Update on Superannuation Surplus in Australia

GBK Trahair - Australia

Executive Summary

This paper outlines the major changes which have occurred in the past 3 years to the regulatory environment governing superannuation funds in Australia, and discusses developments in relation to surplus in defined benefit funds.

The principal legislative changes have been the implementation of extensive prudential legislation which requires the trustee of most funds to be a corporation, codifies the duties of trustees, restricts the extent to which an employer can influence trustee decisions and establishes a specific regime for surplus repayments. The legislation spells out the penalties where there are breaches.

A new reasonable benefit limit (RBL) regime comes into operation from 1 July 1994. This regime will simplify RBLs for the great majority of fund members but will restrict the tax concessions available to the highly paid. There are transitional arrangements for members over age 45 which will ensure complexity remains in the system for the next 20 years.

From 1 July 1996 there will be compulsory preservation of superannuation entitlements for most future benefit accruals whether financed by the employer or member. The age to

which benefits must be preserved will gradually be increased from 55 to 60 over the next 25 years.

Where the trustee of a fund decides to repay fund surplus to an employer it can only do so

- after satisfying itself that the repayment and any benefit improvements are a reasonable balancing of the interests of the employer and of the members,
- after giving members three months notice,
- after securing actuarial certification that the fund will continue to be in a satisfactory financial condition after the transfer, and
- when the 3 months notice has expired, resolving to repay the surplus.

In practice its seems likely that surplus repayments will be part of a package which involves benefit improvements for members. Any improvements are likely to be influenced by the extent to which the fund's benefits are below average.

Economic conditions over the past 3 years have been favourable for the generation of surplus with most funds achieving real rates of return in excess of 10% p.a.

There is likely to be a flurry of activity to repay surpluses in the period up to 30 June 1995. This reflects the greater certainty provided by the new legislative framework, favourable economic conditions and the fact that surplus repayments attract a 15% tax credit up to 30 June 1995.

A. Introduction

My December 1991 paper for IACA's 1992 Conference in Vancouver was titled "Issues on Ownership and Use of Superannuation Surplus in Australia". While its major focus was surplus in superannuation funds, it also covered subjects then of current interest.

This paper brings you up to date on events over the last 2½ years. There have been significant changes to the legislative environment surrounding superannuation funds, some court cases resolved and several interesting developments in relation to the use of fund surpluses.

Also relevant to the subject of fund surpluses are recent economic conditions and accounting standards for defined benefit funds both in respect of sponsoring employers and funds themselves.

B. Legislation

As seems to be the case in many countries, Australia has continued to add to the amount of regulation and red tape surrounding superannuation funds.

While much of the supervision of superannuation funds now rests with the Insurance and Superannuation Commission, recently the administration of Reasonable Benefit Limits (RBLs) has been transferred back to the Australian Taxation Office. (Funds can provide benefits in excess of RBLs but concessional tax treatment of benefits only applies for amounts up to the RBL).

The Income Tax Act has been amended not only to reflect this change but also to introduce a new RBL regime from 1 July 1994.

The latest piece of superannuation legislation - the Superannuation Industry (Supervision) Act - is focussed on the prudential management of superannuation funds. In part it was a reaction to the Maxwell debacle in the UK. The legislation was enacted in December 1993 with the subsequent regulations published in March 1994. Some of the legislation became effective when it was announced in October 1992 but most of it applies from 1 July 1994 with several parts deferred until 1 July 1995.

Of particular interest in the SIS legislation are

(1) increased preservation rules which take effect from 1 July 1995, and

(2) the procedure which must be followed for surplus repayments.

Taxation of Superannuation Benefits, Reasonable Benefit Limits

The Government has been almost in continuous change mode since 1983 in relation to RBLs. The latest change from 1 July 1994 is that RBLs will be unrelated to length of membership and level of salary.

The limit will be $400,000 where the benefit is paid in lump sum form increasing to $800,000 where at least half the benefit is taken in the form of a pension or annuity which "complies" with standards laid down by the Government.

(These standards are that the pension/annuity must be for life, non commutable and provide cost of living indexation - it can also have a contingent spouse pension). The $400,000 and $800,000 figures will be indexed each year in line with changes in the Average Weekly Ordinary Time Earnings (AWOTE) index.

Transitional lump sum RBLs apply to many employees who had RBLs in excess of $400,000 under the old rules. The transitional lump sum RBL will be

(1) for members under age 45, the member's resignation benefit at 30 June 1994 if it exceeded $400,000,

(2) for members who are between 45 and 50 at 1 July 1994, an amount equal to the resignation benefit at 30 June 1994 plus a proportion of the excess of the old RBL over that entitlement. The proportion starts at zero at 45 and grades up to 1 at age 50, and

(3) for members over 50 or more at 1 July 1994, an amount equal to the RBL under the previous regime.

Similar rules apply to transitional pension RBLs.

Transitional RBLs will also be indexed in line with AWOTE changes.

The announcement of the impending changes to the RBL system in 1992 sparked a flurry of activity amongst sponsoring companies to maximise the RBL positions of long service executive members by 30 June 1994.

Companies are also considering restructuring future benefit accruals and remuneration packages for senior executives to reflect the reduced tax incentives for superannuation.

Optimising the position for established members can be achieved in a variety of ways including

i) employers increasing benefits before 1 July 1994. Possibilities include additional contributions, enhancement of benefit rates or improvement to vesting scales (effective retrospectively) and bringing forward benefit accruals, and

ii) employees increasing their taxable salaries. Higher paid employees typically receive part of their remuneration packages in non taxable form e.g. cars, loans on concessional terms, club membership dues etc. However RBLs are based on the average **taxable salary** over 3 consecutive years. Accordingly an employee has been able to increase his/her RBL over the last two years by taking more in taxable cash and less in low tax or tax free benefits.

Preservation

Australia has been slow to recognise the desirability of preserving superannuation entitlement on resignation. Its first move towards preservation was in December 1986 when any increase in resignation or early retirement benefit financed by employer contributions had to be preserved until at least age 55.

The introduction of union ("award") negotiated superannuation soon after involved the full preservation of all those entitlements. For many lower paid employees these were the first superannuation entitlements they had.

Award superannuation was overtaken in 1992 by the Superannuation Guarantee Charge (SGC) legislation which has led to compulsory, fully vested and fully preserved superannuation contributions of 5% of salary for all employees. The level of SGC contribution is due to rise by 1% steps until it reaches 9% of salary by 1 July 2002. There is also the possibility that a mandatory employee contribution of 3% of salary will be introduced leading to a minimum contribution of 12% of salary.

Thus there have been significant steps in the past few years to ensure that retirement contributions are actually held until the employee nears or reaches retirement age.

There are two other aspects of the SIS legislation which will accelerate preservation.

First is increasing the minimum preservation age from 55 to 60 with a long phase in period.

Second is the requirement that all benefits which accrue after 1 July 1996 whether employer or employee financed are to be preserved on a change of employment. What is to happen is that all benefits will be preserved whether pre or post July 1996 with an exemption equal to the non preserved component which applied at 1 July 19965 increased in line with changes in AWOTE.

C. Surplus Issues

In October 1992 the Government announced it would introduce prudential legislation via the SIS Act. At that time it outlined a process which funds would have to follow before surplus could be refunded. That process took effect immediately.

The Government indicated it was not going to intervene directly in the issue of who owned superannuation surpluses leaving that to be resolved on a case by case basis in accordance with the fund's trust deed (and in some cases by the legal process).

Process for Surplus Refunds

The process that the Government has instituted for surplus refunds is as follows:

i) the governing rules of the fund must permit the refund;

ii) the trustee, while consisting of equal employer and member representatives, must (by resolution) declare its intention to refund surplus;

iii) prior to the trustee making its resolution

- an actuary must certify that the fund will remain in a satisfactory financial position after the surplus refund, and

- the trustee must be satisfied that the surplus refund and any associated rule changes to improve benefits are a reasonable balancing of the interests of the employer and the members;

iv) the trustee must give members a notice stating

- its intention to refund the surplus to the employer after 3 months,

- the actuary has given the required certificate, and

- any changes to the governing rules associated with the refund;

v) at the end of the three month notice period, the trustee must further resolve to repay the amount.

The requirements that the trustee

(1) must be satisfied the refund of surplus and associated benefit improvements are a reasonable balancing of the interests of the employer and the members, and

(2) must act in the best interest of beneficiaries

could create problems unless a significant part of the surplus is used to improve benefits.

How much might be provided to improve benefits will depend on the particular circumstances of each case. Where a fund already provides generous benefits with high vesting there may be relatively little provided to improve benefits.

However in a fund with benefits well behind average practice, the trustee may conclude a much greater proportion of the surplus should be used to improve benefits.

In each case half the trustee board will be member elected.

Recent Case Histories of Surplus Refunds

The Government announcement in October 1992 has clearly affected the way in which surplus recoveries are undertaken but it certainly has not stopped them. While the trustee of a fund needs to decide a course of action which represents a fair balancing of interests this doesn't necessarily mean that the surplus division needs to be down the middle nor even for that matter in proportion to the contributions made by employee and employer.

The recent cases I have seen, have all resulted in the majority of the surplus repaid to the company with the minority used to improve benefits. In each of these cases the benefits already provided were comparatively generous so that the fund was already well placed in terms of market position.

The three cases summarised below illustrate recent experience.

Case 1

Assets and surplus before repayment	$150 million & $90 million
Date repaid	January 1993
Amount repaid	$60 million

Value of improvements	$10 million
Type of Fund (before)	Above average defined benefit
Type of Fund (after)	Defined benefit but with some improvements
Benefit Improvements	A one off credit of $500 for each year of membership plus 15% of past member contributions with interest as well as better death and disability benefits.
Comment	In spite of an extensive communication exercise, there was strong adverse reaction from some members who believed members should received a bigger share of surplus. The trustees were petitioned to negotiate higher benefit improvements but they reaffirmed their original decision.

Case 2

Assets and surplus before repayment	$50 million & $20 million
Date repaid	March 1993
Amount repaid	$18 million

Value of improvements	$2 million
Type of Fund before	Defined benefits
Type of Fund after	Accumulation
Improvements	Generous benefit paid on transfer to accumulation.
Comment	The trustee board had a member representation so approval was requested from ISC and granted.

Case 3

Assets and surplus before repayment	$200 million (over 3 funds) & $130 million
Date of repaid	June 1991
Amount repaid	$110 million
Value of improvements	$20 million
Type of Funds before	Defined pension benefits with poor vesting. Did not allow return of surplus.
Type of Funds after	3 new funds established - partly defined benefit, partly accumulation. Return of surplus permitted.

	Surplus transferred to new funds and then repaid to company.
Benefit improvements	Actuarial reserve plus one off credit of 30% of past member contributions with interest on transfer. Better vesting provided in new funds. Pensions being paid were increased by 30%.
Comments	Members had to agree to transfer. The Union tried to push for a bigger share of surplus. The company held out and all except 2 members plus some pensioners agreed to transfer. There was an extensive communication exercise.

The Shell Case

My 1991 paper discussed three specific cases, the two major ones involving Westpac and Shell.

The Westpac case was finalised in 1991. It involved the repayment of $300 million of surplus to one of Australia's largest trading banks as part of a package which saw a further $300 million of surplus earmarked to improve benefits and $400 million of surplus retained to finance a contribution holiday for Westpac. The trustees' decision to repay surplus was challenged by a member (with union support) but he lost the case and the validity of the package was confirmed.

The Shell case had not been settled by the end of 1991. Shell had operated a generous fund for many years which did not permit surplus repayment. It established a new fund which did permit surplus repayment and invited members to transfer for improved benefits (but in the knowledge that the surplus in the old fund would transfer with them and later be repaid to Shell). More than 99% of members transferred but several declined and (with union support) took action to have more of the surplus used for members.

In December 1991 the Shell case was in the process of being litigated. The first step by the union and dissenting members had been to seek to have the case heard in the Industrial Relations Commission (IRC) rather than the High Court of Australia. Shell had challenged this approach.

In 1992 Shell learned it had lost its challenge.

That loss was seen to favour members and unions since using the IRC is

(3) more straight forward than the High Court,

(4) more informal, and

(5) thought more likely to favour members than employers.

Late in 1993 the Industrial Relations Commission handed down its decision on the employee/union claim. It decided not to intervene in the dispute since it believed members had on balance received a fair deal in transferring to Shell's new fund.

On the whole employers in general and Shell in particular must have found that a satisfying result. First because it was one handed down by the IRC and employers had generally had felt they would have been in a weaker position in dealing with the IRC. Second the IRC were unconvinced by the submissions made by the unions seeking IRC intervention and a greater share of surplus.

Since the IRC decision there has been a further play in the Shell case. The unions have appealed to the Insurance and Superannuation Commission (ISC) to overturn the decision of the trustees of the new Shell fund to repay the surplus to Shell as being illegal.

In the new Shell fund the Trustees comprise 3 member and 3 employer elected representatives and an independent chairman i.e. 7 trustees in all. When it came to a vote on repaying the surplus the three employer nominated representatives plus one employee representative plus the Chairman voted in favour giving 5 votes for 2 against. There was thus the necessary 2/3 majority required for a valid decision.

The ISC regulations due to come into effect from 1 July 1995 outlaw the chairman of trustees of a fund having a casting vote. The unions argue that the single vote of the chairman in the new Shell fund was effectively a casting vote and that the decision should therefore be set aside. The ISC decision on this appeal is still to come. However on the surface the unions argument appears to be very thin. The concept of outlawing casting votes was developed against the background of past practice where a chairman of trustees often had not only a normal vote but also an additional casting vote if there was an equal division of votes.

If the union's latest claim fails, then presumably the surplus will be repaid to Shell - some six years after Shell set up its new fund!

Impact of Recent Economic Conditions on Surplus

The substantial surpluses reported by defined benefit funds in the late 1980's and early 1990's were largely driven by high real investment returns (despite the October 1987 share "crash" and a mini crash in October 1989). During this period inflation was moderate but not particularly low.

In the last few years investment performance has not been as high but inflation has been markedly lower and funds have been achieving high real rates of return. For example a recent survey of pooled superannuation trusts (which many funds use for investing their assets) displayed an average rate of return before expenses and tax of 15.3% for the 3 years ended February 1994. During the same period inflation as measured by changes in the consumer price index or changes in average weekly earnings averaged 3.1% and 4.2% p.a. respectively. Currently (May 1994) price inflation is running at less than 2% p.a.

Thus during the last few years financial conditions have led to defined benefit funds generating significant surplus. Of course since the heady 1980s many funds have

- removed surplus, or
- used surplus to improve benefits, or
- provided a contribution holiday for the employer, or

- done all three.

As a consequence many of the very large surpluses that were seen in the early 1980's have been substantially reduced. Nevertheless in the past few years defined benefit funds have proved to be significant profit centres provided of course that the employer can access the surplus either by contribution holiday or surplus refund.

Financial Reporting of Superannuation Surpluses and Deficits

In my 1991 paper I discussed the draft accounting standard (ED53) under which companies were to report superannuation surpluses or deficits in their balance sheets. Surplus was defined as the excess of the realisable value of assets over the actuarial value of accrued benefits. Any initial surplus or deficit was to be amortised but subsequent experience from one year to the next was to be recognised in full in the company profit and loss account once the standard had been implemented. It was unclear how the assumptions for determining actuarial values were to be set.

The draft standard has yet to be converted into a final standard. As far as I am aware there are only two companies which have adopted the concepts of ED53 - they are both very large companies by Australian standards. While that has given some benefit in the sense of reporting fund surpluses as assets in the their balance sheets, they each have had to live with the volatility of reporting experience gains and losses in full each year. Quite significant variations in share prices and interest rates have occurred in the past 3 years. As a result experience gains and losses have had a major impact on the

profit and loss account of at least one of these two companies in the past three years.

The Australian Accounting Research Foundation (AARF) developed ED53 and is in the process of drafting a final standard for consideration by the accounting profession. It has had a lot of feedback on ED53 and its perceived short comings.

At least one major company has indicated its concern about the volatility arising under ED53. The actuarial profession and others have pointed out it is also inappropriate for Australia to adopt an accounting standard for reporting surpluses and deficits which is not consistent with either the US FAS87 standard or the UK SSAP24 standard. Amortising experience gains or losses each year would meet most of this criticism. It is possible that the final standard will require or permit amortisation.

After some early antagonism between AARF and the Institute of Actuaries of Australia on the subject of accounting standards for superannuation, a rather more co-operative approach has emerged. This has led to the Institute with the acquiescence of the AARF producing a new draft of ED53 intended to maintain the original concepts but to overcome the major criticisms that have been made and ensure greater compatibility with overseas standards.

It is not clear when a final standard will be introduced although indications are that it is likely to be by the end of this year.

The two companies who have already adopted the concepts of ED53 could have an interesting situation when the final

standard emerges. This is because they booked the full surplus in their superannuation funds at the outset whereas ED53 contemplates any initial surplus or deficit would not be reported in full but be spread over a number of years. Each may have a major writeback of net assets when the final standard comes out.

While ED53 is a draft which applies to corporate reporting of surpluses or deficits there is a final standard (AAS25) which applies to how superannuation funds should report the value of accrued liabilities and the extent of any surplus or deficit.

This standard also gave rise to a considerable degree of friction between the accounting and actuarial professions. Accountants were looking for the surplus (or deficit) of a defined benefit fund to be reported annually in a profit and loss statement. Actuaries believed that reporting surplus (deficits) as a "profit" (or "loss") and reporting annual changes as a profit or loss would be misleading and that the volatility of results could

- unsettle members, and
- encourage trustees to adopt more conservative investment policies to reduce short term volatility.

In the last year there has been some clarification as to how the assumptions used in calculating the actuarial value of accrued benefits under AAS25 and ED53 should be determined.

The accounting profession expects the interest rate used to be related to current fixed interest rates with appropriate allowances for both the investment policy of the fund

concerned (i.e. a risk adjustment), the average term of liabilities and the outlook for inflation of liabilities. In Australia there are relatively few long term fixed interest securities on issue. This means the rate of return on reinvestment of investment income and maturing securities are important considerations when setting the interest rate.

It appears other assumptions will be left largely to the judgement of the actuary.

The basis for determining assumptions will be implemented for AAS25 for fund years ending on or after 1 July 1995. Prior to then liability figures based on the last actuarial valuation can be used. The basis will also presumably apply to those companies which have adopted the principles of ED53 from the same date.

Tax Credits on Surplus Refunds

The October 1992 SIS changes will moderate pressure from employers for surplus. However that does not mean refunds will cease.

In fact in the short term, there could be an increase in activity. This is because a surplus refund before 1 July 1995, results in a tax credit for the fund equal to 15% of the amount paid out - after that date there is no tax credit. The complexity of taxation legislation means that it is not necessarily a simple matter for a fund to secure full value for any such tax credit. However with some restructuring of assets the value of the 15% tax credit can be secured - to improve benefits or reduce contributions.

As a consequence some companies with funds in surplus will be seeking a surplus repayment before 1 July 1995. However any plans for surplus refunds need to be well under way by early 1995 to have much chance of achieving a 30 June 1995 deadline.

Future scope for Generating Surplus

The last few years has seen considerable activity in defined benefit funds to refund surplus usually accompanied by significant benefit improvements and contribution holidays.

As a consequence the overall extent of surplus in funds has been considerably reduced. This has been accompanied by many defined benefit funds being converted to accumulation benefits.

It appears likely that surplus will be rather less of an issue in the future than it has beeen over the past 5 to 10 years.