AUSTRALIAN DEFENCE FORCE RETIREES ASSOCIATION
We act on behalf of Defence Force Retirees and their Military Superannuation grievances

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Mr Michael Manthorpe PSM
Commonwealth Ombudsman
GPO Box 442
CANBERRA ACT 2601

14 January 2020

Dear Mr Manthorpe,

I refer to your Investigation into the administration of the Defence Force Retirement and Death Benefits scheme and your report number 06/2019 dated December 2019.

We dispute the findings in your report because:

a. Your observation of the Commutation provision omits pertinent facts and makes unreasonable assumptions;

b. The modelling methodology used to demonstrate the financial benefit of Commutation is biased and your findings are correspondingly flawed;

c. There is a factual error in Part 4 of your report and your observation of the Pension Increases provisions omits pertinent facts; and

d. You fail to acknowledge, in Part 5 of your report, our concerns regarding the inequitable and discriminatory effect of the Commutation and Pension Increase provisions.

Therefore, on behalf of the current 3,852 members of the Australian Defence Force Retirees Association, and indeed all DFRDB beneficiaries and contributing members, I request a review of your decision.

Comment regarding your Observation of the Commutation Provision

Your definition of Commutation in Figure 1 of your report fails to acknowledge that the Commutation provision, set down by the Jess Committee in Recommendation 14 (a) and (b), is one of a **_proportionate_** _exchange of part of a DFRDB member's future retirement pay for an immediate lump sum_. The Government implemented this recommendation, as stated by the Minister in his second reading speech, when he presented the Bill. Nowhere, in any explanatory memoranda, Bills Digest or second reading speech by a responsible Minister, has there been a change to that definition.

We dispute your finding in paragraph 2.40 *"that the meaning of the Commutation provision is not ambiguous"* and the finding in AATA 599 (Reynolds vs Defence Force Retirement and Death Benefits Authority) that there is "neither ambiguity nor obscurity.

While the ordinary meaning of the wording in Section 24 of the Act may be perfectly clear, the effect of Schedule 3 makes it otherwise. The lack of clarity and the ambiguous effect is illustrated in Annex A.

In paragraph 5.12, your suggestion that *"the scheme drafters never envisaged the use of current life tables, but rather, preferred a static commutation factor"* is baseless and an attempt to justify the use of static life expectancy. This ignores the Jess Committee's explanation of the rationale behind its recommendation for a proportionate reduction in paragraph 109 of its Report, which states:

> *"A retiree may not commute more than he could be expected to draw as pension. The assessment of his individual life expectancy is designed to ensure this."*

This explanation implies that the assessment of individual life expectancy should occur at the time an individual elects to commute.

The Jess Committee, who were the *Scheme's* drafters, did not specify which life expectancy tables should be used. A reasonable assumption would be that, consistent with the Committee's rationale, life expectancy at the time of the election to commute would be used.

It was the *Bill's* drafters, that is a committee of public servants from which Service representation was excluded[1], who incorporated static life expectancy tables in Schedule 3, thereby transforming the Jess Committee recommendation from *"retired pay proportionately reduced in relation to commutation remain payable after commutation"* into a provision in which retired pay reduction becomes increasingly disproportionate over time. There is no evidence of an Explanatory Memorandum or advice of such a change in the second reading speech by the responsible Minister[2].

Annex B illustrates average male life expectancy derived from the life expectancy tables published up to the time the Bill was drafted. The question arises: Why were the 1960-1962 life expectancy tables used when the 1965-1967 tables were the most current at that time?

A reasonable explanation is that there was a reduction in life expectancy in the 1965-1967 tables, in what was otherwise an upward trend. It is conceivable that the drafting committee considered that to be an aberration.

Under *"What is commutation"* you fail to acknowledge that the commutation arrangement is terminated on the death of the recipient member and that *"for the purpose of determining a widow's entitlement commutation should be disregarded."*

Comment regarding your Financial Modelling Methodology

The DFRDB Act does not stipulate how a member who commutes must use the lump sum. Your assumptions on how the lump sum was used are speculative and while they may be relevant for some they and not fully representative of the cohort who commuted.

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[1] Robert Bonnett - House of Representatives Hansard - 30 May 1973
[2] Lance Barnard – House of Representatives Hansard - 25 May 1973

The only valid modelling approach is the *Term Deposit – Drawdown Method*, put forward by the Australian Government Actuary, because it applies equally for *every* member who commuted. But its application by the Australian Government Actuary is biased because it does not apply the inflationary factors to the pension forgone after commutation and is therefore flawed.

This methodology has been used in the past to make the Commutation provision appear more generous than it is[3]. And an even more disparate variant, which completely ignored retired pay reduction, was incorporated in Section 24[4] to significantly disadvantage re-entrants.

The *Term Deposit – Drawdown Method*, which applies the lump sum inflationary factors equally to the forgone amount of pension is illustrated in Annex C, from which it is evident that:

    a.   The break-even point falls exactly on the date the member reached the date of his life expectancy, determined from Schedule 3; and

    b.   Depending on how long members who commuted survive:

        i.   The surviving spouse or the estate of those who die before reaching their break-even age enjoy a decreasing gain; and

        ii.   Those who die after reaching their break-even age suffer an increasing loss.

It is equally obvious from Annex C that, of the current 39,400 recipient members, *all* who have reached their Schedule 3 life expectancy will suffer a loss and, as has already been demonstrated in Annex A, of the remainder, including those who are yet to discharge, a minimum 74% of males and 68% of females will suffer a loss.

Comment regarding your Observation of the Pension Increase Provisions

Under *"How indexation works"* in Part 4 of your report, you fail to acknowledge that:

    a.   The purpose of indexation is to maintain the relativity of pensions;

    b.   All payments by the Commonwealth under the DFRDB Act (that is 100%) are payable from the Consolidated Revenue Fund[5];

    c.   The principle embodied in the Superannuation scheme adjustment provisions, which were revised in 1976, is that only the portion of the pension payable from the Consolidated Revenue Fund is to be adjusted[6]; and

    d.   Indexation increases are applied to only a part of DFRDB pensions to accord with that principle;

We drew this to your attention, yet you observed no contradiction in this.

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[3] Paragraph 24 - Long Term Costs of Military Superannuation Schemes, prepared by the Australian Government Actuary in 2011
[4] This provision was incorporated by Section 12 of Defence Force Superannuation Legislation Amendment Act 1991 until it was removed, effective 1 July 2016, by Section 19 of Defence Legislation Amendment (Superannuation and ADF Cover) Act 2015
[5] Defence Force Retirement and Death Benefits Act 1973 - Section 125(3)
[6] Page 27 of Cabinet Minute - Canberra, 8 December 1976 – Amended Decision No. 1991

The effect of the Pension Adjustment provisions you rightly describe in paragraph 4.16 of your report is to apply indexation increases to a part of pensions from;

   a.   59.9% for males aged 65 who elected to commute their maximum entitlement, to

   b.   90.27% for females aged 30 who chose not to commute.

We drew this to your attention, yet you observed no inequity or discrimination in this.

There is a factual error in paragraph 4.7 of your report in that there were only two interim adjustments between 1972 and 1976, namely:

   a.   Defence Force Retirement and Death Benefits (Pension Increases) Act 1974 which applied a 16.2% increase in average weekly earnings to almost 80% of DFRB pensions and to five-sevenths (71.43%) of DFRDB pensions[7].

   b.   Defence Force Retirement and Death Benefits (Pension Increases) Act 1976, which applied a 17.6% increase in the CPI to DFRDB pensions and approximately a 20% increase to DFRB pensions[8].

We drew to your attention the fact that the Act which incorporated these partial indexation provisions[9] also applied indexation increases to 100% of DFRB pensions, and we drew to your attention the fact that both DFRB and DFRDB were unfunded schemes.

Yet you failed to observe any inconsistency in the manner in which the two schemes were indexed in 1974, 1976 and from 1977 onwards.

In Section 39[10], the Act states that the spouse of a deceased recipient is entitled to a pension at the rate of five-eighths of the pension the deceased member would have been entitled to, *had that member not commuted*. But for the determination of the spouse's entitlement, Section 98B[11] *excludes from indexation of the pension on which that entitlement is based, an amount equal to the deceased member's entitlement to commutation*, regardless of whether or not the member elected to commute.

We drew this to your attention, yet you observed no contradiction in this.

Comment regarding your Acknowledgement of our Concerns

Our concerns, which we conveyed to you in great detail, are:

   (1)   That the use of static expectation of life factors, to determine the proportionate reduction of retirement pay after commutation, has transformed the Commutation arrangement from one that may have appeared to be equitable in 1973 into one that is now manifestly inequitable.

   (2)   That the Pension Increases provisions have failed to maintain the relativity of DFRDB pensions because:

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[7] Lance Barnard – House of Representatives Hansard - 13 November 1974
[8] James Killen – House of Representatives Hansard – 27 April 1976
[9] Defence Force (Retirement and Death Benefits Amendments) Act 1977
[10] Section 39 - Defence Force Retirement and Death Benefits Act 1973
[11] Section 98B - Defence Force Retirement and Death Benefits Act 1973

(a) Indexation increases are not applied to the full amount of DFRDB pensions paid from the Consolidated Revenue Fund, as is Government policy and as they are applied in other contemporary Commonwealth superannuation schemes;

(b) The Consumer Price Index long ago ceased to be a valid measure of the increase in the cost of living; and

(c) The effect is an inequitable financial detriment to DFRDB beneficiaries, discriminating by age, gender, time of retirement and time of death.

(3) That Defence Force Retirement and Death Benefits (Fair Indexation) Act 2014 failed to remedy this situation because it did not restore DFRDB benefits to the fair indexation baseline that Act established.

We represent all DFRDB beneficiaries and not just the members of the Australian Defence Force Retirees Association. Unlike the majority who submitted to your investigation, we understand what the DFRDB Act says and what it means at Law, and we understand fully its effect on DFRDB beneficiaries.

We also understand that under the Australian Constitution we have no right of appeal in the Courts, regardless of how inequitable and discriminatory the Act may be and that any remedy of our concerns requires an Act of Parliament.

We expected that an *independent* and *impartial* inquiry would acknowledge this. But in your report, you merely endeavoured to justify the provisions in the Act and suggested that the Government should clarify its policy position.

Most of the supposedly *independent* inquiries into the DFRDB commutation and indexation you refer to in paragraph 5.16, such as the Podger[12] and Matthews[13] reviews, were biased and produced recommendations which were pre-destined by their terms of reference, as is evident in your report.

The Minister's announcement, on 25 March 2019, of an Independent Inquiry into 'The Administration of Defence Force Retirement and Death Benefits Scheme Commutation Arrangements', included:

The Government recognises the importance of open and transparent discussion around veteran concerns and we will consult with the ex-service community about the terms of reference for the inquiry, as well as panel membership.

Ex-Service Organisations and scheme members will have the opportunity to make submissions to the inquiry and raise any other concerns relevant to the scheme.

On 27 March 2019, we met with the Minister and briefed him on our concerns, in the hope that we would influence the terms of reference for the inquiry. But we failed.

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[12] Department of Defence, December 2007, Report of the Review of Military Superannuation Arrangements ('Podger Report')

[13] Department of Finance and Deregulation, December 2008, Review of Pension indexation Arrangements in Australian Government Civilian and Military Superannuation Schemes ('Matthews Report')

We note that in your response to the Minister, on 10 April, you stated:

> *We will also consult with the Department of Defence and the Commonwealth Superannuation Corporation (CSC), as the scheme administrators, on the scope of the investigation.*

Why did you not consult with the ex-service community on the scope of the investigation?

We appreciate that policy matters which are of great concern to us are outside the scope of your investigation.   But you included Part 5 in your report, presumably to satisfy the statement in the Minister's announcement.

But you chose not to draw attention to our concerns.

Under the circumstances, it is not unreasonable to conclude that:

(1) The purpose of the Minister's announcement of an independent inquiry was to placate us during the lead up to the 2019 Federal Election; and

(2) Your selection to conduct this investigation and the terms of reference for your investigation were designed to ensure that the most serious of our concerns would not be addressed.

Should you require more information in respect of any of the matters we have raised, we will travel to Canberra again to provide any further clarification needed.

We look forward to your reply.

Yours sincerely,

Herb Ellerbock

Australian Defence Force Retirees Association

Annexes: A. The Ambiguity of the Commutation Provision.

B. Life Expectancy 1881 to 2017

C. Determining the Commutation Break Even Age

THE AMBIGUITY OF THE COMMUTATION PROVISION

1. As observed in paragraph 5.8 of the Ombudsman's report, the *Expectation of Life Factor* table in Schedule 3 creates the commutation divisor using the figures in the 1960-1962 life expectancy tables published by the Australian Bureau of Statistics (ABS).

2. And, as observed in paragraph 5.9 of the report, these figures have been the same since the DFRDB Act commenced in 1973, despite the considerable increase in life expectancy since 1962.

3. Figure 1 illustrates the increase in male life expectancy by comparing the *Expectation of Life Factors* in Schedule 3 with those in the latest 2015-2017 Life Expectancy tables published by the ABS.

FIGURE 1 – AVERAGE MALE LIFE EXPECTANCY AT SINGLE AGES (*ex*)
Source: Table 6.2 in 3105.0.65.001 Australian Historical Population Statistics, 2019
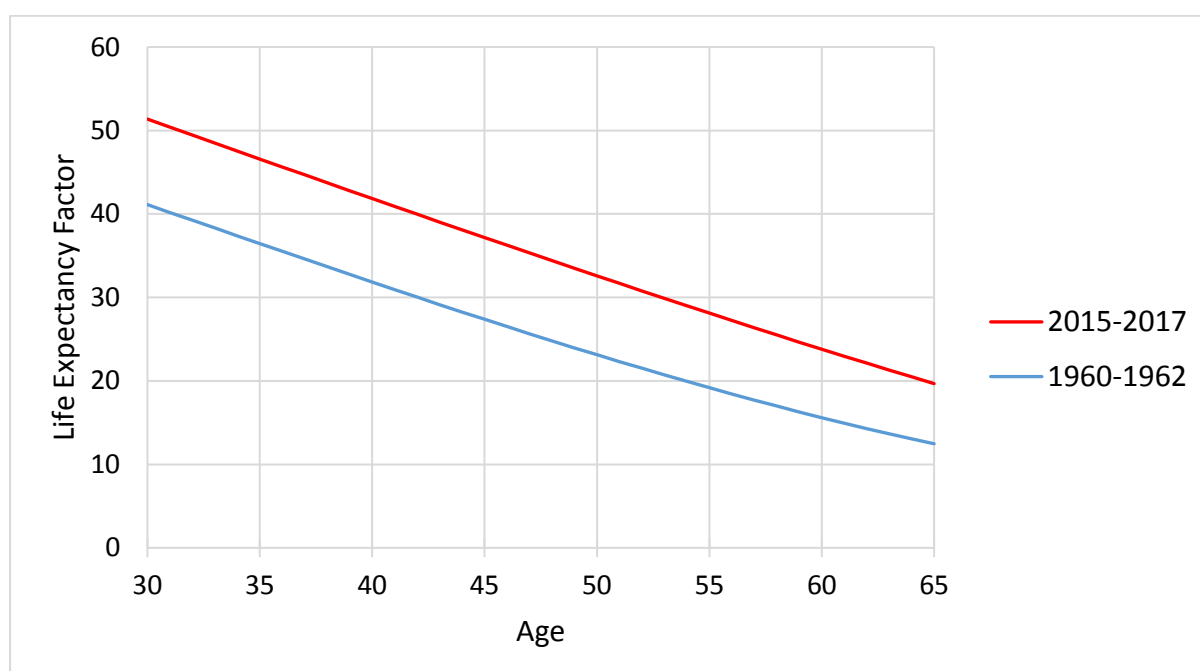
Understanding Life Expectancy

4. Life expectancy is a statistical probability with a skewed distribution about a mean. It is a concept which a majority service personnel and indeed parliamentarians would not understand. The DFRDB Act does not make it clear nor does the very latest information published by the Commonwealth Superannuation Corporation.

5. Even when illustrated as in Figure 1, the effect of the Expectation of Life Factors in Schedule 3 is unclear and does not support the view expressed in paragraph 2.40 of the report that the *"legal meaning is plain and not capable of any other interpretation"*. Nor does it support the AAT finding, cited in paragraph 2.41, that there is *"neither ambiguity nor obscurity"* in the provision.

6.   In an article on *Understanding Uncertainty*[14], Sir David Spiegelhalter OBE FRS[15] provides a more meaningful view of life expectancy, termed *Probability Density for Survival*, which is expressed as the expected number of deaths at each age out of 100,000 births.

7.   *Probability Density for Survival* (*dx*), is published by the British Office for National Statistics but not by the ABS. However, is readily derived with the formula *dx = lx (qx)* from the following statistics, which are also published in the ABS Life Expectancy tables[16]:

    a.   Table 6.3 Number of persons at exact age x (lx), males, Australia, 1881 onwards;

    b.   Table 6.5 Probability of dying between exact age x and exact age x+1 (qx), males, Australia, 1881 onwards;

    c.   Table 6.7 Number of persons at exact age x (lx), females, Australia, 1881 onwards; and

    d.   Table 6.9 Probability of dying between exact age x and exact age x+1 (qx), females, Australia, 1881 onwards

8.   Figure 2 illustrates Male Probability Density for Survival, derived from the *lx* and *qx* tables for 1960-1962 and the latest tables for 2015-2017.

FIGURE 2 - MALE PROBABILITY DENSITY OF SURVIVAL

Source: Tables 6.3 and 6.5 in 3105.0.65.001 Australian Historical Population Statistics, 2019

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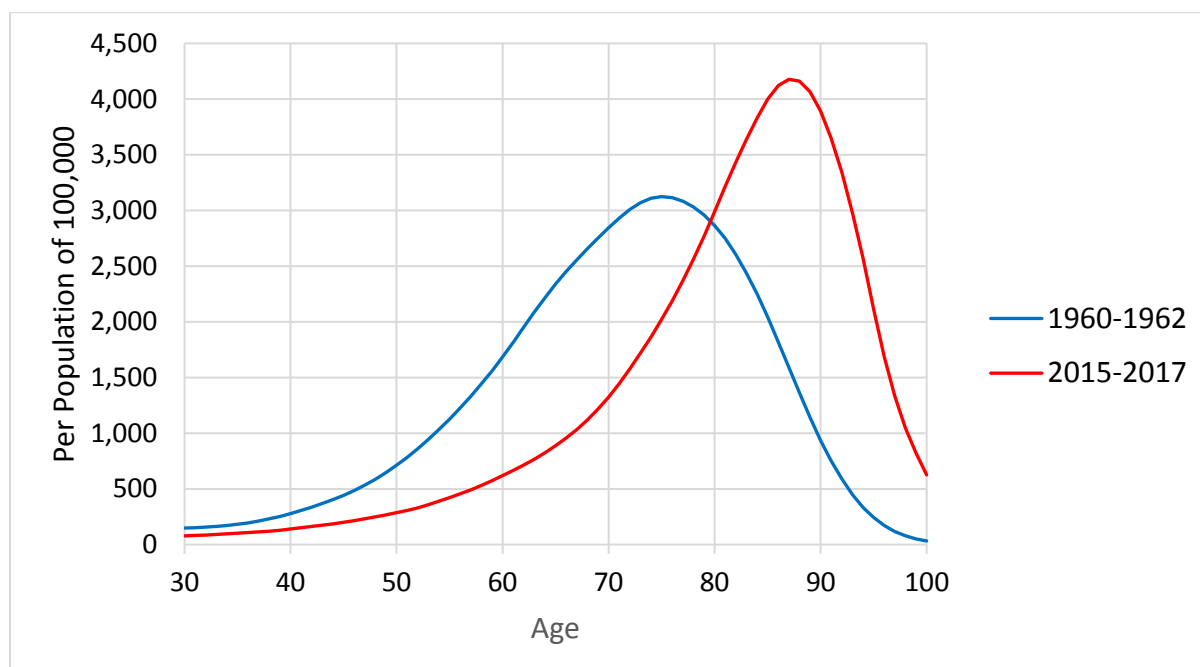
[14] Why 'life expectancy' is a misleading summary of survival
[15] Sir David Spiegelhalter OBE FRS, a British statistician and Winton Professor of Public Understanding of Risk in the Statistical Laboratory at the University of Cambridge, a Fellow of Churchill College, Cambridge and an Intercollegiate Studies Institute highly cited researcher
[16] 3105.0.65.001 Australian Historical Population Statistics, 2019

9. Figure 2 clearly shows the distribution of life expectancy and the effect of the increase in life expectancy from 1962 to 2017.

**FIGURE 3 - THE EFFECT OF THE EXPECTATION OF LIFE FACTOR IN SCHEDULE 3
ON MALES WHO COMMUTED IN <u>1973</u>**

Source: Tables 6.3 and 6.5 in 3105.0.65.001 Australian Historical Population Statistics, 2019
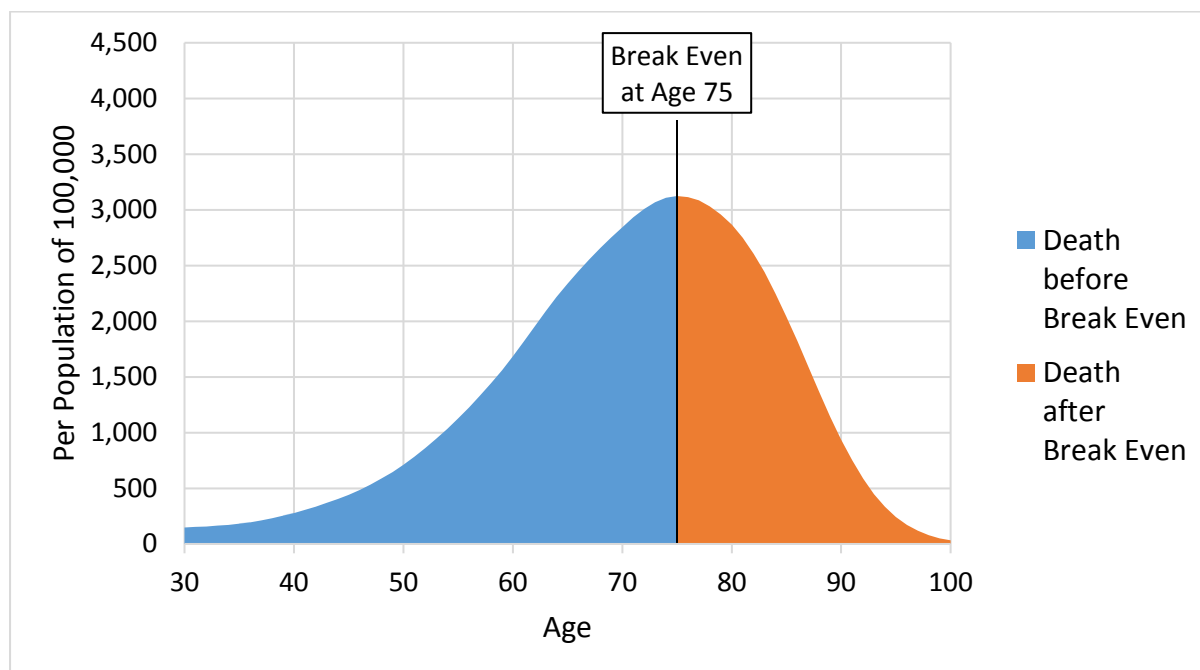
10. Figure 3 shows the effect of the Expectation of Life Factors in Schedule 3, when applied in 1973. From the area under the graph, the probability of death at a certain age and the proportion of deaths before and after reaching the commutation break-even age can readily be determined. Which goes some way toward explaining the statement in para 65 of DFRDB Authority Circular 173/3[17], which states:

> *Although a life expectancy factor is used, full retirement pay is not restored should the member live beyond normal life expectancy. By the same token, should the member die before attaining the expected age no attempt is made to recover the amount of the lump sum outstanding from dependents or the estate.*

11. This distribution would appear to favour the member who elected to commute. But it actually favors the Commonwealth because when the member dies, retirement pay or invalidity pay ceases entirely or is reduced to a five-eighths pension for a surviving spouse.

12. Figures 4 to 8 illustrate the effect of the Expectation of Life Factors in Schedule 3 when the commutation provision is applied in 1980, 1990, 2000, 2010 and 2020 respectively. From which, it can readily be seen that the static expectation of life factor in Schedule

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[17] DFRDB Authority Circular 173/3, dated 2 August 1973, was a 182 paragraph outline from the Secretary of the DFRDB Authority, Mr R J Perriman to all Service Departments, of the provisions of the new scheme. This advice was not circulated by the Service Departments and did not appear publicly during the life of the DFRDB scheme, from 1972 to 1991.

3 produces a different outcome depending on the time the Commutation provision is applied.

**FIGURE 4 - THE EFFECT OF THE EXPECTATION OF LIFE FACTOR IN SCHEDULE 3
ON MALES WHO COMMUTED IN <u>1980</u>**

Source: Tables 6.3 and 6.5 in 3105.0.65.001 Australian Historical Population Statistics, 2019
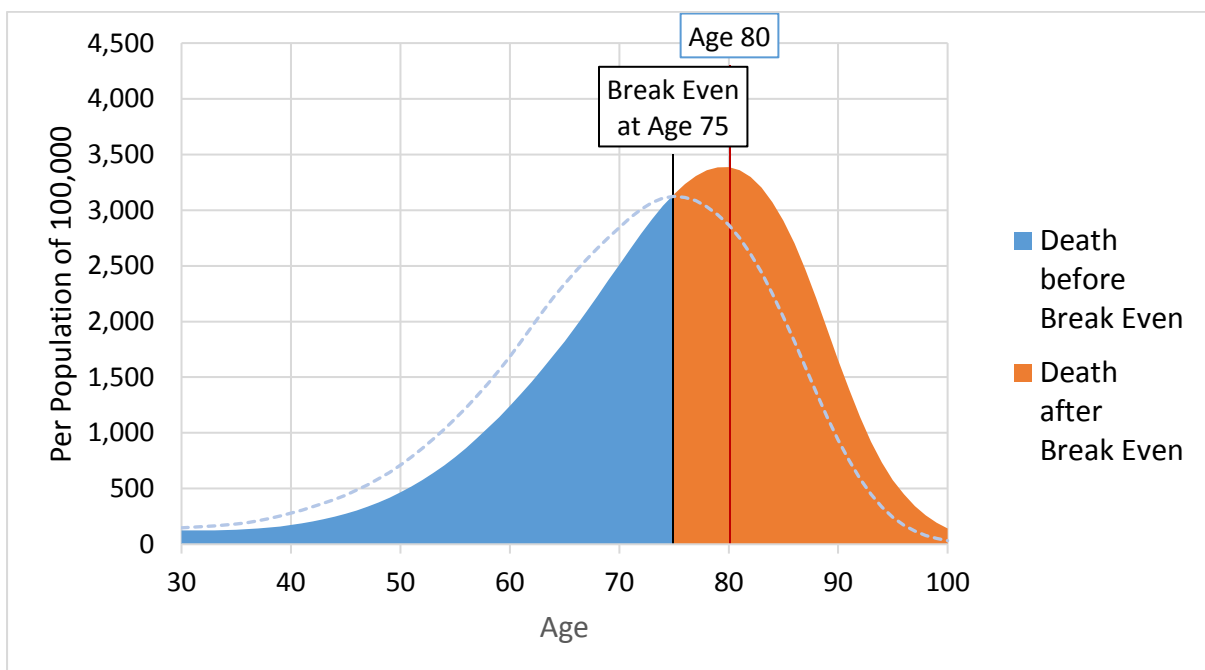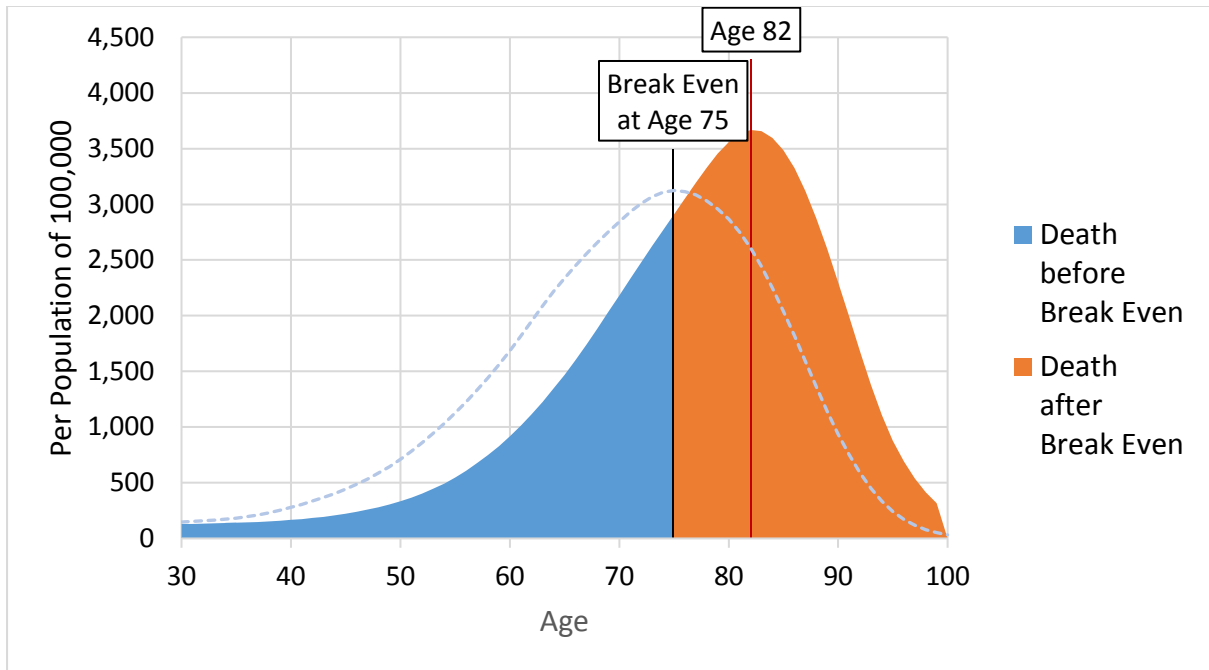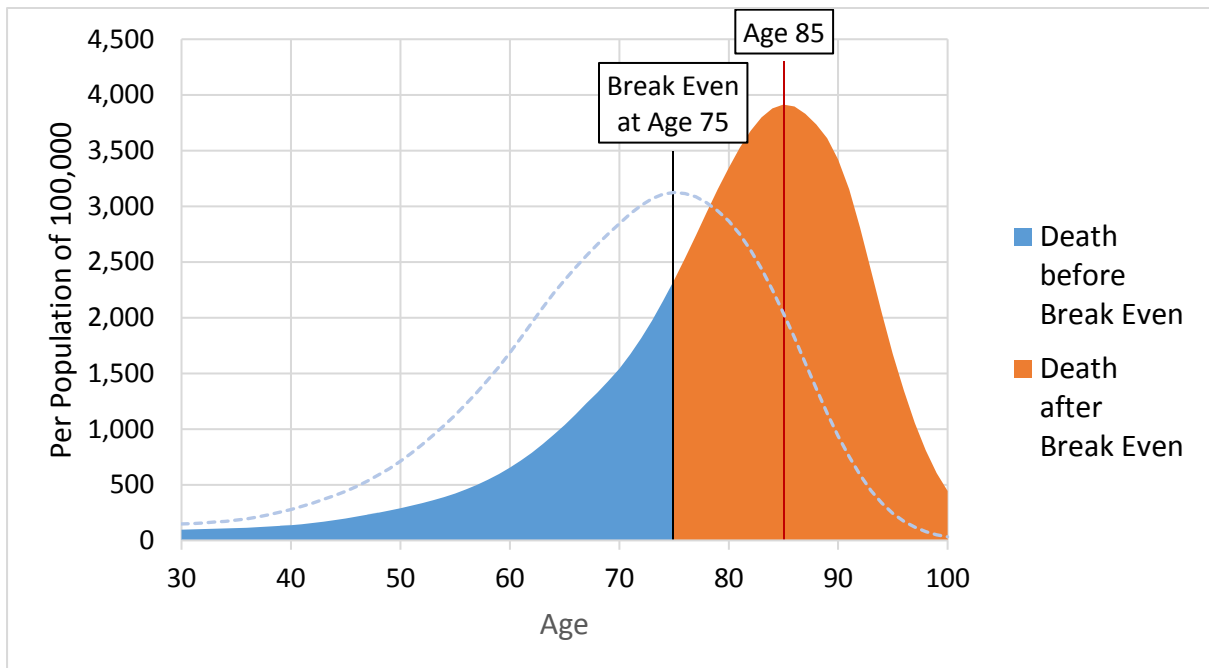

**FIGURE 5 - THE EFFECT OF THE EXPECTATION OF LIFE FACTOR IN SCHEDULE 3
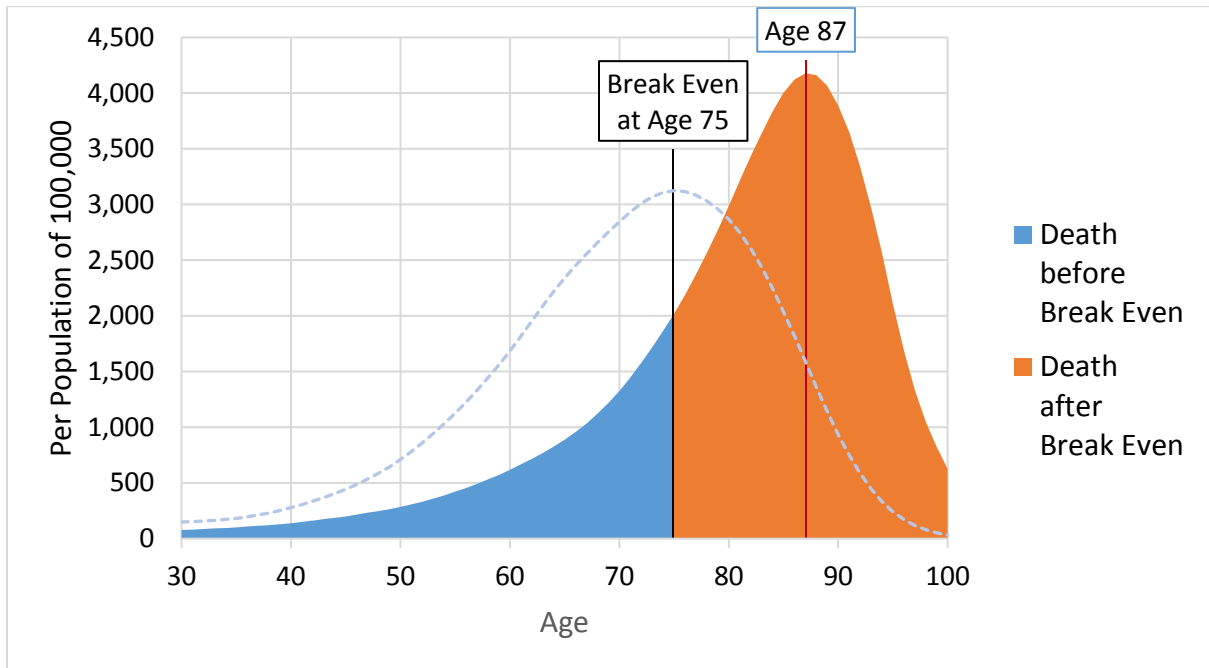ON MALES WHO COMMUTED IN <u>1990</u>**

Source: Tables 6.3 and 6.5 in 3105.0.65.001 Australian Historical Population Statistics, 2019

FIGURE 6 - THE EFFECT OF THE EXPECTATION OF LIFE FACTOR IN SCHEDULE 3

ON MALES WHO COMMUTED IN <u>2000</u>

Source: Tables 6.3 and 6.5 in 3105.0.65.001 Australian Historical Population Statistics, 2019

FIGURE 7 - THE EFFECT OF THE EXPECTATION OF LIFE FACTOR IN SCHEDULE 3 ON MALES WHO COMMUTED IN <u>2010</u>

Source: Tables 6.3 and 6.5 in 3105.0.65.001 Australian Historical Population Statistics, 2019

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**FIGURE 8 - THE EFFECT OF THE EXPECTATION OF LIFE FACTOR IN SCHEDULE 3
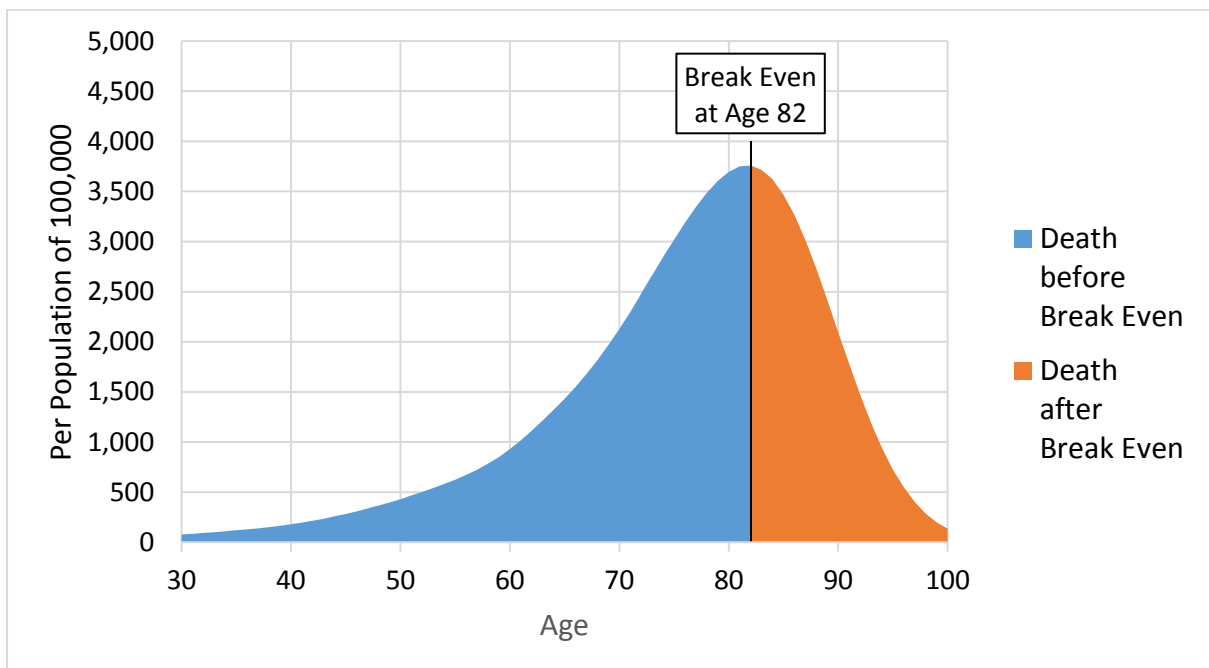ON MALES WHO COMMUTED IN 2020**

Source: Tables 6.3 and 6.5 in 3105.0.65.001 Australian Historical Population Statistics, 2019

13. Figures 9 and 10 show the effect of the Expectation of Life Factors in Schedule 3 is similar for females but differs in quantum.

**FIGURE 9 - THE EFFECT OF THE EXPECTATION OF LIFE FACTOR IN SCHEDULE 3
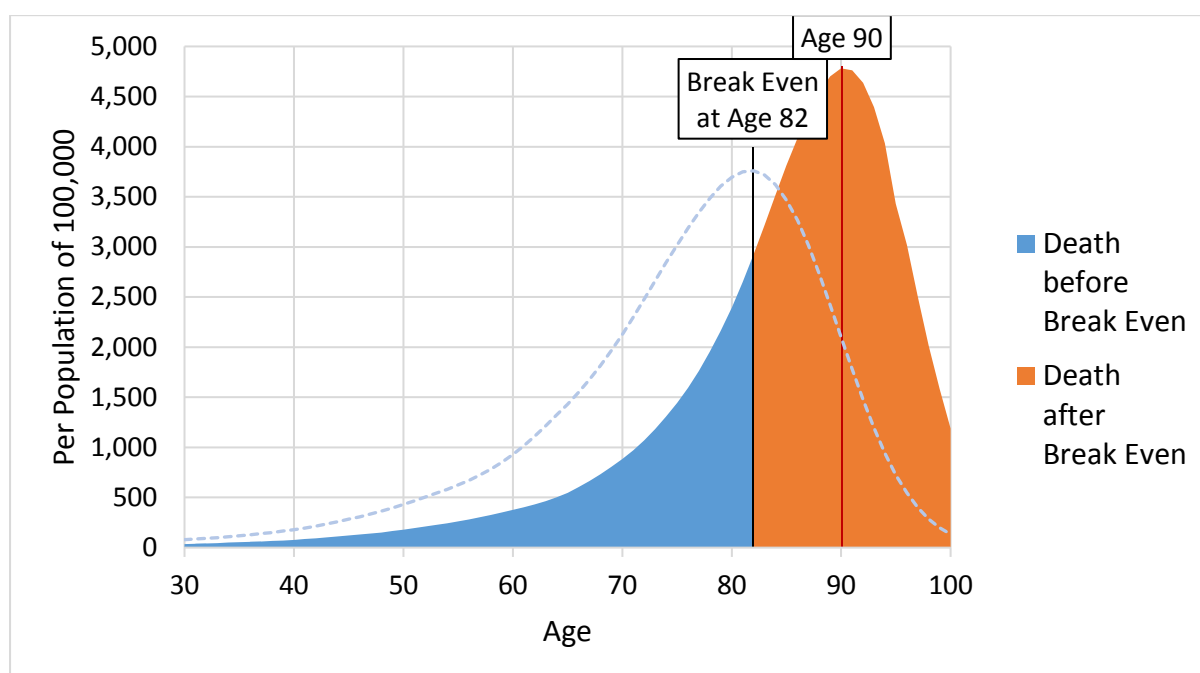ON FEMALES WHO COMMUTED IN 1973**

Source: Tables 6.7 and 6.9 in 3105.0.65.001 Australian Historical Population Statistics, 2019

**FIGURE 6 - THE EFFECT OF THE EXPECTATION OF LIFE FACTOR IN SCHEDULE 3
ON FEMALES WHO COMMUTED IN <u>2020</u>**

Source: Tables 6.7 and 6.9 in 3105.0.65.001 Australian Historical Population Statistics, 2019

14.   The ambiguous effect of the *Expectation of Life Factor* table in Schedule 3 and therefore, the proportionality of the Commutation provision is shown for males in Table 1 and females in Table 2.

TABLE 1 – EFFECT OF THE STATIC EXPECTATION OF LIFE FACTOR ON MALES

Year of Commutation	Life Expectancy Tables in effect	Probability of Death	
		Before Break Even	After Break Even
1973	1960-1962	59%	41%
1980	1975-1977	56%	44%
1990	1985-1987	47%	53%
2000	1995-1997	39%	61%
2010	2005-2007	28%	72%
2020	2015-2017	26%	74%

TABLE 2 – EFFECT OF THE STATIC EXPECTATION OF LIFE FACTOR ON FEMALES

Year of Commutation	Current Life Expectancy	Probability of Death	
		Before Break Even	After Break Even
1973	1960-1962	65%	35%
2020	2015-2017	32%	68%

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LIFE EXPECTANCY 1881 TO 2017

1. Defence Force Retirement and Death Benefits Bill 1973 was drafted between 26 October 1972, when then Prime Minister The Rt Hon William McMahon commended the Jess Report to the Parliament[18] and 25 May 1973, when The Hon Lance Barnard moved that the Bill be read a second time[19].

2. With a real-time lag of at least 3 years in the production of Life Expectancy tables by the Australian Bureau of Statistics (ABS), the latest Life Expectancy tables in effect would have been for 1965-1967.

3. In Defence Force Retirement and Death Benefits Bill 1973, Schedule 3 covered only ages from 30 to 60. That range was extended to 65 at a later date.

4. Figure 1 illustrates Life Expectancy, as published by the ABS in its tables from 1881 to 1967, averaged for males and female aged 30 to 60.

FIGURE 1 – AVERAGE LIFE EXPECTANCY FOR AGES 30 TO 60
Source: Table 6.2 in 3105.0.65.001 Australian Historical Population Statistics, 2019
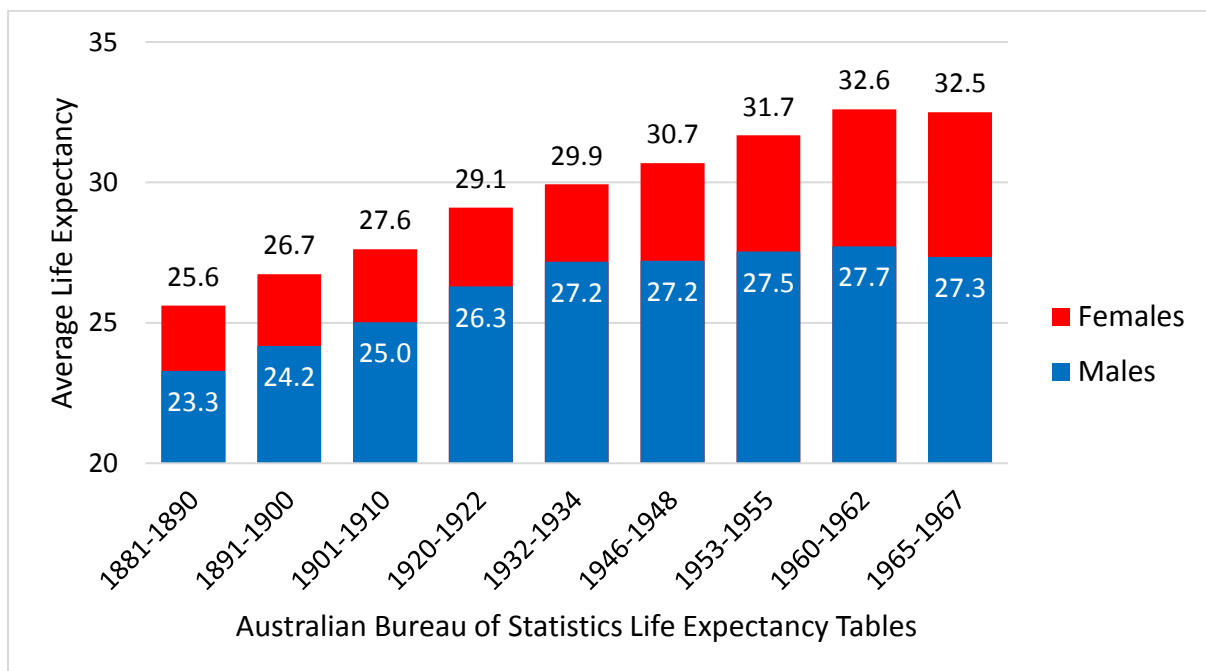
5. As confirmed by Figure 2, there is an aberration in the trend of Life Expectancy increase for which the ABS has, to date, not yet been able to provide an explanation.
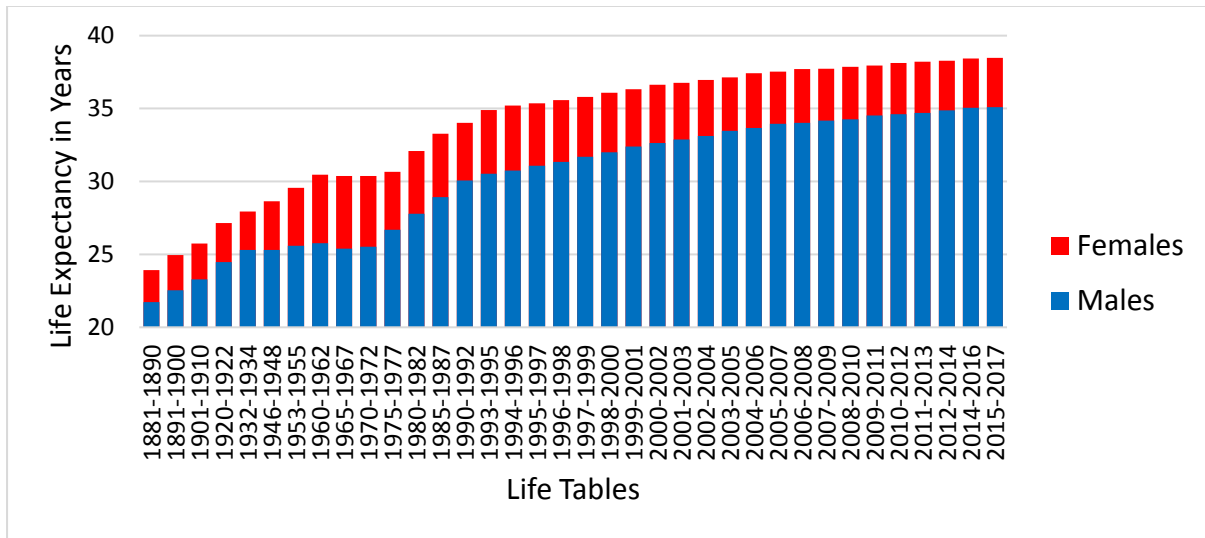
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[18] House of Representatives Hansard – 26 October 1972 – William McMahon
[19] House of Representatives Hansard – 25 May 1973 – Lance Barnard

FIGURE 2 – AVERAGE LIFE EXPECTANCY FOR AGES 30 TO 65

Source: Table 6.2 in 3105.0.65.001 Australian Historical Population Statistics, 2019

## DETERMINING THE COMMUTATION PROVISION BREAK EVEN AGE

1. The only valid approach to comparing the value of the lump sum and the pension forgone after commutation is the *Term Deposit – Drawdown Method*, because it applies equally for *every* member who commuted, regardless of:

   a. The amount commuted;

   b. The age of the member at the time of commutation;

   c. The time at which the election to commute was made; or

   d. The rate of inflation.

2. However, in the Australian Government Actuary's application of this method, the inflationary growth applied to the lump sum is not applied equally to the pension forgone after commutation.

3. This approach has consistently been used to overestimate the benefit of the commutation provision in the DFRDB scheme, as is evident in the Government Actuary's report of 2011[20] which states:

   > "Members retiring from the DFRDB (other than on the grounds of invalidity A or B) have the option to convert part of their pension to a lump sum. Experience over the last two decades suggests that members choose to take the maximum allowable lump sum. As the conversion factors provide for a lump sum which is greater than actuarial value of the forgone pension at virtually all ages, this is not a surprising outcome. Accordingly, it has been assumed that all retiring members take advantage of this option to the maximum extent permissible."

4. When the inflationary factors, applied to the commutation lump sum, are also applied reduction of retirement pay after commutation, the outcome is substantially different.

5. Figure 1 illustrates the effect, for a Male Member who commuted $300,000 at age 54, at linear inflation rates of 2.0%, 4.0% and 6.0%. From Schedule 3 of the DFRDB Act, this member's life expectancy is determined to be 19.94 and his initial annual retirement pay reduction is $15,045.14 ($300,000 ÷ 19.94).

6. Not surprisingly, the break-even point is reached at exactly 73.94 years of age, regardless of the rate of inflation. This is the member's age when he elected to commute (54) plus his life expectancy from Schedule 3 (19.94). An outcome which is consistent with the Jess Committee's definition of a **proportionate** reduction retirement pay in exchange for a pre-payment of an immediate lump sum.

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[20] Report on Long Term Costs of Military Superannuation Schemes, prepared by the Australian Government Actuary in 2011

FIGURE 1 –THE COMMUTATION PROVISION BREAK-EVEN AGE

$300,000 Commuted by a Male Member aged 54
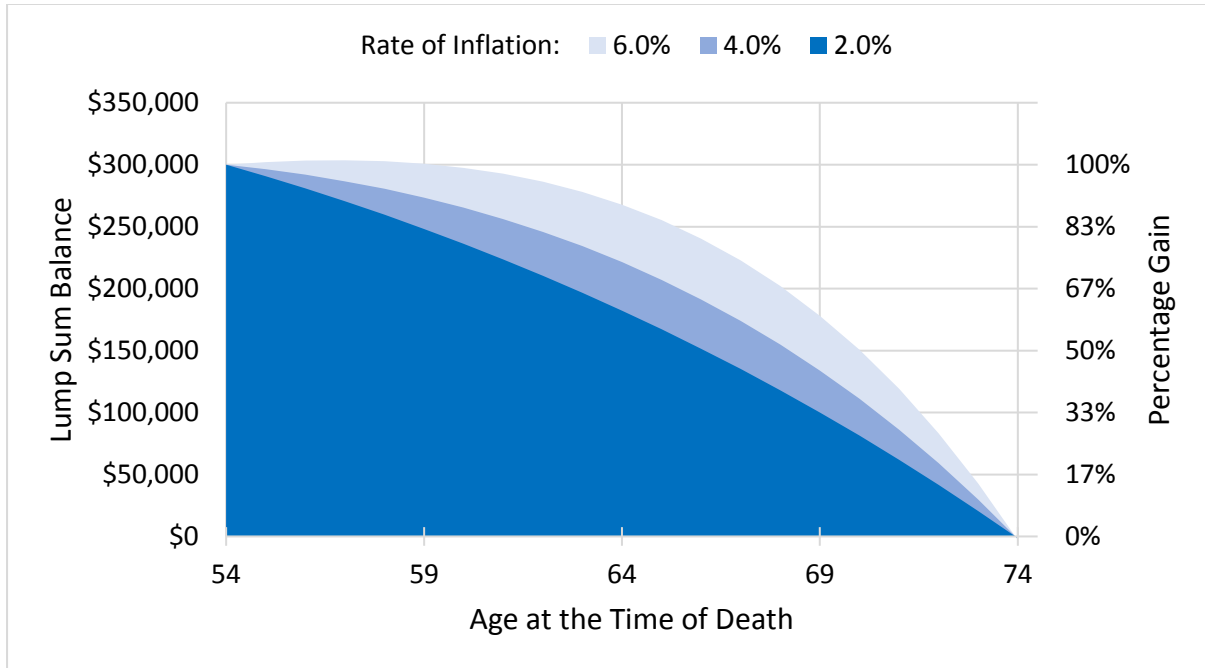
7.   There is no provision in the DFRDB Act to cease retirement pay reduction after the break-even age is reached, so it continues until the death of the member.

8.   Figure 2 illustrates the effect for the member described in the above example.

FIGURE 2 – CONTINUED LOSS AFTER REACHING THE BREAK-EVEN AGE

$300,000 Commuted by a Male Member aged 54
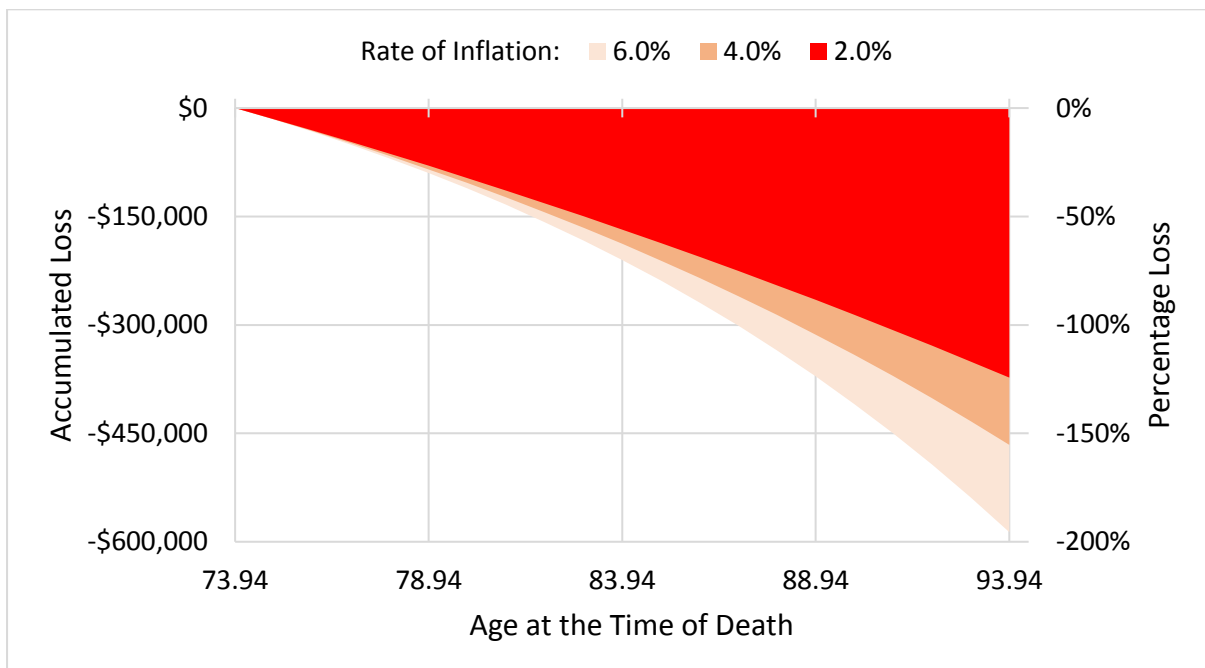
9. If this member dies before reaching the break-even point it is viewed as a gain because, the Commutation arrangement ceases on the death of the member and the act does not seek to recover the lump sum balance from the member's spouse or estate.

10. This member's spouse or estate would gain the full amount of the commutation lump sum if he died on the day after commuting, that is, almost 20 years before reaching his life expectancy. But if he lived for an equal period, after reaching his life expectancy, he could, depending on the rate of inflation, lose up to the equivalent of almost twice of the commutation lump sum.

11. That is not consistent with the Jess Committee's definition of a ***proportionate*** reduction retirement pay in exchange for a pre-payment of an immediate lump sum.