



Institute of Actuaries of Australia

30 June 2003

Dear IAAust Members,

Actuarial Practice in Regard to Superannuation Funds Falling into an Unsatisfactory Financial Position

I previously wrote to members on 10 April 2003 regarding the provision of actuarial advice with respect to superannuation funds that are in, or might fall into, an unsatisfactory financial position (“UFP”). As noted, Council has established an Urgent Issues Task Force to review the issues involved. Attached to this letter is a paper based on the initial work and considerations of that Task Force. While this paper has not been through the due process of the IAAust for it to be issued as formal guidance, I urge members to consider its contents and conclusions and take these into account in providing their professional advice.

The paper emphasises the need for actuaries to take a proactive approach and provide comprehensive advice on the risks and ramifications of actions or inaction that may be considered in the current environment.

The Superannuation and Employee Benefits Practice Committee is currently reviewing the Professional Standards and Guidance Notes, and has been requested to take account of the contents of the attached paper in undertaking that review. Nonetheless, I would encourage actuaries to ensure they remain fully acquainted with the provisions of the existing relevant Professional Standards and Guidance Notes. These provide helpful advice that is particularly relevant in the current difficult environment.

Any enquiries regarding the contents of the attached paper should be directed to Martin Stevenson via e-mail at martin.stevenson@mercer.com or via telephone on (02) 8272 6818.

Chris Lewis
President



Institute of Actuaries of Australia

Unsatisfactory Financial Position – Actuarial Considerations

Urgent Issues Task Force

30 June 2003

This paper is primarily focused on the role of actuaries in advising on the financial management of APRA-regulated corporate superannuation funds. Actuaries advising in respect of government funds, semi-government funds and self-managed funds should also have regard to the principles set out in this paper that are relevant to those funds.

Background

The advice of the actuary to the trustee and/or employer of a defined benefit superannuation fund is central and often crucial to its appropriate financial management. Furthermore, in fulfilling their role, actuaries do so against the background of:

- Legislation and statutory requirements; and
- IAAust Professional Standards, Guidance Notes and the Code of Conduct.

Importantly, the role and responsibilities of the actuary are not limited to those set down in legislation, but extend beyond the “minimum” requirements. This is reflected in the Professional Standards, Guidance Notes and Code of Conduct of the IAAust, for example, paragraph 11.1 of GN 460 which reads as follows:

“This section of the Guidance Note is included to remind actuaries of their professional responsibilities when dealing with superannuation funds. The Institute believes that actuaries have a professional responsibility that extends further than the specific requirements of the Act and Regulations. Accordingly, there are circumstances in which the Institute would expect actuaries to take action, notwithstanding that the Act and Regulations do not require any action, or to undertake more rigorous calculations than required by the Act and Regulations. Further, the Institute believes the actuary's professional responsibility exists whether or not the actuary is performing an actuarial function under the legislation.”

Furthermore, it is noted that under the current legislative environment, the regulator, APRA, has limited powers with respect to funds in an unsatisfactory financial position. This environment places actuaries in a position of particular responsibility. Actuaries need to take a leadership position in advising trustees and/or employers of funds in an unsatisfactory financial position. Actuaries' advice, whether that be to the trustee and/or employer, must at all times be framed in terms of actions the actuary considers necessary to maintain the financial wellbeing of the fund and the reasonable security of member benefits.

Nonetheless, it is recognised that the issues involved are often complex and their communication challenging, and require trustees, having regard to the advice of actuaries, to balance the potential consequences for the various stakeholders in defined benefit superannuation funds. The issues typically encompass:

- Securing member benefits:
 - The broad expectation of members and the community is that superannuation is deferred pay and that the purpose of having a trust fund separate from company assets is to ensure that members' benefits are secure and not subject to the ongoing viability of the employer.
 - Assets should exceed Minimum Requisite Benefits by a comfortable margin and should normally exceed vested benefits.
 - Consideration should be given, in advance, to the implications of adverse experience and to the establishment of appropriate buffers or other strategies to respond to such adverse experience.
- Considering the financial impact on the employer:
 - Investing assets to optimise the long-term cost outcome for the employer. Investments may be structured for higher long-term returns (e.g. equity assets), however the risks involved with this must be quantified and then limited to acceptable levels.
 - Avoiding the build up of excessive assets in the fund.
 - Offering the sponsoring employer some stability and predictability in contributions.

It is impossible to concurrently invest in equity assets for higher returns, slavishly target a specific level of cover for vested benefits, achieve stable company contributions, and eliminate the temporary build up of excess assets and/or emergence of occasional, temporary shortfalls.

Furthermore, achieving an appropriate balance is particularly difficult under present circumstances:

- Changes to benefit design and increases in the Superannuation Guarantee rate have increased vested benefits to levels comparable with, and sometimes in excess of, the reserves necessary to secure long-term retirement benefits for members;

- Legislation, and industrial practice, has acted to discourage employers from allowing assets to build up in superannuation funds in excess of the accrued benefit liabilities; and
- Sustained falls in equity investment values over the last 2 ½ years, now being compounded by a rising \$A, have reduced and/or exhausted what excess monies may have previously existed in funds.

In meeting these challenges, the essence of good actuarial advice is the application of professional judgement and experience. The underlying process cannot be totally codified but must relate to the specific circumstances at hand.

The purpose of this paper is to highlight the need for actuaries to take a proactive approach and to provide comprehensive advice on the risks and ramifications of actions or inaction that may be considered in the current environment. This paper sets out a number of important issues the actuary should consider in this regard. Not all points will be relevant to all funds, and the actuary must take into account all relevant circumstances relating to the specific superannuation fund.

Actuaries are also reminded of APRA's views on funding defined benefit funds in the current environment that were summarised in the IAAust's Notice to Members dated 10 April 2003. A copy of that notice is attached for ease of reference.

Addressing "Unsatisfactory Financial Position" Deficits

It is estimated that a significant proportion of the defined benefit funds (or defined benefit sections of composite funds) in Australia are currently in an "unsatisfactory financial position" ("UFP"). That is, they have vested benefit obligations to members in excess of the current realisable value of the fund's assets. The appropriate management of this position, including the advice provided by actuaries, will be important, and in some cases crucial, to all stakeholders in the fund.

Once it is identified that a fund is in an UFP, the SIS legislation requires the trustee to take action to deal with the matter, and requires the actuary to inform APRA of the situation if the trustee's action is not satisfactory. Generally such action comprises a funding strategy to correct the financial position, based on actuarial advice. **The Task Force believes that such a strategy should seek to restore the fund to a satisfactory position as soon as is practical and that the actuary's primary concern in advising on such a strategy must be for the overall security of the members' benefits.** In this case it is incumbent on the actuary to be proactive, and encourage and facilitate the development of an acceptable corrective strategy by the trustee and employer.

In arriving at an appropriate strategy to address an UFP there are a wide range of factors that need to be taken into account, including actions that can be taken to help protect the security of members' benefits until the funding position is corrected. These factors and actions include, but are not limited to:

- The current status and risk profile of the fund:

- The current investment policy of the fund (including any large exposures to single assets or to assets which are illiquid or are not listed on a major stock exchange) and the degree to which the security of members' benefits could further decline if there are further falls in the investment markets. The sustainability of ongoing exposure to volatile assets needs to be considered if responsive contribution support is not forthcoming from the employer.
 - Any Future Income Tax Benefit included in the assets of the fund. The inability to realise such an asset on the termination of a fund further weakens the financial position of the fund.
 - Any potential reductions in the membership of the fund and the expected benefits payable, and their potential to significantly worsen the financial position of the fund in respect of the remaining members. This is particularly the case for small funds, redundancy payments (especially if greater than normal vested benefits) and/or the departure of senior executives.
 - The maturity of the defined benefit section of the fund and therefore the degree to which additional contribution requirements can quickly and significantly change as a result of the investment performance or other adverse experience.
 - Any relevant provisions of the governing rules affecting funding and/or security of members' benefits.
- Action that is or can be taken external to the fund to support its position:
- Putting arrangements in place to protect the financial position from further deterioration. For example, agreement by the employer to pay extra contributions to meet the unfunded part of current benefit payments.
 - Providing additional protections to members' benefits beyond the current assets of the trust. For example, the employer may obtain a bank guarantee in respect of the deficiency or there may be provisions in the trust deed, or elsewhere, giving the fund legal recourse to the employer for any deficiency on a winding up of the fund.
- The viability of potential funding strategies with respect to the employer:
- To the extent that the actuary can reasonably assess it, the financial strength of the sponsoring employer and the consequent level of confidence in the ability of the employer to continue to fund a deficiency in the future.
 - The limits on the tax deductibility of employer contributions (it is noted that the IAAust is seeking changes to the law to prevent these limits from acting as a disincentive for employers to top up under-funded arrangements).
 - The prospect that a "demand" for funding of the deficit over a short period could lead to the employer initiating a wind-up of the fund while in deficit. This must be considered within the context of both broader law and the specific governing documents in particular circumstances.
- Other concerns of the trustee in managing a fund that continues to be in an UFP.

Where a funding strategy is adopted which is not expected to result in an immediate correction of an UFP, then the recommendation of the actuary should:

- Include suggested strategies (such as those outlined above) that seek to protect beneficiaries' interests and reduce the potential for further deterioration of the fund's financial position during the funding period.
- Incorporate regular and appropriately frequent monitoring of the financial position of the fund, together with identified observable/measurable trigger points indicating the need to review the recommendation.
- Be discussed with and generally be peer reviewed by an experienced actuary.
- Encourage the trustee not only to inform the members of the fund of the UFP event (as required by SIS), but also to inform members of the strategy being adopted to correct the position. The actuary should encourage the trustee to obtain appropriate legal advice if there is any doubt as to their obligations in this situation.

In making the recommendation, the actuary should be mindful of the responsibilities and duties of each stakeholder, including his or her own professional responsibilities in providing advice as distinct from the trustee's responsibilities and duties in managing the fund.

While the above refers specifically to a fund that is identified as being in an UFP, the discussion and expectations apply equally to a fund that the actuary suspects is in an UFP or that is likely to be in an UFP in the near future.

Other Areas for Attention

Irrespective of whether a fund is in an unsatisfactory financial position or not, the current volatile environment may well lead to a need for the trustee and the actuary to re-examine a number of the operational and monitoring aspects of the financial management of a fund.

The following list of issues and actions are recommended for consideration by actuaries in relation to all funds they advise. The actions are in addition to any specific statutory requirements. If a comprehensive review of all the relevant issues is undertaken the outcome could be an overall strategy for the future financial management of the fund.

Reporting of UFP to Members

If it is clear to the actuary that a fund is in an UFP at any time, or due to recent experience is likely to be in an UFP at the next formal measurement date, the actuary should immediately advise the trustee even though a formal measurement of the position has not been made.

Actuaries should remind trustees that a fund falling into an UFP would usually be considered to be a significant event that needs to be reported to members. In these circumstances, employers may wish to make an immediate contribution to the fund to restore the position so that members may also be advised that the UFP has been rectified. Similarly, employers may wish to make an additional contribution before the next annual review date to ensure that the fund accounts and the annual report show that the fund is in a satisfactory financial position at that time.

Actuaries should discuss these issues with their clients.

Investment Policy

While many superannuation funds now retain the services of a specialist asset consultant, the actuary continues to be charged with the responsibility for advising on the interaction of the investment policy with the liabilities of the fund. Consequently, actuaries should review the investment policy of the fund to be satisfied that:

- The policy provides for sufficient liquidity to meet the normal requirements for benefit payments and other outgoings without the need to realise assets at possibly temporarily depressed prices; and
- The likely volatility of investment returns has been taken into account in the funding strategy adopted (i.e. the more volatile the investment returns, the greater the need to maintain a prudential margin above vested benefits in the funding policy).

In particular, the implications for a closed fund, with an aging membership base and with vested/accrued benefits rising as percentage of member salaries, being heavily exposed to volatile assets should be included in the actuary's advice with a recommendation that they be discussed between the trustee and the employer.

If appropriate, actuaries should recommend a review of the investment policy. If the trustee is unwilling to review the investment policy, actuaries should consider whether or not the funding recommendations should be amended (especially, as noted above, in regard to the funding of any deficiency relative to vested benefits).

Funding and Solvency Certificates (FSCs)

The FSC includes a monitoring process that relates to technical insolvency. In this regard:

- Actuaries should remind defined benefit fund trustees of the need to monitor the fund in regard to the "notifiable events" listed in the FSC and to report to the actuary should any of those events occur.
- In preparing any FSCs, actuaries need to ensure that the notifiable events are sufficiently comprehensive to catch any situation that might threaten the solvency of a fund. Where the funding position is relatively weak, it may also be appropriate to have a shorter term for the FSC than normally applies.
- Actuaries should review all current FSCs and determine whether those FSCs are still appropriate or should be withdrawn and replaced (e.g. with revised notifiable events).

Monitoring

Similar to the FSC monitoring process (which is only required to deal with technical insolvency), the actuary should ensure that an appropriate process is in place for ongoing monitoring of asset coverage of vested benefits and for responding to adverse experience.

Contribution Recommendations

Actuaries should examine their most recent contribution recommendations and consider whether or not they continue to be appropriate in the light of:

- Subsequent financial experience;
- Other experience in relation to the fund in question; and
- The issues covered in this note.

Actuaries should recommend a formal review of the funding position and company contribution rates if they believe that their client's existing arrangements are no longer appropriate.

Actuaries should take care in making any new contribution recommendations to ensure that their recommendations pay appropriate attention to the interests of the members. Actuaries who are advisers to both the trustee and the employer need to be especially careful – while the views of the employer are clearly relevant, it is important to avoid allowing the wishes of the employer to influence the actuary's recommendations in a way that is contrary to the interests of the members.

Furthermore, the actuary needs to consider all the circumstances of the fund and the attitude of the employer to the funding of deficits in determining an appropriate target level for the funding of vested benefits. For example, while a highly equity-oriented investment policy may lead to a lower long-term cost, it is also likely to lead to more volatile investment returns and a need for a higher target funding level to protect the security of members' benefits. Similarly, if an employer is reluctant to fund any future deficits over a short period, a higher target level of funding would be appropriate to minimise the risk of significant deficits arising.

Interest Rates

Some funds declare interest rates that are not directly related to investment earnings for the corresponding period, most typically through some smoothing technique. Actuaries should consider the impact of the policy in relation to declared or interim rates on the overall financial position of the fund in making funding recommendations. Where the actuary has a responsibility for the setting of the declared interest rates, the actuary should consider whether or not the method of determining the declared interest rates can and should be modified in the current circumstances. Where the actuary is not directly responsible for the setting of the declared interest rates, the actuary should consider whether or not it would be appropriate to suggest a modification of the current approach to the trustee. In all cases, the actuary should consider the need for appropriate reserves to be maintained.

Insurance

Actuaries should review the current insurance arrangements, including the insurance formula, to ensure that they remain appropriate in the light of recent fund experience. For example, recent investment experience may mean that a fund is effectively self-insuring some of the death and disability benefits to a greater extent than previously planned.

Other Responses

Where it appears that the employer may be reluctant to fund any future deficits in a timely manner or modifying the investment risk profile of the fund to mitigate the need for such deficit funding, then the actuary should also consider discussing with the trustee and/or the employer the possibility of reducing future accruals, converting to defined contribution arrangements or winding up the fund. Special contributions may still be required to meet any current shortfall but such actions may reduce or eliminate the risk of further funding problems arising in future.

Composite Funds

Where a fund contains both defined benefit and accumulation categories, actuaries need to be mindful when making recommendations of the interaction of the two categories. For example, the potential impact of smoothed interest rates for accumulation members on the solvency of the defined benefits and the potential for a deficit in the defined benefit category to impact the benefits of accumulation members on the winding up of the fund.

Documentation

Irrespective of whether specific action is taken or not following a review of the matters outlined above, actuaries should document the matters that have been considered and the conclusions reached.

There will be some cases where the last measured funding position is so far above 100% of vested benefits that many of the above actions will not be necessary at this time but those cases are likely to be relatively rare.

For further information, please contact Martin Stevenson via e-mail at martin.stevenson@mercer.com or via telephone on (02) 8272 6818.

Greg Martin
Convenor
UFP Taskforce



Institute of Actuaries of Australia

NOTICE TO MEMBERS

APRA's concerns about certain actuarial practice in Superannuation

Recently a meeting was held between representatives of the Australian Prudential Regulation Authority (APRA) and the Institute.

The purpose of the meeting was to discuss APRA's findings and concerns, particularly in relation to actuarial work, following its review of the financial position of defined benefit (DB) superannuation funds; and in particular those funds that were in an unsatisfactory financial position (UFP).

Following advice of APRA's views, Council has established an UFP [Urgent Issues] Task Force to review the issue and to report back to Council at its June meeting. In the interim (and before Council has had an opportunity to form its opinion on the matters raised) it is appropriate that APRA's main views be reported to members.

Summary of APRA's views:

APRA believes that the current problems should be viewed in the context of what it believes to be a significant shift in investment outlook from previous occasions as well as the closed nature of many DB funds.

APRA's comments covered the following issues. Please note the references to relevant passages of the Institute's Professional Standards and Guidance Notes, shown in parentheses.

- Actuaries should seek to monitor funds regularly in times of deteriorating financial position and not rely solely on the regular triennial timetable (refer paragraphs 11.1 and 11.2 of GN 460).
- Funding recommendations should be accompanied by the appropriate communication of the reasoning behind the recommendation (refer paragraph 52 of PS 400). APRA was specifically concerned with the reasons behind the amortisation period chosen.
- Where the fund has both a defined benefit and a defined contribution section the actuary needs to consider financial equity between the two sections (refer paragraph 28 of PS 400 plus the actuary's general duty of care).
- Actuaries should seek to actively review the appropriateness and impact of investment mix on funding levels in light of recent market environments and recent states of solvency of defined benefit funds generally (refer paragraph 64 of PS 400).

- Whilst actuaries must work within legislative limits, actuaries should also use professional judgement to determine if higher prudential standards than those set by legislation are appropriate in each particular circumstance. For example, while the legislation states that the financial position of a fund in technical insolvency must be restored within 5 years, in many instances a shorter period would be appropriate (refer paragraphs 11.1 and 11.2 of GN 460).

APRA also put forward a position that goes beyond our current standards: that for funds in an unsatisfactory financial position, amortising the deficiency over three to five years is too long a period (subject to individual exceptional circumstances which must be articulated).

APRA officials drew comparisons with other deposit taking institutions (whilst acknowledging superannuation funds are different) and noted that all other financial institutions would always cover the amount of the liability plus have reserves in place. This position reinforced the message given to actuaries in last year's open meetings with APRA.

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Any enquiries about the contents of this memo should be directed to Martin Stevenson via e-mail martin.stevenson@mercero.com or telephone (02) 8272 6818.

Issued on 10th April 2003
by Chris Lewis, President