Institute of Actuaries of Australia

SUPERANNUATION AND EMPLOYEE BENEFITS PRACTICE COMMITTEE

Discussion Note:
Benefit Certificates – Earnings Base Change from 1 July 2008

April 2008

The Superannuation and Employee Benefits Practice Committee ("SEBPC") intends to issue guidance to members on the preparation of Benefit Certificates allowing for the Superannuation Guarantee (SG) earnings base change to Ordinary Time Earnings (OTE) from 1 July 2008. This is expected to take the form of a Professional Standard (say PS456) which will replace the current GN456.

The purpose of this Note is to inform members of the SEBPC's current views on the designs of minimum requisite benefits (MRBs) which it anticipates will be able to be used under PS456 to cater for the change in earnings base from 1 July 2008.

BACKGROUND

The SG legislation was introduced in 1992 and requires employers to provide at least a minimum level of superannuation for employees.

The default earnings base has been OTE since the commencement of the SG regime but, subject to certain conditions, employers who had established a superannuation earnings base other than OTE prior to 21 August 1991 have been able to use the 'grandfathered' earnings base for SG purposes.

For employees in accumulation funds, employers can meet the SG requirements by making contributions of at least the legislated minimum. However, for employees in defined benefit funds, including those with only accumulation benefits in defined benefit funds, employers must obtain an actuarial certification in the form of a "Benefit Certificate" to the effect that the minimum benefits accrued each year are worth at least 9% of the relevant earnings base (if the full SG rate of 9% is to be met via the fund).

LEGISLATION AMENDMENTS

The Superannuation Guarantee Administration Act 1992 ("the Act") was amended in 2004 to remove the ability to use earnings bases other than OTE with effect from 1 July 2008.

However, the necessary consequential amendments have not yet been made to the Superannuation Guarantee (Administration) Regulations 1993 (the Regulations) which deal with the preparation of benefit certificates for defined benefit funds. These amendments are expected shortly and follow confidential discussions between the Institute and the Australian Government Actuary on appropriate changes to implement the intended requirement that Benefit Certificates measure SG support against OTE in all cases for periods commencing on or after 1 July 2008.

This guidance is based on the SEBPC's expectations as to the content of the amendments.

The most significant changes are expected to be made to Regulation 6, which sets out formulae for determining the SG support for a specified defined benefit design.

It is worth noting that the defined benefit design specified in Regulation 6 is unlikely to precisely match the MRB design of any particular defined benefit fund, either before or after 1 July 2008 (e.g. based on SEBPC proposals, it requires an unchanged NECR since 1992 and member contributions based on OTE from 1 July 2008).

However Regulation 6 does serve to provide a legislated standard on which Institute guidance as to the SG value of defined benefits can be based. In particular, with the changes for OTE from 1 July 2008, Regulation 6 is expected to allow for:

- The MRB in respect of service up to 30 June 2008 to continue to be determined using the same formula and notional earnings base as applied up to 30 June 2008; and
- Averaging of OTE over a period for the MRB in respect of service from 1 July 2008.

Regulation 6 is also expected to allow for the MRB in respect of service from 1 July 2008 to be determined using the 'annual rate of ordinary time earnings' at the date of withdrawal. It is noted that an annual rate of OTE at a particular date is not appropriate in many situations, such as where OTE includes irregular items such as bonuses, commissions, shift loadings etc. However, in the case of an employee whose OTE is comprised only of regular base salary, for example, the annual rate of OTE at a particular date is readily determinable as the annualised base salary at that date.

Because the benefit design in Regulation 6 is unlikely to match the MRB of any particular defined benefit fund, actuaries will need to specify MRBs and Notional Employer Contribution Rates via Benefit Certificates in accordance with Regulation 4.

GUIDANCE

Work is proceeding on preparation of a new Professional Standard providing updated guidance to members on the preparation of Benefit Certificates using OTE as the earnings base.

The SEBPC anticipates that this guidance will provide suitable flexibility for SG on OTE to be met via various minimum requisite benefit designs. Examples of some of the designs which the SEBPC expects will be permissible and comments on a number of issues which arise as a result of the change to OTE are set out below.

In the following, NECR% is the Notional Employer Contribution Rate, expressed as a percentage of OTE, to be certified in the Benefit Certificate in respect of a period after 30 June 2008.

A. Fully Accumulation MRB

The employer contributions credited to the MRB from 1 July 2008 must be at least NECR% of the employee's OTE, subject to the SG maximum contributions base (MCB).

Employer contributions, whether actual or notional, should be based on the actual OTE received for the relevant period not on the OTE measured at a point of time or averaged. The intention is for there to be consistency between fully accumulation MRBs and the legislated requirements for accumulation funds.

B. Accumulation Add-on to Existing DB MRB

For a fund with a current defined benefit-style MRB certified as worth NECR% of the current Notional Earnings Base (NEB), a modified MRB worth NECR% of OTE from 1 July 2008 could be constructed as:

- The existing DB MRB formula carried forward and continuing accruals on the same basis as prior to 1 July 2008 (including continuing to use NEB as the salary base), plus
- An additional accumulation MRB component based on employer contributions of at least NECR% of the lesser of:
  1. the employee's OTE minus the employee's NEB, and
  2. the MCB minus the employee's NEB,

subject to a minimum of zero.

NEB can be the employee's actual NEB for the period or be calculated from the NEB at the date the additional employer contributions are calculated (i.e. the rate of NEB calculated consistently with the existing DB MRB formula). The MCB can be applied on either a quarterly or annual basis.

So, for example, if the only OTE item outside the NEB was annual bonuses, the additional accumulation MRB component would be based on employer contributions of NECR% of the annual bonus, or a lower amount where the MCB is reached for the quarter or the year (depending on if and how the MCB is being applied).

C. Standard Formula DB MRB Based on OTE

For a fund with a current defined benefit-style MRB based on Regulation 6 and Section 4 of GN456, options for continuing a fully defined benefit MRB based on OTE include (but are not limited to):

(i) maintaining the existing MRB formulae with the salary base increased to OTE or Average OTE from 1 July 2008, both for the accrued MRB at 1 July 2008 and future accruals thereafter.

- If OTE may be significantly greater than the existing SAL and the MRB may exceed the standard benefit payable, then this could involve a significant increase in past service liabilities
- This approach is only possible where OTE will always be at least equal to SAL
- Also see comments on OTE/Average OTE Issues

(ii) maintaining the existing MRB formulae with the salary base increased to OTE or Average OTE only for accruals from 1 July 2008.

- Requires the existing NEB to be maintained as well as OTE or Average OTE
- More complex than (i)
- Avoids increase in past service liabilities
- Also see comments on OTE/Average OTE Issues

OTE/Average OTE Issues

In the case of an employee whose OTE is comprised only of regular base salary, for example, an annual rate of OTE at a particular date is readily determinable as the annualised base salary at that date and no special issues would arise in the change to OTE.

However, as noted above, an annual rate of OTE at a particular date is not appropriate in many other situations, such as where OTE includes irregular items such as bonuses, commissions, shift loadings or other irregular allowances. In these cases OTE is really only appropriate in relation to a particular period of measurement.

In cases such as these it is expected that accumulation-style or mixed MRB approaches (such as A and B above) will generally be utilised or that, if a defined benefit-style MRB based on OTE is to be used, it will be based on Average OTE. The choice of averaging period should have regard to the frequency of payment and degree of fluctuation in variable OTE items, as well as the administrative constraints such as the ability of the employer to provide the necessary information and any other relevant factors.

The Factor F must be determined having regard to the averaging period – being 0.09 for an averaging period of 3 years (or for other periods 0.0833 +.0022 x the averaging period in years).

For administrative convenience, GN456 currently allows for the use of annual salary(ies) at the prior review date(s), either in lieu of current salary at the date of exit or for the determination of average salary, without modification of the F factor. A similar approach will be allowed for DB MRBs based on OTE averaged over a period prior to the fund review date preceding the date of termination, but with a modified F factor of 0.0925 for an averaging period of 3 years or more generally 0.0856 +.0023 x the averaging period in years. In this case the employer would need to provide the fund at each review date with the OTE for each DB MRB member over the prior year, but would not need to provide a "year to date" OTE figure for each DB exit for the period since the prior fund review date. The Average OTE would be updated annually at each review date and would then apply to members exiting in the 12 months until the next review date.

It is noted that where it is desired to use Average OTE over (say) a three year period and it is considered impractical to collect OTE data for the three years prior to 1 July 2008, a phase-in 'proxy' approach could be adopted as long as it is reasonably expected that the proxy will not be lower than the actual Average OTE, for example:

- OTE data could be collected for the 12 months prior to 1 July 2008 and combined with OTE data for the period after 1 July 2008 to calculate a proxy 3 year average which would phase-in to actual 3 year average OTE over the 2 years to 30 June 2010.

The above example suggests that the phase-in approach would involve utilisation of actual OTE for a period other than an integral number of years. Careful consideration should be given to the make-up of OTE before deciding whether such an approach is reasonable in the circumstances. For example, if bonuses may make up a substantial portion of OTE and these are paid once a year, use of an average annual OTE calculated over a period other than an integral number of years could result in a significant under- or over-estimate, with the scope for distortion being magnified the shorter the part-year period and the larger the bonus. This may be of little concern if MRB's rarely apply in practice (or where distortion only applies to high income earners where the MCB is exceeded anyway) but may be undesirable where MRBs regularly apply – or may apply only as a result of the distortion effect.

Where this issue is a significant concern, basing Average OTE on actual OTE averaged over an integral number of years up to the date of termination would appear to be preferable – the practicalities of obtaining this average would need to be established.

Even if integral years are used, where OTE includes items which can fluctuate significantly from year to year and this could result in significant fluctuations (including reductions) in Average OTE (and therefore a DB MRB) that may affect the actual benefits payable to members, as noted above this would generally point towards an accumulation-style or mixed MRB approach (such as A or B above) being more appropriate than a DB MRB. Anomalies can also arise from periods of leave without pay or part time service or new members (though this will not be an issue for many funds).

The above comments are provided to assist actuaries in considering and advising clients on MRB design options and their advantages and disadvantages and should not be read as precluding the use of DB MRBs in any particular circumstances.

D. Reductions

Reductions to the MRB in respect of surcharge, Family Law splits, contribution splits and any other benefit withdrawals will continue to be allowed as at present.

E. Concessional Contribution Limit Issues

Benefit changes to accommodate the earnings base change to OTE may have implications for notional taxed contributions (possibly changes to the notional taxed contribution rates and/or additional once-off amounts if changes have retrospective impact) and members' eligibility for the concessional contributions 'cap'. Actuaries should consider and advise their clients on any implications, noting that the interpretation of the legislation may be unclear in some circumstances.

F. Replacement of Non-OTE Certificates

Any existing Benefit Certificates which use an earnings base lower than OTE beyond 1 July 2008 must be replaced with effect from 1 July 2008.

G. Timing of Certificates

Members are reminded that a Benefit Certificate cannot be issued with an effective date after the date of issue. Hence a Benefit Certificate commencing 1 July 2008 cannot be issued until on or after 1 July 2008.

However a Benefit Certificate issued in June quarter 2008 could be issued with an effective date on or before its date of issue ((back to 1 January 2008 if it is issued prior to 15 May 2008 or back to 1 April 2008 if issued after 14 May 2008) and covering a period of up to five years, with different MRB formulae applying before and after 30 June 2008.

The latest date for issuing a Benefit Certificate commencing 1 July 2008 is 14 November 2008, unless the Tax Commissioner approves a later date up to 30 December 2008.

H. Funding and Solvency Certificates

Issuing of a new Benefit Certificates to cater for OTE from 1 July 2008 will generally require replacement of the Funding and Solvency Certificate.

Comments & Member Meeting

Comments on this Discussion Note are welcome and should be sent to Paul Shallue via email to paul.shallue@mercer.com.

The SEBPC will schedule an Insights meeting for practitioners to discuss the new requirements and this Discussion Note. This issue is also on the agenda at one of the SEBPC's concurrent sessions at next month's Financial Services Forum.