



Institute of Actuaries of Australia

4 May 2011

Mr Jonathon Rollings
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By email: jonathon.rollings@treasury.gov.au

Dear Jonathon

Institute of Actuaries of Australia submission to the MySuper Consultation Working Group in relation to defined benefit funds

At the last meeting of the MySuper Consultation Working Group, submissions were invited in relation to the treatment of defined benefit funds. The attached submission sets out the Institute of Actuaries of Australia's response.

The Institute is the sole professional body for actuaries in Australia, providing expert and ethical comment on public policy issues wherever there is uncertainty of future financial outcomes. It represents the interests of over 3,800 members, including more than 2,000 actuaries.

I attach a submission from the Institute on this issue. Please do not hesitate to contact me (03 9623 5464) if you have any questions.

Yours sincerely

Dr David Knox
On behalf of Institute of Actuaries of Australia

Attachment

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Paper on Defined Benefits from the Institute of Actuaries of Australia to the MySuper Consultation Working Group

Benefits for a defined benefit member generally consist of a number of components such as those set out below.

Benefits are generally determined as the greater of:

- A standard benefit determined according to the benefit design set out in the fund's trust deed (which may include one or more minimum benefits relating to membership of a previous fund or arrangement); and
- A Minimum Requisite Benefit set out by the fund's actuary in a Benefit Certificate. (This Benefit Certificate certifies the minimum level of employer support in relation to the fund provided by the sponsoring employer to the relevant fund for Superannuation Guarantee purposes.)

In the private sector, although there are a number of components, the benefit is treated as one single interest (although current pensions would be a separate interest). A similar approach applies in many public sector funds.

Standard benefit

The following list sets out the various components of a benefit which can arise in practice. In many cases, the benefit for a particular member may involve a number of these components. Components 1 and 2 would be considered to be defined benefit whilst components 3 to 7 would generally be accumulation (unless the MRB in relation to these components is in defined benefit form). Any minimum benefits payable in relation to membership of a previous fund may underpin the entire benefit, or sometimes components 1-4 plus 8 only.

<p>Component 1</p> <p>Defined benefit component financed by employer contributions</p>	<p>Generally the retirement benefit is calculated using a defined benefit formula. The level of employer financed benefit might depend on the level of employee contributions.</p> <p>The resignation benefit may be calculated using:</p> <ul style="list-style-type: none"> ▪ a defined benefit formula; or ▪ an accumulation approach; or ▪ a combination of the above <p>Generally this component is not separately identified or quantified from component 2.</p>
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<p>Component 2</p> <p>Defined benefit component financed by "compulsory" employee contributions</p>	<p>Generally the retirement benefit is calculated using a defined benefit formula.</p> <p>The resignation benefit may be calculated using:</p> <ul style="list-style-type: none"> ▪ a defined benefit formula; or ▪ an accumulation approach; or ▪ a combination of the above <p>Generally this component is not separately identified or quantified from component 1.</p> <p>Different employee contribution rates might apply to different employee groups or employees may be able to select from a range of contribution rates.</p>
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<p>Component 3</p> <p>Accumulation component financed by employer contributions</p>	<p>The defined benefit might be supplemented by an employer financed accumulation contribution (eg a 3% "productivity" account)</p>
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<p>Component 4</p> <p>Accumulation component financed by compulsory employee contributions</p>	<p>Whilst rare, some funds treat compulsory employee contributions on a purely accumulation basis (rather than as part of the defined benefit). This accumulation component is then paid in addition to any defined benefit component on leaving the fund (for any reason).</p>
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<p>Component 5</p> <p>Accumulation component financed by additional voluntary contributions</p>	<p>This component is wide-spread. Contributions could include:</p> <ul style="list-style-type: none"> ▪ salary sacrifice contributions ▪ post-tax contributions
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<p>Component 6</p> <p>Accumulation component financed by rollover amounts</p>	
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<p>Component 7</p> <p>Accumulation component financed by contributions from:</p> <ul style="list-style-type: none"> ▪ unrelated employers ▪ spouses ▪ Government co-contributions etc 	
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<p>Component 8</p> <p>A negative accumulation component to offset previous payments from fund</p>	<p>Will generally provide a reduction in the total benefit as a result of previous payments made from the fund in respect of the member, including payments due to:</p> <ul style="list-style-type: none"> ▪ superannuation surcharge ▪ excess contributions tax ▪ Family Law splits ▪ early release due to financial hardship/compassionate grounds <p>The interest rate used may be based on the fund's investment return, the return from a particular investment option within the fund, the 10 year Government bond rate, AWOTE etc, depending on the circumstances. Different rates may apply to different parts of this component. (In some cases, the previous payment may have been deducted directly from one of the member's accumulation accounts rather than applying this negative account approach.)</p> <p>This account may be directly or indirectly related to one or more of components 1 to 7. In some cases, eg when it relates to a Family Law split of a defined benefit component, it could be considered to be part of the defined benefit component.</p>
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Notes

In some cases, the various accumulation components of the superannuation interest might be combined into one "account". In other cases, they may be maintained separately.

The member will generally (but not always) have a number of investment options in relation to components 3 to 7.

Minimum Requisite Benefit

Whenever a member becomes entitled to a benefit, the trustee must check that the fund's standard benefit is not less than the Minimum Requisite Benefit (MRB) specified by the actuary in the fund's Benefit Certificate. This ensures that the employer can be treated as satisfying the Superannuation Guarantee contribution requirements up to the level of employer support specified by the actuary in the Benefit Certificate. (Whilst this will generally be 9%, where the employer is contributing to more than one fund for an employee, a lower rate might be specified.)

The MRB can be any one of:

- a defined benefit formula
- an accumulation formula
- a combination of the above.

In many cases, an accumulation approach is used even where the standard benefit is a defined benefit.

Where a defined benefit MRB formula is adopted, the formula implicitly allows for expenses and insurance costs (this allowance is built into the base formula set out in the Regulations). Where an accumulation MRB formula is adopted, the actuary will either implicitly or explicitly specify the allowable deductions for expenses and insurance costs.

It is important to note that the MRB does not just include an employer financed SG component. Rather, it generally includes allowance for:

- employer financed SG contributions of up to 9%
- employee financed contributions (including contributions made by salary sacrifice)
- other benefits not financed by the employer (such as rollovers, spouse contributions etc)
- reductions for previous payments such as family law splits, superannuation surcharge etc

Single defined benefit interest

The total benefit for a defined benefit member is considered to be a defined benefit interest (SIS Reg 1.03AA). It can include:

- a defined benefit component (defined in SIS Reg 6.31) or components
- an accumulation component or components.

(An accumulation interest as defined in SIS Reg 1.03 is any interest that is not a defined benefit interest.)

Exceptions:

At least for tax purposes, the Income Tax Assessment Regulations 1997 require the following to be treated as separate interests:

- a current pension (Sec 307-200.05)
- the untaxed component payable from some public sector arrangements (Sec 307-200.03).

These exceptions are not covered further in this paper.

Proposal for treatment of DB “products” under MySuper

Defined benefit “products” will not be called “MySuper” however it is essential that they be:

- accepted as being an allowable alternative to a MySuper product
- accepted as being an allowable option under Modern Awards.

This leads to the question of whether any additional requirements should be placed on DB products.

We note the complexity of DB arrangements, the multiplicity of different types of arrangements and the fact that the member’s (growth-phase) benefit consists of a single interest even though it is made up of some components which are clearly pure accumulation, some components which are clearly pure defined benefit (ie calculated as a multiple of salary or by reference to a specified amount) and some components which are part of the defined benefits but are calculated using a mixture of defined benefit style formulae and accumulation-style accounts (eg a salary-related benefit on retirement and an accumulation-style benefit on resignation, subject in both cases to an SG minimum benefit which may be either a pure accumulation style benefit or a pure salary-related benefit or a combination).

A relatively simple approach might be to adopt the following general principles:

1. Components of a superannuation interest which are purely in accumulation form (ie in all cases, the component of the benefit is calculated on an accumulation approach) should be broadly treated in the same manner as an accumulation benefit for accumulation members. This would generally apply to components 3 to 7 as set out above (unless the MRB or another minimum under the trust deed applied a defined benefit formula in relation to these components – in which case they would be considered to be a defined benefit component). This would include the following provisions:
 - the member would be able to select any Choice investment option
 - if the member does not make a choice, then the default investment option should be the MySuper default investment option
 - if the default MySuper default investment option applies, it should be possible for the trustee to waive any administration fees and insurance requirements (see below)
 - trustee governance provisions should be consistent with those applicable to MySuper and Choice options where relevant and practicable (the MySuper scale test is an example of a provision which is unlikely to be practicable for some defined benefit funds, such as where the MySuper accumulation benefits would relate only to voluntary additional contributions, because the basic benefits are defined benefit for all members)
2. Other components (ie the defined benefit component, whether calculated on a pure defined benefit basis or calculated using a combination of defined benefit and accumulation elements eg a multiple of final average salary subject to an accumulation style SG minimum benefit) would be considered to be defined benefit and would not be subject to any MySuper requirements.

Such an approach would ensure that, to the extent practicable, defined benefit members are given the same protections and rights in respect of pure accumulation components as accumulation members.

A more complex approach could be adopted if it eventuates that the MySuper rules only require employer SG contributions to be defaulted into the MySuper product (with the potential that a different default could apply to voluntary employer and member contributions).

Death and disability benefits

Generally, defined benefit members are provided with an insured or self insured benefit on death or disablement in addition to their accrued defined benefit retirement benefit.

It would therefore be inappropriate if further insurance was automatically provided through any MySuper account used in respect of the pure accumulation component included in their superannuation interest.

Trustees should be given the flexibility to provide such members with a MySuper account with opt-in (rather than opt-out) insurance provisions.

Fees

Generally some or all fees for defined benefit members are met by the employer. However, any asset based (or percentage) fees in relation to accumulation accounts would normally be met by the member.

For example, consider a fund that charges the following fees to accumulation members:

- a member administration fee of \$5 a month
- an administration fee of 0.1% pa of the member's account balance
- an investment management fee of 0.5% pa of the member's account balance.

For defined benefit members, the employer pays the member administration fee of \$5 a month and the administration and investment management fees on the assets relating to the member's defined benefit components. However, the member pays the asset-based administration and investment management fees in relation to any amounts in the member's pure accumulation accounts.

Assuming a similar fee structure under MySuper, it would be unreasonable for any defined benefit member to be required to pay the \$5 a month member fee in respect of any MySuper investment account.

For this reason, trustees would need to be given flexibility to charge defined benefit members less than the normal MySuper fees.

Benefits payable on cessation of employment

On cessation of employment with the employer sponsor, benefits may take one or more of the following forms:

- a crystallised amount which can be rolled over or retained as an accumulation benefit in the fund (or where applicable, an account based pension)
- a deferred lump sum defined benefit
- a defined benefit pension
- a deferred defined benefit pension

By far the most common is the crystallised benefit. As the crystallised amount is a pure accumulation benefit, an appropriate approach would be to apply the same requirements/protections as for accumulation members.

- Any accumulation components should remain in the pre-exit investment options (which could include MySuper for an accumulation component resulting from employer SG contributions where the member has not made an election).
- After a suitable notice period, any crystallised defined benefit component should be transferred to the fund's MySuper option or transferred to an ERF (unless the member selects a Choice option or elects to rollover or take up an account based pension). There would need to be provision for a suitable notice period (from date of leaving service up to, say, 60 or 90 days after the member is advised of their benefit and termination options) during which trustees would be able to apply a cash-type interest rate rather than immediately transferring the defined benefit to the fund's MySuper investment option where it may be subject to negative returns.
- Standard MySuper fees and insurance provisions would commence to apply (unless there is a continuing defined benefit component).
- A more complex approach could be adopted if it eventuates that the MySuper rules only require employer SG contributions to be defaulted into the MySuper product (with the potential that a different default could apply to voluntary employer and member contributions).
- Any part of the deferred benefit which is a defined benefit component should continue to be exempt from MySuper requirements.

Note that, in the private sector, it would be rare for new employees to be allowed to join as a defined benefit member. It would also be rare for a former defined benefit member to be allowed to rejoin the fund and be provided with future benefits on a defined benefit basis even if the member has retained a defined benefit in the fund in respect of their earlier service (though some such arrangements do exist and it would be difficult to undo these contractual arrangements). Similarly any vesting scales will generally be based on the current period of employment only, though of course exceptions do exist.

Portability

Currently, portability requirements apply to:

- all pure accumulation components of benefits (whether or not the member is still an employee of the employer sponsor)
- defined benefit components of benefits for members who have left the service of the employer sponsor.

The approach outlined above in relation to the treatment of defined benefit arrangements under MySuper should be able to cope with the current portability requirements.

Other issues

Issue 1

Most funds in the private sector do not offer defined benefits to new members. It is therefore likely that they will need to develop a MySuper product for new members. This would enable the approach proposed above for defined benefit members to be adopted relatively easily.

Issue 2

Where a fund does not admit new members or does not have an appropriate accumulation section (rare in the private sector but maybe more common in the public sector), the above approach may be more difficult. For instance, the trustee may not wish to establish an accumulation section that complies with the relevant MySuper requirements.

Several options may be available to such trustees, including:

- coming to an arrangement with another fund (or ERF) which might provide a suitable MySuper account which could be used as a default for, say, crystallised resignation benefits
- ensuring members making voluntary contributions make an investment choice before any voluntary contributions are accepted (the investment choice options would then be subject to the same protections as apply to investment choice options in other funds)

Issue 3

Some existing accumulation accounts provide a guaranteed minimum interest rate. It may not be feasible to include this rate guarantee in the MySuper account. The guaranteed accounts could either be considered to be defined benefit (ie based on a fixed minimum interest rate) or alternatively be considered to be an investment choice option.

Some specific comments in relation to Treasury paper

“Net return is irrelevant for DB fund members” (Statement in last para on page 1 of Treasury paper)

The Treasury paper states that “net return is irrelevant for DB fund members”. This statement is generally incorrect as many members will have at least one of:

- an additional accumulation account
- a defined benefit component in which the resignation benefit is related to the net investment return
- an MRB which is at least partly based on the net investment return
- an accumulation based minimum based on membership of a previous fund

Payment for actuarial advice (Issue 2 on page 2 of Treasury paper)

The Treasury paper appears to have been written under a misconception that actuarial advice is provided to the employer. In fact, actuarial investigations and advice in relation to employer contribution rates are almost invariably provided to the trustee and not the employer. In fact, the legislation (e.g. SIS regulation 9.29) specifically requires the trustee to obtain such advice. It is totally reasonable that the cost of any advice to the trustee is paid for from the fund’s assets as it is an expense incurred by the trustee in accordance with legislative and trust deed requirements. In most cases, however, the sponsoring employer ultimately meets this expense through higher contributions to the fund.

Advice to the employer in relation to accounting issues which the employer may require for the employer’s own accounts would generally be charged to the employer and not the fund.

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