583, 666 (Nov. 8, 1985).
[19] Pub. L. No. 108-375, § 644, 118 Stat. 1811, 1960 (Oct. 28, 2004).

For fiscal year 2006, Congress included an open season for SBP enrollment in the fiscal year 2005 National Defense Authorization Act.[20] Retirees can begin participation or increase their current level of coverage during the period beginning October 1, 2005, through September 30, 2006. Those retirees electing to begin or change coverage will have to pay all applicable back premiums, interest, and an additional amount calculated by the DOD OOA to help protect the actuarial soundness of the Fund either in a lump sum or in 24 equal installments. To remain eligible, retirees must also pay monthly premiums for at least 2 years. From October 2005 through May 2006, the Defense Finance and Accounting Service - Cleveland Site (DFAS-Cleveland) reported that fewer than 1,600 of the over 1.3 million retirees who were eligible to make an SBP election during the open season have chosen to do so. DFAS-Cleveland has estimated an average buy-in cost of almost $23,000 for those electing SBP participation earlier during this open enrollment season, which may have contributed to the small percentage of retirees changing their SBP election. Although the results of the SBP open season cannot be fully known for at least 2 years, the DOD OOA estimates that the increase in the SBP liability will likely range from $31 million to $86 million, depending on the number of elections made from June 2006 through the end of September 2006 and the health of the retirees and their beneficiaries.

Enactment of the Paid-Up Provision

Eliminating further SBP premiums to be paid by retirees who are aged 70 or older, and who have paid such premiums for 30 years, increased SBP liabilities by an estimated $2.5 billion. Of this amount, Treasury will be responsible for an estimated $2.4 billion. DOD will need to fund $0.1 billion for normal costs related to current full-time employees.

On October 1, 2008, the SBP “paid-up” provision will become effective.[21] This provision requires that SBP premiums stop when two conditions are met: (1) the retiree is at least 70 years of age and (2) the retiree has participated in the SBP for 360 months or more.

Extension of Benefits for Spouses and Children of Personnel Killed While on Active Duty

Extending SBP surviving spouse or child benefits for all personnel who are killed on active duty and are not eligible for retirement at the time of their deaths increased SBP liabilities by an estimated $72 million. Of this amount, Treasury will be responsible for an estimated $28 million. DOD will be responsible for funding $44 million in normal costs related to current full-time employees.

Under the original SBP, a benefit was paid following the death of an active duty military member only if the deceased, at the time of death, (1) was eligible to receive retired pay or (2) was a commissioned officer and had completed 20 years of service but was not yet eligible to retire as a commissioned officer. Legislation effective

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[20] Pub. L. No. 108-375, § 645, 118 Stat. 1811, 1962 (Oct. 28, 2004).
[21] Strom Thurmond National Defense Authorization Act for Fiscal Year 1999, Pub. L. No. 105-261, § 641, 112 Stat. 1920, 2045 (Oct. 17, 1998).

September 10, 2001,[22] expanded the coverage to the survivors of individuals who die while on active duty and who are not eligible for retirement. Members who die on active duty are assumed to have retired with full disability on the day they died and to have elected full SBP coverage for the combination of spouse, former spouse, and children that yields the most advantageous survivor benefit.

Effect of Potential SBP Benefit Changes on Payments to the Fund

If legislation allowing for a second insurable interest and eliminating the current DIC offset were enacted, DOD normal cost payments and the annual Treasury amortization payments would likely increase in order to offset these extended benefits and maintain the actuarial soundness of the Fund. Since specific details for implementation have not yet been legislated, the DOD OOA used assumptions based on knowledge of other SBP benefit legislation and on professional judgment in order to develop the required cost estimates. Consequently, if implementation requirements change or election behaviors differ from the assumptions used in the estimates, actual increases in funding needs will also differ from the following estimates. For the two proposed changes, the DOD OOA estimated that the SBP liability would have to increase by $12.9 billion, of which Treasury would be responsible for about $12.3 billion and DOD for approximately $645 million.

- Currently, an unmarried DOD retiree without dependent children may elect to have another person with an insurable interest as the SBP beneficiary. Such a person could be a business partner or family member, with a valid interest in the retiree's life. Currently, the retiree cannot designate another insurable interest beneficiary even if the insurable interest beneficiary dies. To calculate the effect to SBP of allowing a second insurable interest beneficiary option, the DOD OOA assumed that the retirees electing this option would have below-average health and would select individuals with above-average health to be insurable interests. Further, the DOD OOA assumed that retirees electing this option would be those for whom, on a present value basis, expected SBP benefits would most exceed expected SBP premiums paid. In other words, the retirees who would benefit most and create the highest liability to the Fund would be the retirees who would elect the second insurable interest option. Further, implementation requirements currently in effect for electing a first insurable interest were assumed to also be in effect for electing a second insurable interest. Using such assumptions, the DOD OOA calculated that SBP liabilities related to adding an option for a second insurable interest would increase by an estimated $2.2 million. Of this amount, Treasury would be responsible for an estimated $2 million and DOD for $231,000 ($211,000 for normal costs related to full-time employees and $20,000 for normal costs related to part-time employees).

- DIC is paid to survivors of veterans who die from (1) injuries or disease incurred or aggravated in the line of duty while on active duty, active duty

[22] Pub. L. No. 107-107 § 642, 115 Stat. 1012, 1151 (Dec. 28, 2001); National Defense Authorization Act for Fiscal Year 2004, Pub. L. No. 108-136, § 644, 117 Stat. 1392, 1517 (Nov. 24, 2003).

training, or inactive duty training or (2) disabilities compensable under laws administered by VA. The survivors of veterans who die because of complications resulting from service-connected diseases or injuries are entitled to DIC payments from VA; however, the survivor of a retired veteran is currently not entitled to receive the combined total of full SBP and DIC benefits. Instead, the SBP benefit is offset by the amount of DIC payments received, with certain limitations.

To calculate the effect of eliminating the current offset of surviving spouses' SBP benefits for the DIC benefits, the DOD OOA had to make an assumption about the amount of refunded SBP premiums to be repaid for the expanded SBP benefits.[23] Using this assumption, the DOD OOA calculated that the SBP liability would increase by an estimated $12.9 billion. Of this amount, Treasury and DOD would be responsible for an estimated $12.3 billion and $645 million, respectively. Of DOD's $645 million increased responsibility, $617 million would be for normal costs related to full-time employees and $28 million for normal costs related to part-time employees.

Effect of Potential Changes to the SBP Program on Actuarial Soundness of the Fund

Benefit and coverage changes to the SBP program usually require changes to DOD and Treasury payments in order to maintain the actuarial soundness of the Fund. If the proposed legislative changes are enacted, the DOD OOA would be required by law to reflect the increased benefits in its calculation of the required DOD and Treasury contributions to ensure that additional appropriations are requested to cover all benefit payments to eligible recipients each year and that sufficient Fund assets will be available in the future to liquidate all current unfunded liabilities. The Board would have to approve these calculations.

Agency Comments

In responding to a draft of the report, DOD did not have any objections or substantive comments. DOD separately provided some technical suggestions, which we incorporated as appropriate.

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We are sending copies of this report to the Secretary of Defense; the Under Secretary of Defense (Comptroller); the Deputy Under Secretary of Defense for Program Integration; the Director, Defense Finance and Accounting Service; and the Chief Actuary, Department of Defense Office of the Actuary. Copies will be made available

[23] Currently, surviving spouses who become eligible for DIC benefits are refunded SBP premiums because of the reduction in SBP benefits by the amount of the DIC benefits. With the elimination of the DIC offset, the SBP benefits would be expanded, and the related SBP premiums that were previously refunded would likely be recollected. Without legislation to clarify whether such refunded SBP premiums would be 100 percent repayable, the DOD OOA estimated that one-third of such previously refunded SBP premiums would be recollected.

to others upon request. In addition, this report is available at no charge on the GAO Web site at http://www.gao.gov.

Please contact me at (202) 512-3406 or at engelg@gao.gov if you or your staffs have any questions about this report. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to the report were Joseph Applebaum, Chief Actuary; Molly Boyle, Assistant Director; Linda Garrison, Assistant Director; Danielle Free; and Vera Seekins.

Gary T. Engel
Director
Financial Management and Assurance

Scope and Methodology

In conducting this work, we identified prior year audit and actuarial reports related to the Military Retirement Fund (Fund) and other background information to obtain a better understanding of the Survivor Benefit Plan (SBP) program and the nature and extent of related audit work performed. We visited the Department of Defense (DOD) Office of the Actuary (OOA), the DOD Office of the Inspector General (OIG), and the office of the Fund's independent public accountant (IPA). We also contacted contract personnel at the Defense Finance and Accounting Service - Cleveland Site (DFAS-Cleveland). We performed the following procedures:

- Interviewed DOD OOA, OIG, and IPA officials to obtain a general understanding of the SBP and its relationship to the Fund.
- Reviewed DOD OOA documentation related to its estimates of Department of the Treasury (Treasury) and DOD payments for certain recent and potential SBP program changes.
- Reviewed selected OIG and IPA audit documentation supporting the fiscal year 2005 financial statements audit of the Fund.
- Gathered data from DFAS-Cleveland on the numbers and status of SBP open season applications through April 19, 2006.

To determine the effect that recent significant SBP program changes have had on the actuarial soundness of the program, we met with DOD OOA staff to identify significant legislative changes that occurred within the last 7 fiscal years that have had a significant effect on SBP annual costs, the related Fund liabilities, or both. We determined that the Fund liabilities were required by law to be funded on an actuarially sound basis,[24] and that the financial statements of the Fund, which included the annual changes in funding requirements, were subjected to audit for each of the last 10 fiscal years and were determined to be reliable. We determined that it was not practical to determine the actuarial soundness of the SBP separately from the Fund since the assets of the SBP cannot be readily identified and segregated from the rest of the Fund. We obtained an understanding of the DOD OOA's process for calculating the change in the annual normal cost and Treasury payments needed to ensure actuarial soundness of the Fund and the role of the DOD Board of Actuaries in approving key economic assumptions used in estimating these payment changes and reviewing DOD OOA's resulting payment change amounts. We determined that under the fiscal year 2005 Defense Authorization Act, the current open enrollment season for the SBP ends on September 30, 2006, and that the impact of this ongoing SBP open season enrollment on the increased cost to the SBP will not be fully estimable for at least 2 years. Therefore, current cost estimates may be subject to significant changes once the enrollment period has ended. We reviewed the

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[24] 10 U.S.C. § 1461 (a). "The Fund shall be used for the accumulation of funds in order to finance on an actuarially sound basis liabilities of the Department of Defense under military retirement and survivor benefit programs."

reasonableness of preliminary estimates made by the DOD OOA using current participant and cost information and certain assumptions considered likely by actuarial staff.

To determine the effects that significant SBP program changes have had by (1) the various categories of participants and in total on DOD normal cost payments for the program and (2) in total on Treasury payments to amortize the unfunded liability amounts, we gained an understanding of the DOD OOA's process for calculating the cost of the SBP changes. We compared this process and inputs to those tested by the IPA as part of its audit of the Fund's fiscal year 2005 financial statements. In September 1997,[25] we reviewed the process and model used by DOD to estimate the Fund liability and concluded that they were reasonable. The same process and model continue to be used for the estimated Fund liability and are subject to audit annually. Since the same process and model were also used to calculate the cost estimates of the significant SBP changes, we used the work of other auditors performed for the fiscal year 2005 financial statements audit where possible to gain assurance over the cost estimate calculations. For the three significant SBP program changes in the last 7 fiscal years, we reviewed key assumptions, limited supporting documentation, and the processes used to calculate changes in the normal cost payments and to calculate and amortize the unfunded liability amounts, which affect the amount of Treasury's annual payments into the Fund.

To determine the potential increase to Treasury and DOD payments that would be necessary if a law were enacted repealing the Dependency and Indemnity Compensation offset (provisions now codified at 10 U.S.C. §§ 1450(c), 1451(c)(2) for beneficiaries), we obtained supporting documentation for the calculation of the potential increase and determined that it was prepared using the same process and model as the long-term pension liability of the Fund. Again, since the process and model used to calculate the cost estimates were the same as those previously reviewed by GAO and are subject to audit by the IPA in connection with its annual audit of the Fund's financial statements, we used the work of other auditors where possible. We reviewed selected key assumptions and parameters that the DOD OOA considered likely and therefore used to estimate the cost changes.

To determine the potential increase to Treasury and DOD payments that would be necessary if legislation were enacted permitting participants in the program to designate an insurable interest if a previous designated beneficiary dies, we obtained an understanding of the payment estimation process, which differed from the process referred to above; reviewed the assumptions considered likely by the DOD OOA; obtained supporting documentation; and recalculated selected formulas used in the calculation of the estimated potential increase in payments prepared by the DOD OOA.

To determine the effect that each potential legislative change would have on the actuarial soundness of the Fund, we obtained an understanding of the process for

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[25] GAO, *Financial Management: Review of the Military Retirement Trust Fund's Actuarial Model and Related Computer Controls*, GAO/AIMD-97-128 (Washington, D.C.: Sept. 9, 1997).

calculating the change in the normal cost and Treasury payments from the DOD OOA to ensure actuarial soundness and the role of the Board of Actuaries in reviewing and approving key economic assumptions used in DOD OOA's estimation of payment changes.

We requested comments on a draft of this report from the Secretary of Defense or his designated representative. DOD's response provided by the Deputy Under Secretary of Defense for Program Integration is reprinted in enclosure II. DOD also provided us with technical suggestions, which we incorporated as appropriate.

We conducted our work from February 2006 through June 2006 in accordance with generally accepted government auditing standards.

Comments from the Department of Defense

OFFICE OF THE UNDER SECRETARY OF DEFENSE
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WASHINGTON, D.C. 20301-4000

PERSONNEL AND READINESS

JUL 21 2006

Gary T. Engel
Director, Financial Management and Assurance
U.S. Government Accountability Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Engel,

This is the Department of Defense (DoD) response to the GAO draft report 06-837R, 'Implications of Significant Recent and Potential Changes for the Actuarial Soundness of the Department of Defense Survivor Benefit Plan Program,' dated June 29, 2006 (GAO Code 191038).

We do not have any objections or substantive comments about the report. We have already communicated technical suggestions which GAO has incorporated in the final report.

Jeanne B. Fites
Deputy Under Secretary of Defense
Program Integration

(191038)

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