Defence Reserves
Association

Royal Australian
Regiment Association

RESPONSE TO THE 2007 MILITARY SUPERANNUATION REVIEW TEAM'S REPORT

By

Australian Peacekeepers & Peacemakers Veterans Association

Defence Force Welfare Association

Defence Reserves Association

Legacy Co-ordinating Council

Naval Association of Australia

Returned & Services League of Australia

Royal Australian Air Force Association

Royal Australian Regiment Association

Australian Special Air Service Association

The Australian Federation of Totally and Permanently Incapacitated Ex Servicemen and Women

Vietnam Veterans Association of Australia

Vietnam Veterans Federation of Australia

DETAILED ANALYSIS OF THE REPORT OF THE REVIEW INTO MILITARY SUPERANNUATION ARRANGEMENTS

Introduction

1. The Review of Military Superannuation was conducted in accordance with a directive issued by the Minister Assisting the Minister for Defence in February 2007. The Terms of Reference (TOR) for the review defined two interconnected principles to guide the conduct of the review and form the philosophical context within which the TOR were to be addressed. The two principles were defined as;
    a. The unique nature of military service; and
    b. The need to compensate members of the ADF for that uniqueness in their superannuation, invalidity and death benefits.

Did the Review Adequately Address the Terms of Reference?

2. The TOR were reasonably comprehensive and required the Review Team to review current military superannuation arrangements and the suitability of those arrangements in the light of a range of factors including the contemporary legislative and regulatory framework within which superannuation benefits are provided in Australia. The TOR also listed specific issues to be addressed many of which were included as a result of the plethora of representations and complaints regarding superannuation that have been submitted by Ex-Service Organizations and individual serving and former members of the ADF over many years.

3. Annex A to the TOR defined the characteristics of the unique nature of military service. The first characteristic was the liability for combat operations which is both compulsory and continuous and includes the very real possibility of being exposed to the risk of physical or mental invalidity or death. No other form of employment has a similar liability. This particular characteristic of the unique nature of military service was acknowledged and recognized in the course of the review especially with regard to the need for "generous" invalidity and death benefits. There were however seven further characteristics of the unique nature of military service such as the military discipline code, regimented way of life, long and irregular working hours, statutory retiring ages well below community norms, high standards of physical fitness, frequent relocations and separation from family. The Review Team seems to have had little or no regard for these characteristics especially when considering reform of the current DFRDB and MSBS schemes.

4. The TOR required the Review Team to review current arrangements in light of "the current and future costs associated with providing, managing and administering military superannuation arrangements" The TOR did not stipulate that the Review Team should not make recommendations that would result in expenditure outside of the current Defence superannuation budget. The Review Team took it upon itself to apply such a restriction and as a consequence much needed and overdue reforms to the current schemes were either ignored or given very weak support. In addition, by adopting that constraint, it was simply not possible for the Review Team to propose any new scheme which costs the same as the current arrangements (as they claim to have done) *and also* address any of the major problems with the current schemes. The proposed measures therefore do not meet the requirements of the Terms of Reference to address the future and also rectify the past. It is hard to escape the conclusion that so far as reform of the current schemes and costs were concerned, the Review Team was working to a different and unpublished agenda. <u>It is our strong opinion that the Review has failed to meet the requirements of the Terms of Reference.</u>

Desirable Characteristics of Military Superannuation in Australia Today

5. In the Executive Summary at page viii of the report the Review Team has defined a set of Guiding Principles for any new arrangement. These principles seem to have been well thought out and are supported. Against the principle of 'Adequacy' the definition states that military superannuation for all members of the ADF, both short term and long term *should facilitate the maintenance of living standards both on and through retirement.*

6. The abovementioned adequacy principle is fundamental to the welfare of superannuation recipients. The operative words are 'maintenance of living standards' and this can only be achieved by indexing pensions to community living standards, which in practice means linking pensions to CPI and Male Total Average Weekly Earnings (MTAWE). The failure of the Review Team to be consistent with regard to this principle is one of the major weaknesses in the report.

Assessment of Current Schemes

7. The Review Team compared the current schemes against their desirable principles and found that the MSBS compares reasonably well but still falls well short of best practice contemporary superannuation and does not contribute significantly towards recruitment and retention. The review team concluded that the DFRDB Scheme is rated well below the MSBS. It is therefore very surprising and disappointing that given this assessment and the opportunity to recommend

reforms that would improve these existing schemes the Review Team failed to do so. This failure is especially disappointing as the changes to bring, especially the MSBS scheme to a comparable “best practice” standard would not on the surface be a costly exercise and would have provided a real policy choice for the Government in deciding how best to provide superannuation support for future ADF members. Fixing the deficiencies of the DFRDB scheme is more problematic but many of these (especially the “discounted” indexation and adherence to out of date life expectancy tables) are a very real source of discontent among existing DFRDB superannuants and equity demands changes be made regardless of any proposals for future ADF superannuants.

The Proposed New Scheme

8. Against the TOR it was not surprising that the Review Team has recommended the replacement of the current superannuation schemes with a contemporary defined contribution scheme that would have the effect of eventually eliminating government unfunded liability whilst transferring risk from the government to the individual member of the ADF. This is not necessarily an undesirable development provided the scheme is sufficiently beneficial to reward the unique nature of military service and the risk now assumed by it's members, and it offers other essential features such as flexibility and well developed death and disability benefits. Some will argue that the new scheme does away with the long standing paternalism for young and economically unsophisticated ADF entrants that were inherent in the existing defined benefit schemes. It is considered that those arguments can be set aside provided the level of Government (employer) contributions, expected returns and eventual pension levels;
   a. produce benefits superior to those provided by MSBS,
   b. recognize the transfer of risk to the individual in a tangible way; and
   c. can be confirmed by independent expert analysis.

9. As a first step one aspect of the defined contributions levels clearly deserves further consideration. The employer contribution proposed for the first six years of service is 16% of military salary per year. This is less than 1% more than is provided in the public service accumulation scheme, 2% less than is provided in the first 7 years in the MSBS and is considered an insufficient reward for the unique nature of military service.

Detailed Comments on the Report’s Recommendations

Recommendation 1

The Australian Defence Force should continue to have its own mandated superannuation scheme with benefits that reflect the unique nature of military service.

Commentary

10. The Review Team noted that superannuation contributes to the overall level of satisfaction with the ADF conditions of service package, and it is a significant factor in supporting a positive view of continued military service for longer-serving members. They also recognized that ADF members of all ages understandably focus strongly on the support for themselves and their dependants in the event of death or injury, particularly in the present climate of high operational tempo and risk.

11. They went on to say that best practice contemporary schemes in Australia provide maximum flexibility to members and recognise that members own their accumulated benefit. These schemes feature a menu of options for contributions (pre or post tax) and for benefits (lump sums and/or various types of retirement income streams). Consequently, members are given considerable choice in respect of their contributions and investments. Members are also kept informed of the current value of their account in the fund. The best schemes also provide access to mathematical models that allow members to conduct 'what if' calculations to help with life choice decisions. The Review Team also noted however that many overseas military superannuation schemes are based on defined benefit.

12. The Terms of Reference set out by the Government required the review to recognise the unique and special features of military service (detailed in the Terms of Reference). The requirement to accept being placed in life-threatening circumstances not covered by contemporary insurance arrangements, demands that there be superior death and invalidity benefits for members and dependants. The case for such benefits goes beyond service-related death or disability, as military service requires a level of physical and mental fitness that can be undermined by non-service incidents and lead to medical discharge.

13. The Review Team (correctly in our view) came to the conclusion that the ADF should have its own mandated superannuation scheme and that the unique nature of military service and employment requires an appropriate military superannuation scheme provide:

    a. Benefits beyond community standards to members and their dependants where the member dies, is disabled or medically discharged;
    b. Retirement benefits that are sufficient for a career ADF member to finance a pension from age 55 that broadly maintains his or her pre-retirement standard of living (this is termed “adequacy” in the Private Sector schemes and is “set” at 65% of final salary);

c. Preserved benefits for those who separate to embark on a different career, that represent a fair contribution towards an adequate retirement income (from the usual retirement age of 60 to 65); and
d. A scheme designed to facilitate the preferences not only of members but also of their families, and of members who move in and out of the ADF.

14. We believe that the unique nature of military service dictates that a member should be able to fully retire from the workforce at an earlier age than community standards and the Team has reaffirmed this position. This principle is analogous to the eligibility of war service veterans to the Service Pension at age 60 rather than 65 as applies to the general community for eligibility to the Age Pension.

Position Recommendation 1

Fully endorse this recommendation.

Recommendation 2

Defence should close the Military Superannuation and Benefits Scheme to new members of the ADF and introduce a new superannuation scheme for all new members of the ADF comprising an accumulation plan for retirement and separate defined benefits for death and disability.

Commentary

15. The Review Team outlines the principles it says are applicable to an appropriate Military superannuation scheme. These are stated as:
    - **Flexibility**, to meet individual member preferences regarding both contribution arrangements and the form of benefits and to respond to future changes to the broader superannuation or ADF environments.
    - **Simplicity**, to enable ADF members to clearly understand and measure the value of their current employer contributions to superannuation and the potential future benefits.
    - **Adequacy**, for all members of the ADF, both short-term and long-term, with a level of benefit that facilitates the maintenance of living standards, both on and through retirement.
    - **Tailored**, to address the unique nature of military service by providing generous life-time support for dependants in the event of death or disability and rewarding long and arduous military service.
    - **Visibly attractive**, forming an integral part of the remuneration package, enhancing the ADF conditions of service package and, in particular, supporting retention at critical points for the ADF and attracting former ADF members to re-enlist.

- **Financially sustainable**, with stable employer contributions over time and no increasing unfunded liability.

16. In looking at the existing schemes (DFRDB and MSBS) the Review Team concluded that neither scheme fully met these principles. The Review Team determined that, while the MSBS compares reasonably well with most overseas military schemes and with other Australian schemes for 'uniformed bodies', it still falls well short of best practice contemporary superannuation and does not contribute significantly towards recruitment and retention. They rated the DFRDB scheme well below the MSBS.

17. They noted, although did not fully discuss or justify their conclusion that incremental changes to the MSBS might alleviate some of the weaknesses, but could not satisfy all of the Guiding Principles.

18. The Review Team has proposed the introduction of a new military superannuation scheme that it claims would satisfy all of the guiding principles. In relation to the new scheme the Review team:

    - Suggested the overall generosity of the scheme and its cost should be commensurate with current arrangements;
    - Noted the requirement in its Terms of Reference of no forced detriment to current and former ADF members; and
    - Considered that:
        - while the special nature of military service dictates that a member should be able to fully retire from the workforce at an earlier age than community standards and have access to an indexed or flexible income stream from age 55, earlier access to superannuation benefits is not justified;
        - the ADF has a special responsibility to look after the interests of the significant number of young members, balancing a "paternalistic" approach with the development of increasing individual responsibility.

19. The claims in the report concerning the impact on current ADF members who transfer to the new scheme as well as the claimed benefits that will accrue to future members of the scheme are not always easy to follow. Some doubt has been cast upon a number of the example cases outlined in the report and detailed discussions have begun with the Review Team in order to clarify and validate some of the data and the basis of calculations in the report. These ongoing discussions have so far not alleviated our basic concerns about the potential level of benefits that might accrue based on the Review Team's proposals. Our position is that it is reasonable for the new scheme to cost the same as existing schemes once their acknowledged problems have been fixed but it will be necessary for there to be a very high probability for the eventual pension benefits to be superior to those that would arise from MSBS, so as to compensate for the higher

risk accepted by the members. It would have been useful also to use the MSBS fund historic earning pattern as a comparison.

20. The Review Team agrees with our position that the unique nature of military service dictates that a member should be able to fully retire from the workforce at an earlier age than the community norm. As the proposed new scheme is a taxed scheme it would be appropriate for the full provisions of "Better Super" with respect to tax free pension payments to apply from age 55 instead of age 60 for retired ADF members to recognize the uniqueness of ADF service.

Position Recommendation 2

Unqualified endorsement of this recommendation can not be provided until;

a. an independent examination of the proposed new scheme shows it to be superior in its benefits to an extent that offsets the risk that is passed from the Commonwealth to the scheme members;

b. the death and disability provisions are shown to entail no disadvantage vis a vis the current arrangements including appeal mechanisms, and

c. the "Better Super" tax arrangements are adjusted to allow benefits to retired ADF members from age 55.

Recommendation 3

The new superannuation accumulation plan for retirement should be fully funded and taxed with the following key elements:

a. **employer contribution rates of 16% of superannuation salary for the first six years of completed service, 23% for the next nine years of completed service and 28% after 15 years of completed service (with recognition of prior military service);**
b. **flexibility for members to set their own contribution rate, if any (with a default rate of 5% from after tax salary), select their investment risk profile and to make contributions following separation from the ADF;**
c. **members to have choice over the superannuation scheme into which their contributions will be invested whilst maintaining membership of the mandated death and disability benefits under the new scheme;**
d. **options for members with 15 years or more service, from age 55, to purchase indexed pensions (with a choice of indexation factors, at an unsubsidised price determined periodically by a Government-approved actuary) and/or an account based pension;**
e. **a range of options for the way members can access their benefits after preservation age, including through an account-based pension. This would allow members to take advantag of the Government's transition to retirement provisions; and**
f. **flexibility for spouses and children of members to contribute (personally and/or from an external employer).**

Commentary

21. Under the proposed scheme, employer contributions will be made to the fund fortnightly for members who are serving ADF members or who are Reservists on continuous full-time service. Employer contributions are proposed to be a percentage of superannuation salary (base salary plus Service Allowance) increasing with longer periods of service. The proposed employer contribution rates are;
    - for the first 6 years, 16%;
    - for the next 9 years, 23%;
    - and thereafter, 28%.

22. The equivalent MSBS employer contributions are;
    - for the first 7 years, 18%;
    - for the next 13 years, 23%;
    - and thereafter, 28%

23. We are concerned that the proposed contribution in the first six years is less than the current MSBS rate of 18% and only 0.6% more than the employer contribution rate for the Commonwealth Public Service Scheme. It is insufficient reward for the unique nature of military service as detailed in the Terms of Reference.

24. The report outlines the methodology for ADF members with 15 years or more service (including any years of receiving disability income) to convert their accumulated lump sum into an indexed lifetime pension at any time between ages 55 and 65. The conversion rates will be subject to a regular review by a Government-approved actuary and will be set an "actuarially fair price" defined as "cost neutral to the Government". The team notes that based on current market conditions, they expect that these conversion rates will be 20-40% lower than the rates available in the commercial market. . Under current MSBS arrangements for an eligible member (or surviving spouse) the conversion factor for a lump sum at age 55 years is 12:1. That is $12 of lump sum buys $1 of lifetime CPI indexed pension, with appropriate reversion and child benefits. Under the proposed arrangements a conversion factor of 20:1 is proposed for members and 18.6:1 to spouses for a similar CPI indexed pension. Thus for each $100,000 of lump sum current MSBS arrangements would yield $ 8333 of pension. Under the proposed scheme the pension would be $5000 - a difference of $3333 or 40% less. Further, electing to have a 'wage based' indexation requires a conversion factor of 24:1 a reduction of 50% in pension. The conversion rates are quite different to those that currently apply in the MSBS. This is to be expected as they are actuarially calculated to provide an unsubsidized pension. This makes a direct comparison with the MBSBS rates somewhat difficult however it reinforces the need to demonstrate that the accumulated lump sum will invariably be sufficient to ensure a larger pension than would be provided under MSBS in identical career circumstances.

25. The question of certainty of the ongoing funding of these lifetime pensions is not clarified in the report. For example, are we to assume that once a member's lump sum is converted to a pension, that the amount of the pension is guaranteed, and if so by whom, the Government or the scheme itself? On the other hand if, after some years, an audit of the scheme reveals a surplus in the fund would the surplus be returned to pensioners?

26. Under the proposed scheme indexed pensions will incorporate a reversionary component on the member's death. That is, in the event a member in receipt of an indexed pension dies, their surviving spouse would continue to receive 62.5% of the relevant pension. This rate is less than the effective DFRDB rate, the Commonwealth public service schemes and MSBS rate of 67%, and is considerably less than the reversionary rate for the parliamentary scheme of 82.5%. The rationale for proposing this lower rate is not explained.

27. The remaining recommendations have innovative and flexible features that if properly implemented are likely to benefit members of the ADF.

Position Recommendation 3

The independent actuarially calculated pension conversion factors are an essential element in the projected levels of pension. We need to be satisfied that these suggested conversion factors are valid and what are the input factors that influence the calculation and how sensitive are these calculations to changed inputs. For example if life expectancy was to increase from the current 83 to 88, what effect would this have on the conversion factors?

The employer contribution rate of 16% for the first six years is only 0.6% more than the Commonwealth public service accumulation scheme and 2% less than for the first seven years in the MSBS Scheme. We could not recommend this to ADF members and it would be a hard ask for young service personnel to accept. We therefore recommend that the initial rate be raised to 18%.

We appreciate the opportunity to have detailed discussions with the architects of the proposed new scheme in order to gain a better understanding of the methodology used to calculate the expected accumulated lump sums and the resultant expected levels of pension. However we need an assurance that pension levels will exceed those expected from MSBS to an extent that adequately rewards the greater risk assumed by members.

The question of ongoing certainty of pension amount once a lump sum has been converted requires clarification and also the method of disposal of excess funds in the scheme should that situation ever arise.

We can think of no valid reason why the reversionary rate of pension for a surviving spouse should be less than for MSBS and Commonwealth public service pension schemes and strongly advocate it be set at 67% as applies in these schemes but preferably at the rate applying to the parliamentary scheme outlined in the commentary.

The adoption of the so called "AWOTE indexation" for the proposed new scheme instead of using the now established benchmark methodology that applies to Age/Service and DVA disability pensions indicates a level of confusion on the types and application of indices. This has been a contributing factor in undermining our confidence in a number of calculations contained in the Report.

Recommendation 4

Death and disability benefits under the new superannuation scheme should have the following key attributes:

a. **Defence as employer should continue to meet the costs.**
b. **Compensable and non-compensable arrangements should be brought under one assessment and administration regime with an emphasis on rehabilitation, under the auspices of the Department of Veterans' Affairs.**
c. **Compensable disability benefits should be fully the responsibility of the Military Rehabilitation and Compensation Act 2004 (MRCA) until age 60 at existing rates of benefits.**
d. **For non-compensable disability, the current three-tiered invalidity benefits should be replaced by a single benefit for loss of earnings, akin to the Military Rehabilitation and Compensation Act 2004 (MRCA) benefits and conditions, with a minimum of 40% and maximum of 70% of final salary (based on actual and prospective service), indexed to Defence earnings and payable to age 60.**
e. **Employer contributions to the superannuation retirement fund should continue whilst a person is in receipt of either MRCA or superannuation disability benefits at a rate of 23% of the 'salary maintenance', up to age 60.**
f. **Death benefits from the superannuation scheme should supplement the accumulated benefit on the basis of 23% of final salary for each year of prospective service to age 60, payable in addition to any MRCA death benefits. Where there is a surviving spouse, the superannuation death benefit may be converted to an indexed pension with additional payments for up to three dependent children.**
g. **In the case of terminal illness, early access to the death benefit should be allowed.**

Commentary

28. The scheme proposed provides for a defined benefit where a member dies or is medically discharged from the ADF. This death and disability element is designed to complement the accumulation plan. Serving ADF members who have elected to have their employer contributions directed to another scheme will remain eligible for the death and disability element.

29. The Review Team states that it tried to ensure in the design of the new scheme that the death and disability benefits are at least on a par with the existing schemes unless, of course, a medically discharged member can be successfully rehabilitated. Unfortunately the report contains insufficient detail to allow examination of the proposal to verify there will be no detriment suffered by ADF members under the proposed new scheme compared to the existing arrangements.

30. In the proposal where the injury responsible for the medical discharge is a compensable injury, the level of salary maintenance will be determined under the MRCA. Generally this is 100% of salary for the first 45 weeks, reducing to 75% thereafter. The current arrangement of superannuation disability payment plus a top-up of compensation will be replaced by making MRCA fully responsible for these cases. This is in line with normal contemporary (workers compensation)

practice, and will remove the duplication of assessment and payment arrangements that is the source of many complaints about inconsistency.

31. Where a non-compensable injury is involved, salary maintenance will be met under the new superannuation scheme, and will be determined taking into account the total service of the member along broadly similar lines as apply now in the MSBS. Total service is the sum of actual service undertaken by the member plus prospective service from date of discharge until the member's 60th birthday. The base salary maintenance rate is calculated at 2% of salary for each year of total service. To maintain consistency between the compensable and non-compensable entitlements the base rate has a maximum cap of 70%. To protect later entrants a minimum cap of 40% will also apply. The actual rate of salary maintenance paid to members under the scheme's disability provisions will take into account the member's ability to undertake paid employment. This will be undertaken in a similar fashion to the economic and work test assessments currently undertaken under the MRCA.

32. It is interesting and pleasing to note that the team proposes the MRCA salary maintenance for non-compensable injuries under the new superannuation scheme be indexed by Defence earnings, not just the CPI (as applies currently to MSBS and DFRDB payments).

33. The Review Team also proposes that while the salary maintenance is being paid, an employer contribution will also be paid to the superannuation account of the member. Employer contributions are paid in both situations, compensable and non-compensable injuries. The rate of contribution will be 23% of the actual salary maintenance payments being made to the member. The accumulation of these employer contributions and investment earnings will provide retirement benefits for the member at age 60. Members who have 15 years or more of service will be able to convert part or all of their lump sum into an indexed pension. This period of service includes actual service, plus periods during which the member qualified for salary maintenance. We view this aspect as a positive feature but remain to be convinced that no disadvantage will accrue within the proposed arrangements vis a vis current provisions.

34. The proposed death benefit aspects of the new scheme are in general terms considered a positive but we remain to be convinced that no disadvantage will accrue within the proposed arrangements vis a vis current provisions . However the proposed reversionary pension for the surviving spouse of a Defence pensioner is 62.5% of final pension which is less than the reversionary pension of 67% provided by the MSBS and Public Service schemes. This is unsatisfactory. Proposing such a rate is even more provocative when the reversionary rate for the parliamentary scheme is 82.5%. Furthermore the capping of additional payments for dependent children at three is considered arbitrary and discriminatory.

Position Recommendation 4

We agree Defence should continue to meet the costs of death and disability benefits as employer of ADF members.

We also agree in principle that there should be one assessment and administrative regime and that DVA is the appropriate organisation for this. However more detail is needed on how this will be organized and administered before unqualified support can be given.

The proposed reversionary pension for the surviving spouse of a Defence pensioner should be at least 67% but preferably at the rate applying to the parliamentary scheme outlined in the commentary.

The proposal that additional payments made for dependent children be capped at three is both arbitrary and discriminatory. This proposed limitation, which follows on from the MSBS scheme should be removed.

Recommendation 5

Superannuation for Reservists should be along the following lines:

- **a.** **Reservists should be allowed to contribute personally and/or from an external employer into the new scheme.**
- **b.** **Reservists on full-time service should continue to be included in normal Defence superannuation arrangements including the proposed new scheme.**
- **c.** **Reservists not on full-time service whose pay is tax-exempt should not be included in normal Defence superannuation arrangements and should not receive the proposed employer contributions under the new scheme.**

Commentary

35. As set out in Chapter 4, the Review Team does not recommend that Reservists, other than those on continuous full-time service, be eligible for employer-financed contributions to the new scheme. It believed more careful consideration of the role and nature of Reservists is required, and that this should flow through to consideration of the appropriate remuneration package including the applicability and level of superannuation.

36. Reserve service has changed from the traditional Citizen Military Force concept to include elements such as High Readiness and Specialist Reserves which clearly provide significant levels of capability on a daily basis. Arguably, Reserve service

is a form of part-time ADF employment, and it would be appropriate for full-time ADF conditions of service to be the prime basis for calculating remuneration including superannuation for Reserve members. This is not to say Reserve service isn't some ways uniquely different to full-time ADF service and should attract some unique conditions of service.

37. The proposal that all Reservists become eligible for membership of the scheme with the ability to make their own post-tax superannuation contributions to the scheme or have Superannuation Guarantee contributions from other employers made to the scheme is a long overdue initiative but does not go far enough. We are disappointed at the limited nature of the Team's recommendation on the Reserves issue.

Position Recommendation 5

We endorse the Review Team's recommendations concerning membership of the military superannuation scheme for ADF reserve members on continuous full time service but recommend that the Commonwealth extends an employer contribution of 9% under the Superannuation Guarantee (Administration) Act 1992 to all Reserve service not covered by the recommendation as it stands.

Recommendation 6

Defence should meet the costs of administration of the scheme for individuals in receipt of an ADF employer contribution or a benefit from the scheme, family members of these individuals and Reservists who choose to use the scheme.

Commentary

38. At recommendation 3f the team proposed that membership of the new scheme be open to the spouse and dependent children of a serving ADF member. While the ADF member remains in service, the family members would be exempt from administration fees. Having established their individual membership, family members would continue to be members even if the ADF member either subsequently leaves the ADF or the scheme. However, fees would not be subsidised from that time.

39. Under this type of membership ADF family members would be able to make their own post-tax superannuation contributions to the scheme or have employer contributions made to the scheme. They would not eligible for the defined benefit death and disability benefits from the scheme.

Position Recommendation 6

We support this recommendation.

Recommendations 7 & 8

<u>Recommendation 7</u> Contributing members of current schemes should be offered the choice, for a limited period, of remaining in their current scheme or having their existing accrued benefits funded and then taxed on transfer to the new scheme, or to a scheme of their choice.

<u>Recommendation 8</u> Preserved members of the MSBS should be given the option, for a limited period, to have the current face value of their benefit funded and then taxed on transfer to the new scheme, or to a scheme of their choice.

Commentary

40. If a new scheme is authorized, the transition arrangements should allow current serving members the option of remaining in the existing schemes or transferring to the new. There will be numerous factors that might influence whether or not an MSBS member decides to transfer to the new scheme. These will include:
    a. An MSBS member who has or is about to separate from the ADF at a young age after say 6 or 7 years will probably transfer if he believes the growth of his accumulated fund at market rates up to age 55 will provide a sufficiently lump sum to offset the less advantageous conversion factors associated with the new scheme.
    b. An MSBS member with longer service is unlikely to transfer because by doing so he will lose the benefit of his employer contributions being related to his final salary and the significant benefit of the MSBS's better conversion factors. This would be especially so if he considers he might be promoted before age 55 or retirement.
    c. An MSBS member who has medium (?) length service will need careful advice taking into account his likely promotions, the benefit of market growth of his accumulation fund, the possibility of salary sacrifice into the fund, the option of a transition to retirement pension at age 55 and the option of an account based pension or an indexed pension using the less favourable new scheme conversion factors. This decision is unlikely to be simple or easy.

    Detailed data to enable each serving member to make an informed choice will have to be calculated and proper financial advice provided as well. This will have to include comparative data to show relative outcomes in both the old and new schemes

Position Recommendations 7 & 8

We support in principle these recommendations but note the absence in the report of detailed processes of how the transition would be handled at the individual level.

Recommendation 9

A single governance structure should be put in place for the DFRDB and MSBS, as well as the new scheme, along the following lines:

- **a. The structure should be established under legislation, with a Trust Deed for the MSBS and new scheme.**
- **b. There should be a seven-member board of trustees comprising two employee representatives, two employer representatives and three independent representatives, including the chairperson.**
- **c. A committee structure is to be determined by the Board to assist with all the Board's responsibilities for the DFRDB, MSBS and new scheme.**
- **d. Pending establishment of the proposed new governance structure covering all schemes, the DFRDB Authority should have an independent chairperson, appointed by the Minister.**

Commentary

41. The Review Team considered closely the report of the Review of Corporate Governance of Statutory Authorities and Office Holders (the Uhrig Report) and the Government's response to that report in August 2004. They agreed the current governance arrangements are inappropriate, presenting possible conflicts of interest. They considered they also involve constraints on the financing of the administration of superannuation, and possibly restricting the capacity of Defence as well as the MSBS Board to oversee the costs and performance of the administrator.

42. Turning to future governance requirements, the Review Team acknowledged that there is a distinct blend of skills and abilities required of superannuation fund trustees under Australian Prudential Regulation Authority (APRA) licensing requirements. Their central consideration in this respect was to ensure military superannuation trustees collectively have the legislated skills, knowledge and abilities, as well as an appropriate knowledge of members, ex-members and Defence interests. They, came to the conclusion that combined with increasing training and development requirements, there were advantages and efficiencies to be gained in forming a single board of trustees with responsibilities for all military superannuation schemes. We acknowledge the sense in this approach but are concerned that the Board be properly constituted and be supported by appropriate professional expertise and administration capacity.

Position Recommendation 9

We agree a single governance board be put in place to administer all military superannuation schemes and that it be established under legislation with a trust deed for MSBS and the proposed scheme if approved.

We agree a 7-member board is appropriate but believe it should be constituted as follows:

- *Independent Chairman*
- *Independent member with superannuation industry expertise*
- *Independent member with investment/financial services industry expertise*
- *2 employer members (with at least 1 from Department of Defence)*
- *Employee member nominated from within the ADF.*
- *Ex-employee member nominated by the military superannuants' community.*

Recommendations 10 & 11

Recommendation 10
Defence, with the ADF Financial Services Consumer Council and in consultation with the MSBS (or new) Board, should conduct an extensive education and awareness campaign to support informed choice by ADF members and MSBS preserved members to transfer to the new scheme or to remain in their current scheme. This campaign should include access to computer modelling to allow individuals to estimate the likely effect of transferring or not transferring given their personal situation, and access for current ADF members to subsidised financial advice.
Recommendation 11
The new superannuation board, in consultation with Defence and the ADF Financial Services Consumer Council, should develop an ongoing education and awareness program to ensure ADF members are able to make informed choices about their superannuation investments (including member contributions) and benefits, with access to subsidised financial advice, for serving members, at key career points (including after six years service, 15 years service and on approaching age 55).

Commentary

43. We agree the proposed new scheme will require substantial effort by Defence, the new board and others to educate members not only during the transition but also on an ongoing basis.

44. The lessons from the education and awareness campaign conducted in 1991 to aid ADF members in choosing whether to transfer to the MSBS have to be taken to heart. The 12-month campaign was extensive and involved base level information sessions, newspaper articles, "what-if" models and individualised information packages. The campaign on the face of it appeared to be comprehensive and sufficient for members to make an informed decision. Nevertheless, across the ADF there is a widespread view that members were misled into either remaining with the DFRDB or transferring to the MSBS (depending on the outcome in hindsight). We believe an extensive and ongoing education program supplemented by individualized financial advice from trained professional financial advisors will be needed to assist ADF members make informed choices on their superannuation requirements.

Position Recommendation 11

We support these recommendations with the caveats;

a. We believe the individualized financial advice should be free of charge to the ADF member. and

b. The key career points be in line with the variation points in the scale of employer contributions.

Recommendations 12 & 13

<u>Recommendation 12</u>
The MSBS Maximum Benefit Limits should be abolished.
<u>Recommendation 13</u>
The proposed new scheme should recognise interdependent relationships. Recognition of interdependent relationships in the existing military superannuation schemes should be consistent with, and reflect, Government policy for the other Commonwealth defined benefit superannuation schemes.

Commentary & Position Recommendations 12 & 13

The application of general community standards proposed by both these recommendations is considered appropriate.

Recommendation 14

If the Government is willing to go beyond the envelope of current costs, it should consider indexing DFRDB/DFRB pensions for those over 55 on a similar basis to that applying to age pensions. Because of the costs involved, this option does not warrant the priority attached to the other recommendations. An alternative option the Government could consider is to limit this change to pensions paid from age 65.

Commentary

45. In this area of the report the Review Team has demonstrated an alarming level of inconsistency. On the one hand they concede "it is also true that DFRDB and MSBS pensions generally provide only modest incomes to retired ADF members" and provide a table showing DFRDB and MSBS pension levels to support this statement, but on the other hand they state "The DFRDB is already a particularly generous scheme for those in receipt of pensions" and "MSBS provides very generous benefits to long-serving members with a choice of an indexed pension or lump sum, or both".

46. The Review Team also asserts, "Indexation based on the CPI does, in fact, adjust pensions for the costs of living". This is at direct odds with the view of the **Australian Bureau of Statistics**, which compiles the CPI, declaring in its publication *6440.0 - A Guide to the Consumer Price Index: 15th Series, 2005*, that the "***CPI is not a purchasing power or cost-of-living measure***"

47. The Review Team further asserts "there is no evidence that, over time, the costs of living of pensioners such as DFRDB and MSBS benefit recipients increase faster than those of the broader Australian community around which the CPI index is based". This discredited belief was rejected by the previous government when, in 1997, with bipartisan support, it decided to alter the method of indexing the age and service pensions from CPI to effectively the higher of CPI and MTAWE. Since that date a large number of other Government funded pensions, allowances and disability payments have been aligned with this new "benchmark" indexation method. The Review Team acknowledges that originally the DFRDB scheme provided wage based indexation that was removed in the mid 1970 when CPI indexation was adopted for a wide range of superannuation and welfare payments. Now that this policy has been substantially reversed it has become a matter of equity and justice that the same benchmark indexation method be applied to all military superannuation pensions. It would have been a useful and instructive exercise for the Review Team to have been briefed on the policy issues that led the previous Government to change the indexation method for the range of pensions and benefits that are now effectively indexed to the higher of CPI and MTAWE. The underlying rationale for this change is also applicable to

military retirement pay especially if the unique nature of military service is to be recognized.

48. The Review Team states "Most importantly, changing the indexation method would be expensive, and the additional expense could not be absorbed within the envelope of the costs of current arrangements, which the Review Team has aimed to achieve with its recommendations" It is considered that in applying a cost restraint that was not a requirement of the TOR, the Review Team has neglected a number of important factors that were contained in the TOR. Indexation is one of those factors. The cost of changing indexation of all military superannuation pensions would be approximately $20 million in the first year but possibly nothing if, as seems possible, CPI exceeds MTAWE in the near future.

49. The Review Team's costing of changing the indexation of DFRDB pensions for over 55s and the consequent increase in unfunded liability is based on Annex H to the report. At Annex H the Government Actuary has outlined the cost of changing indexation from CPI to AWOTE. This information is grossly misleading. AWOTE indexation has never been sought, is not used for the age pension and figures from the Australian Bureau of Statistics show it is significantly higher than the benchmark CPI/MTAWE indexation measure. If as explained by the Review Team in subsequent discussions, the reference to "AWOTE" did not equate to the ABS defined AWOTE index, this should have been made clear. Never-the-less, our point that "fair" indexation would be achieved by adoption of the methodology applying to the age/service and DVA range of pensions remains valid.

50. The Team's use of the Government policy on preservation arrangements for the general community, to come to the conclusion that "there is no case to increase the generosity of benefits payable prior to age 55, but there is a case for older DFRDB pensioners" is at odds with the two principles embedded in the Terms of Reference (i.e. the unique nature of military service and the need to compensate members of the ADF for that uniqueness in their superannuation, invalidity and death benefits). To exclude the under 55 year old DFRDB recipients ignores the fact that the features of the DFRDB scheme were designed to recognize the uniqueness of military service and the application of general community standards in this way is a retrograde step. We acknowledge the Team's partial recognition of the need for a change to the indexation method but believe it should apply to all in receipt of military retirement pensions.

Position Recommendation 14

If this recommendation were to be implemented, it would provide immediate relief for some 53,000 DFRDB recipients who are aged 55 years or more with another *approximately 4,000 having to wait 1 – 10 years. On that basis we feel compelled to provide qualified endorsement of this recommendation.*

The Review Team in formulating this recommendation has recognized the need to adjust the indexation method however the recommendation as it stands does not go far enough. We strongly believe it should be replaced by a general recommendation to index the total amount of DFRDB payments using the now established benchmark that applies to Age/Service and DVA disability pensions.

Recommendation 15

There should be no change to the MSBS pension indexation arrangements.

Commentary

51. The Team notes MSBS provides lump sum benefits, with a choice to convert at least 50% of the lump sum employer component into an indexed pension. The conversion factor of 12 at age 55 means that on reaching the current preservation age, an eligible member who converts their lump sum employer benefit, will receive 1/12th of the lump sum as an annual pension. They declare this to be a very generous option, especially when compared to the actuarial value of the indexed pension, which would be in the order of 1/20th of the lump sum on a cost-neutral basis. The report then states it would be difficult to justify an even higher subsidy for pensions by indexing them on the basis of earnings rather than prices. This line of thought completely misses the point. The MSBS scheme was designed to meet the needs of the ADF and its members. Use of the term "subsidy" in describing some of its features is misleading and not relevant. The point is that once a retirement benefit is paid the only way for the recipient to maintain a standard of living is for that retirement income to have some linkage to wage movements. This is in keeping with the Guiding Principles for military superannuation established by the Review Team. Clearly the Government has recognized that using the CPI as the basis of maintaining a relative standard of living is inadequate and it is time the Nation's former servicemen and women were treated with the same degree of concern for their welfare as other segments of the Australian community.

52. In essence on this issue the Review Team has abandoned its stated principle of '<u>Adequacy</u>' which it describes "military superannuation for all members of the ADF, both short term and long term should facilitate the maintenance of living standards both on and through retirement".

Position Recommendation 15

We do not agree with Recommendation 15. We believe very strongly that it should be replaced by a general recommendation to index all MSBS retirement pensions using the now established benchmark methodology that applies to Age/Service and DVA disability pensions. However a proposal for a stepped implementation of indexing MSBS payments using this benchmark in a planned and legislated move over the life of the present parliament would gain the general support of the Defence and Veteran community.

Recommendation 16

There should be no change to the DFRDB scheme life expectancy factors arrangements.

Commentary

53. We believe the Review Team has not fully understood this issue and its consideration has lacked objectivity. It acknowledged the significant improvement in life expectancy since the 1960s, but failed to acknowledge the unfairness of using outdated Life Tables. As a consequence DFRDB members are subject to a gross injustice. The Review Team states "*The fact is that the conversion factor based on a 1960s life expectancy is substantially more generous than a cost neutral conversion factor that takes into account opportunities to earn interest on the commuted lump sum. A conversion based on current life expectancy would be even more excessively generous*". This statement introduces the idea of a conversion factor. The Jess Report, which led to the DFRDB Act, intended the lump sum to be repaid over the retiring member's remaining life. Neither the Jess Report nor the DFRDB Act makes reference to the earning potential of the lump sum or to a conversion factor. The use of up an up to date and relevant life expectancy factor is a fundamental part of the calculation to produce an outcome that is fair and equitable to the individual member.

54. The option to commute a lump sum was an early manifestation of a reward for the unique nature of military service. The Jess Report refers to military personnel being compulsorily retired at relatively early ages having been frequently moved and having not had the opportunity to establish a home. The need for a lump sum payment being a pre payment of future entitlements was justified against this background. It was not expected that retiring members would be able to invest the lump sum to provide an income stream and there was never any mention of a conversion factor. Furthermore in other Commonwealth funded superannuation schemes the lump sum is provided without any repayment or conversion factor. It is believed that it was an oversight that the DFRDB Act did not provide for the periodic updating of the life factors. <u>Any other explanation requires us to believe that the Parliament intended the repayment of the lump sum should become</u>

progressively more disadvantageous as time passed and life expectancy increased. The Review clearly did not do the sums; for it has now reached the ridiculous situation that a DFRDB member retiring at age 60 with a notional life expectancy of just 15.6 years must earn 6.4% on the lump sum to offset the amount by which his pension has been reduced.

55. In its description of the DFRDB Scheme at Appendix E to the report the Review Team has omitted to mention a most important factor that is relevant to the life expectancy issue. If a retiree elects to not commute a lump sum that part of his/her pension that would have been deducted had he/she commuted, is not indexed at all. This grossly unfair provision was introduced by Amendment No 13 /77 and is contained at appendix Section 98B of the DFRDB Act. The effect of this provision is to force members to commute even though they may prefer to not do so on the grounds if they live to their actual life expectancy or beyond they will repay far more than the lump sum received.

56. The only other superannuation scheme that is remotely similar is the old Parliamentary Super Scheme where the lump sum is ten times the pension entitlement and the pension is halved so the lump sum is repaid over 20 years. After the lump sum is repaid the retiree continues to receive the reduced pension. The important difference is the retiring MP need not take the lump sum in which case his full pension is fully wage indexed for life. Alternatively if the retiring MP is over 65 at retirement the lump sum is reduced proportionately so that it is repaid by age 85. This more realistic life expectancy compares very favourably with the erroneous notional life expectancy of a retired DFRDB member that is (according to the 1962 life table) from 72 - 75 depending on age at retirement. No conversion factor comes into play in the calculation of MP's residual pensions.

57. The continued use of out of date life tables means that the amount of money deducted from each fortnightly pension payment to repay the lump sum far exceeds the amount that would apply if the latest life tables had been used.

58. The Review has established that the DFRDB Scheme is very inferior compared with the MSBS and the proposed new scheme. The life factor anomaly provides a chance to, in part, rectify this relative disadvantage. The Review Team has failed to recognize the importance of this issue and we are unable to understand why governments of various persuasions have not acted to correct this grossly unfair anomaly.

Position Recommendation 16

This recommendation is not agreed and we strongly recommend it be replaced with a recommendation to restore DFRDB military superannuation pensions to the full amount when the retired member has reached 'notional' life expectancy and that up to date life expectancy figures be used for all future DFRDB retirement pension calculations regarding commutation.

Recommendation 17

MSBS death and disability benefits should be calculated on the member's final salary or highest salary for superannuation purposes rather than the current final average salary.

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Commentary & Position Recommendation 17

This recommendation is agreed.

Recommendation 18

Benefits for members or persons imprisoned because of a criminal offence should not be suspended, other than for those offences specified in the Crimes (Superannuation Benefits) Act 1989. The Review Team notes that State authorities may consider recovering amounts from prisoners' income to offset accommodation and administrative expenses, and/or to contribute to victim compensation.

Commentary & Position Recommendation 18

This recommendation is agreed.