

REBUTTAL OF OMBUDSMAN'S REPORT 06 | 2019

October 2020

Foreword

The Ombudsman's *investigation into the administration of the Defence Force Retirement and Death Benefits (DFRDB) scheme Report 06 | 2019*¹ focused on two principles:

1. Were DFRDB members properly informed about the workings of the DFRDB scheme?
2. Was a decision to commute, of itself, likely to have caused financial loss relative to the only other option that was available at law?

DFRDB recipients expected an inquiry into whether the DFRDB legislation is fair and just, but that was beyond the Ombudsman's powers and the scope of his investigation.

The Ombudsman's report endeavoured to explain and justify the operation of the legislation and the indexation arrangements, but in doing so, demonstrated a less than adequate understanding of those matters.

DFRDB recipients also expected an independent inquiry. But the Ombudsman's investigation was funded by, and its terms of reference (TOR) were determined in close consultation with, the Department of Defence, the Department which funds the DFRDB scheme and the actions of which are in question.

The Ombudsman's investigation did not address the matters of concern to DFRDB recipients, and its outcome was a *fait accompli* pre-destined by the Department of Defence and the Minister for Defence Personnel and Veterans' Affairs.

The Ombudsman's report portrayed a selective and uninformed view of the facts. Evidence submitted to the investigation, which did not fit the report's findings, was ignored.

Were DFRDB members properly informed?

This paragraph in the *Foreword* of the Ombudsman's report requires no further comment:

Many DFRDB members, likely numbering in the thousands, were provided incorrect information by Defence personnel who were responsible for providing advice about the workings of the scheme. Those DFRDB members were led to believe, incorrectly, that their commuted pensions would increase once they reached their life expectancy factor age. The absence of clear guidelines and instructions to staff led to this incorrect information being provided, which resulted in a misunderstanding of the basic design of the scheme. In my view, this amounted to defective administration by Defence.

¹ [Commonwealth Ombudsman's Report 06 | 2019](#)

Was a decision to commute, of itself, likely to have caused financial loss?

The Ombudsman's finding, *"I am satisfied the decision to commute is not likely to have, of itself, caused financial loss, relative to the only other option that was available at law"* is based on financial modelling which is blatantly biased.

Because an amount equal to the reduction of retirement pay after commutation is not indexed, whether the member commutes or not, the modelling methodology compares the commutation lump sums, inflated at mortgage interest and term deposit rates, with the unindexed increased component of retirement pay the members would have received had they not commuted.

DFRDB recipients were under no obligation as to how they use their retirement pay entitlement, whether it was paid as a lump sum or not. However, the terms of reference (TOR) for the Ombudsman's financial modelling assume that all members invested their lump sums and achieved positive, albeit conservative, outcomes. The TOR do not consider members who did not invest all or part of their lumps or suffered losses due to adverse investment environments. Nor do they provide for the possibility that if members did not commute, they might have invested the increase in their retirement pay and achieved rates of return equal to those achieved by the investment of the commutation lump sums.

When the commutation lump sum is treated in the same manner as the differential in retirement pay if the members did not commute, that is, it is not increased, an accurate view of the commutation arrangement emerges. This view shows that the members who commuted have a financial advantage which decreases until the age determined by the *Expectation of Life Factor* used to calculate their retirement pay reduction. After which, those members suffer an increasing financial loss until the date of their death.

The latest life expectancy tables published by the Australian Bureau of Statistics (ABS) show that 80% of DFRDB recipients will live beyond the 1960-1962 life expectancy on which the reduction of their retirement pay was based. The Ombudsman's investigation team was made aware of this during a presentation by a delegation from the Australian Defence Force Retirees Association (ADFRA) Inc.

The TOR for the financial modelling commissioned by the Ombudsman required three scenarios to be modelled:

- i. A person commuting the maximum portion of the pension, with a commensurate permanent reduction of their fortnightly/annual pension (in accordance with the DFRDB Act);*
- ii. A person not commuting any portion of the pension, with no reduction in their fortnightly/annual pension (in accordance with the DFRDB Act), and*
- iii. A person commuting the maximum portion of the pension, with a commensurate reduction of their fortnightly/annual pension until their notional life expectancy (per the statutory tables which we can provide), after which point their pension returns to the rate it would have been had they not commuted (assuming, hypothetically, that the DFRDB Act permitted resumption of pre commutation rate in this way).*

Scenario *iii* is an equitable commutation arrangement, but it was not modelled by either the Australian Government Actuary (AGA) or KPMG, suggesting that the requirement to do so was withdrawn by the Ombudsman at some point before the AGA and KPMG submitted their reports.

The Ombudsman's Understanding of DFRDB Indexation

Paragraph 4.7 of the Ombudsman's report states:

When it was passed by parliament in 1973 there was no provision in the DFRDB Act that allowed for pensions to be increased. DFRDB pension increases were authorised by separate annual Acts between 1 October 1972 and mid-1976. The indexation basis was the lesser of 1.4 times the increase in the CPI, or increases in male average weekly earnings.

That understanding of the legislative background is not correct.

There were only two Acts which increased DFRDB pensions between 1 October 1972 and mid-1976. They were:

Defence Force Retirement and Death Benefits (Pension Increases) Act 1974 introduced in the House of Representatives on 13 November 1974; and

Defence Force Retirement and Death Benefits (Pension Increases) Act 1976 introduced in the House of Representatives on 27 April 1976.

The Ombudsman's report does not recognise that the indexation basis of "*the lesser of 1.4 times the increase in the CPI, or increases in male average weekly earnings*", which was recommended by Professor Andrew Pollard in 1973², was applied only to the part of Commonwealth superannuation scheme pensions paid out of the Consolidated Revenue Fund (CRF). That part was deemed by Professor Pollard to be five-sevenths of the total pension payable under the then-current Commonwealth Superannuation Scheme (CSS).

The CSS was a hybrid funded scheme, and the Pollard formula ensured that 100% (that is, 1.4 x 5/7ths) of the indexation increase would be applied to the part of CSS pensions paid from the CRF. The remaining two-sevenths of CSS pensions were met from the CSS Fund comprising member contributions and Fund investment returns.

Nowhere under the *History of the DFRDB* in *Part 2*, does the Ombudsman's report show that DFRB, the predecessor to the DFRDB scheme, was also a hybrid funded scheme, or that after the commencement of the DFRDB scheme in 1973, the assets of the DFRB Fund were appropriated into the CRF and ceased to be DFRB members' money.

100% of DFRB pensions were subsequently paid from the CRF, as was legislated for all DFRDB pensions in Section 125(3) of the DFRDB Act, which states:

² Enquiry into Superannuation Pension Updating – March 1973

All payments by the Commonwealth under this Act shall be paid out of the Consolidated Revenue Fund, which is appropriated accordingly.

In paragraph 2.16, the Ombudsman's report states:

As recommended by the Jess Committee, the (DFRDB) scheme is 'unfunded'. This means there is no 'fund' held by a trustee. Rather, the government pays for the scheme from its consolidated revenue fund as liabilities fall due. Member contributions also go into consolidated revenue. The money from contributions is therefore not invested on behalf of the member—it is, in effect, no longer the member's money.

Since the commencement of the DFRDB scheme, there has been no difference in how pensions are paid in the DFRB and DFRDB schemes. Yet, *Defence Force Retirement and Death Benefits (Pension Increases) Act 1974* applied a 16.2% increase in Average Weekly Earnings to 100% of DFRB pensions but to just five-sevenths (71.4%) of DFRDB pensions³.

And the subsequent *Defence Force Retirement and Death Benefits (Pension Increases) Act 1976* applied a 17.6% increase in the CPI to DFRDB pensions but an approximate 20% increase to DFRB pensions⁴.

Furthermore, the Ombudsman's report does not recognise that the 1974 and 1976 indexation increases were applied to the residual pension of the members who elected to commute, therefore, applying the indexation increases to the reduction of retirement pay resulting from commutation, and thereby further reduced retirement pay entitlements, already diminished by Section 24(3)(b) the DFRDB, by a considerable amount.

In a 1974 review of proposals for a new superannuation scheme for Government employees⁵, Mr G. L. Melville and Professor A. H. Pollard recommended that 100% of Commonwealth superannuation scheme pensions should be increased automatically by the increase in the CPI.

Paragraph 4.8 of the Ombudsman's report states:

In 1977 the DFRDB Act was amended by the Defence Force (Retirement and Death Benefits Amendments) Act 1977, which inserted Part XA into the DFRDB Act. This change allowed the pension to be indexed from 1 July 1976. As a result, pensions were increased if there was an upward movement in the Consumer Price Index (CPI). Pensions were not decreased if there is a downward movement in the CPI.

However, the Ombudsman's report fails to recognise that *Part XA* of *Defence Force (Retirement and Death Benefits Amendments) Act 1977* excludes from indexation a part of DFRDB pensions determined by:

³ [House of Representatives Hansard, 13 November 1974, p.p. 3443](#)

⁴ [House of Representatives Hansard, 27 April 1976, p.p. 1625](#)

⁵ Report on the Treasurer's Proposals for a new Superannuation Scheme for Government Employees – June 1974

Recipient members' *Expectation of Life Factor* in Schedule 3 of the DFRDB Act:

Whether or not members elected to commute; and

The date of members' retirement.

For members who retired before 1 July 1983 and commuted their maximum entitlement and all members who did not commute at least four times retirement pay entitlement, the part of DFRDB pensions excluded from indexation ranges from:

8.6% to 25.5% for females; and

9.7% to 32.1% for males.

The Ombudsman's report also failed to recognise the effect of *Defence Legislation Amendment Act 1984*, which not only increased the amount members could commute but also increased the part of DFRDB pensions excluded from indexation.

For members who commuted their maximum entitlement and retired after 1 July 1983 and before 1 July 2002, the part of DFRDB pensions excluded from indexation ranges from:

8.7% to 31.6% for females; and

9.9% to 39.7% for males.

For members who commuted their maximum entitlement and retired after 1 July 2002, the part of DFRDB pensions excluded from indexation ranges from:

10.8% to 31.9% for females; and

12.2% to 40.1% for males.

The Ombudsman's investigation team was also made aware of this during the presentation by the ADFRA delegation.

Paragraph 5.16 of the report states:

Indexation arrangements more generally have been the subject of numerous government reviews and inquiries. There is no reason to believe that each of these issues are not the intended policy outcome following deliberate and considered government policy decisions.

None of the "*numerous government reviews and inquiries*" recognised that indexation increases are not applied to a significant proportion of DFRDB pensions.

A majority of the reviews, going back as far as the Jess Review⁶ in 1972, concluded that the CPI was not an appropriate index on which to base DFRDB pension increases because, in the

⁶ The review of Defence Forces Retirement Benefits Legislation by the Joint Select Committee on Defence Forces Retirement Benefits Legislation

words of the Jess Report⁷, "*the index does not fairly represent changes in general community standards*".

There is an abundance of empirical evidence which supports those conclusions.

When in 2014, the Government finally gave effect to the 2007 Podger Review recommendation to index retirement pay for members over 55 to the same benchmark as age pensions, DFRDB benefits had been eroded by up to almost 50%. But the *Fair Indexation* legislation⁸ did not restore the relativity of DFRDB pensions.

The Ombudsman's investigation team was also made aware of this during the presentation by the ADFRA delegation.

The Ombudsman's Interpretation of the "Expectation of Life Factor"

Paragraph 5.6 of the report renames the "*Expectation of Life Factor*" to "*Commutation Divisor*" and in paragraph 5.12 states that "*the scheme drafters never envisaged use of current tables, but rather, preferred a static commutation factor.*"

That interpretation is pure conjecture. It ignores the fact that this *static commutation factor* differs for males and females who receive the same pay and conditions in the Australian Defence Force, regardless of gender. It also ignores the purpose of the *Expectation of Life Factor* in the object underlying the DFRDB Act, that is, the *Jess Report*⁹.

In recommendation 14(b), the *Jess Report* states:

*That retired pay **proportionately** reduced in relation to commutation remain payable after commutation.*

Paragraph 109, in the *Jess Report*, explains that in the predecessor DFRB scheme:

*The provision made for commutation ... is designed to ensure that if the option is exercised the actuarial assumptions on which the scheme is based will not be affected. **A retiree may not, therefore, commute more than he could be expected to draw as pension.** The assessment of his individual life expectancy is designed to ensure this.*

It is also fair and reasonable to assume that a member's reduction of retirement pay should not exceed the amount commuted and that the member's life expectancy, at the time of commutation, establishes a fair and reasonable period over which the commutation lump sum must be acquitted.

⁷ [Joint Select Committee on Defence Forces Retirement Benefits Legislation Report May 1972](#)

⁸ [Defence Force Retirement Benefits Legislation Amendment \(Fair Indexation\) Act 2014](#)

⁹ [Joint Select Committee on Defence Forces Retirement Benefits Legislation Report May 1972](#)

But the term **proportionate**, in recommendation 14(b) of the *Jess Report*, was transformed to **permanent** by the wording of Section 24(3)(b) of the DFRDB Act, which the Secretary of the DFRDB Authority subsequently endeavoured to justify in a Circular¹⁰ with:

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 dependants or the estate.

This statement by the Secretary of the DFRDB Authority implies that there is an equal probability of a member dying before or after reaching the age determined by the *Life Expectancy Factor*. However, the ADFRA delegation demonstrated to the Ombudsman's investigation team that the distribution of life expectancy is not symmetrical and that 80% of the DFRDB recipient population will live beyond their 1960-1962 life expectancy, the determining factor for commutation acquittal.

The Secretary's statement also ignores recommendation 16(c) of the *Jess Report*, which states:

That for the purpose of determining a widow's entitlement commutation should be disregarded.

This recommendation terminates the commutation arrangement on the death of the member if it occurs before attaining the expected age.

Paragraph 5.10 of the Ombudsman's report states:

It is understandable why members would prefer the use of later life expectancy figures. If the commutation divisor had increased in line with changes to life expectancy, the flow on effect would have been increased retirement pay for those who commuted (because a higher commutation divisor results in a smaller reduction).

This statement in the report demonstrates a lack of understanding of the effect of the *Expectation of Life Factor* which, not only determines the reduction of retirement pay after commutation but also determines the proportion of recipient members' retirement pay or invalidity pay which is excluded from the application of indexation increases, whether members commuted or not.

There is evidence in Hansard¹¹ that the Department of Defence, Treasury, and the Australian Government Actuary (AGA) were opposed to the DFRDB scheme. There is also evidence in Hansard¹² that the *scheme drafters*, that is, the legislation drafting panel which comprised representatives from Defence, Treasury, the AGA and the Parliamentary Counsel, excluded service representation.

¹⁰ Defence Force Retirement and Death Benefits Authority Circular 1973/7 dated 2 August 1973, paragraph 65.

¹¹ House of Representatives Hansard, 26 October 1972, p.p. [3279](#), [3285](#), [3287](#) and [3290](#).

¹² House of Representatives Hansard, 30 May 1973, p.p. [2879](#)

Through its wording of Section 24(3)(b) and the use of outdated and fixed life expectancy factors in Schedule 3 of the DFRDB Act, this drafting panel substantially altered the commutation arrangement, recommended in the *Jess Report*, to the considerable detriment of DFRDB recipients.

There is no evidence which supports a view that the Parliament was aware of this alteration or its effect. Commutation was a significant feature of the DFRDB scheme, yet it was not referred to once during the Second Reading debate¹³.

The following Acts exacerbated the effect of Section 24(3)(b) and Schedule 3 and amplified the detriment to DFRDB recipients, including the members who did not commute:

Defence Force Retirement and Death Benefits (Pension Increases) Act 1974;

Defence Force Retirement and Death Benefits (Pension Increases) Act 1976;

Defence Force (Retirement and Death Benefits Amendments) Act 1977; and

Defence Legislation Amendment Act 1984; and

Defence Force Superannuation Legislation Amendment Act 1991.

But there is also no evidence in Hansard^{14 15 16 17}, which supports a view that the Parliament understood the effect of these amendments and the reduction of DFRDB entitlements each one implemented. However, there is evidence which suggests that in the case of *Defence Force Retirement and Death Benefits (Pension Increases) Act 1976* not even the Minister who introduced the Bill fully understood it¹⁸.

There was no Second Reading debate of *Defence Force Superannuation Legislation Amendment Act 1991*¹⁹.

The Lack of Independence in the Ombudsman's Investigation

In his letter to the Ombudsman, dated 5 April 2019, The Hon Darren Chester MP wrote:

Noting your independent role as both Commonwealth Ombudsman and the Defence Force Ombudsman, I consider you would be well placed to investigate these issues under the own motion powers of the Ombudsman Act 1976, and this view has been supported by the members of the Ex-Service Organisations Round Table (ESORT) held by the Department of Veterans' Affairs.

¹³ *ibid*, p.p. [2879](#), [2882](#), [2886](#), [2888](#), [2891](#) and [2892](#).

¹⁴ House of Representatives Hansard, 20 November 1974, p.p. [3780](#), [3782](#) and [3783](#).

¹⁵ House of Representatives Hansard, 27 April 1976, p.p. [1625](#), [1858](#), [1858](#), [1859](#), [1860](#) and [1861](#) and [1861](#).

¹⁶ House of Representatives Hansard, 23 February 1977, p.p. [371](#), [371](#) and [372](#).

¹⁷ House of Representatives Hansard, 23 August 1984, p.p. [229](#), [234](#), [237](#), [240](#), [242](#), [243](#), [245](#), [246](#) and [247](#).

¹⁸ House of Representatives Hansard, 4 May 1976, p.p. [1861](#).

¹⁹ House of Representatives Hansard, 15 April 1991, p.p. [2612](#)

However, military superannuation is not included in the Charter of ESORT, and its delegates have no knowledge or understanding of the subject.

In his response to the Minister, dated 10 April 2019, the Ombudsman wrote:

Prior to commencing the investigation, my officers will engage with the Department of Defence to reach agreement on appropriate funding arrangements for this investigation. 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.

There was no consultation with the DFRDB recipient community on the scope of the investigation or its terms of reference.

A Breach of Fiduciary Obligation

Paragraph 2.41 of the 2001 Review²⁰ by the Senate Select Committee on Superannuation and Financial Services states:

The DFRDB is an Exempt Public Sector Scheme for the purposes of the Superannuation Industry (Supervision) Act 1993 (SIS Act), and so is a complying fund under the Income Tax Assessment Act and Superannuation Guarantee (Administration) Act²¹.

The DFRDB scheme is funded through an allocation from the Defence Budget²² under Programs 2.14 and 2.15, which implies that the Government, per the Department of Defence, is the *Trustee* of the *Fund* and therefore, has a fiduciary obligation to the beneficiaries of the DFRDB scheme.

However, the Department of Defence is conflicted between DFRDB beneficiary interests and its budgetary interests and has consistently placed the interests of DFRDB beneficiaries last.

Conclusion

The Ombudsman's investigation was not independent. It was funded, and its scope determined, by the Department of Defence, the same Department whose actions were to be investigated.

Not only has the Department of Defence not met its fiduciary obligation, by showing *single-minded loyalty* to the beneficiaries of the DFRDB scheme, it also mounted a sustained attack on the entitlements of DFRDB beneficiaries to diminish those entitlements over recipients' lifetimes.

²⁰ [A 'Reasonable and Secure' Retirement? – The benefit design of Commonwealth public sector and defence force unfunded superannuation funds and schemes](#)

²¹ [Annual Report of the DFRDB Authority 1999-2000, pp 5-6, and see discussion of Heads of Government Agreement in relation to Exemptions in Chapter 3](#)

²² [Defence Annual Report 2018-19, Table 4-5](#)

The findings in the Ombudsman's report were pre-destined by the Department of Defence and the Minister for Defence Personnel and Veterans' Affairs and evidence submitted to the investigation team, which did not fit those findings, was ignored.

(H. F. Ellerbock)

Secretary, Australian Defence Force Retirees Association inc.