Prudential Practice Guide

SPG 160 – Defined Benefit Matters

November 2013

About this guide

Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

Prudential Standard SPS 160 Defined Benefit Matters (SPS 160) sets out APRA's requirements in relation to the management of defined benefit funds and sub-funds with the objective of meeting the liabilities of the fund as they fall due. SPS 160 also deals with self-insurance where that is permitted.

This PPG aims to assist an RSE licensee in complying with those requirements and, more generally, to outline prudent practices in relation to certain defined benefit matters. In particular, it provides guidance to assist an RSE licensee in complying with the actuarial investigation, self-insurance and reporting requirements set out in SPS 160. It includes a particular focus on action to restore a fund to a satisfactory financial position.

For the purposes of this guide, and consistent with the application of SPS 160, 'RSE licensee' and 'RSE actuary' have the meaning given in the *Superannuation Industry (Supervision) Act 1993* (SIS Act). 'Defined benefit fund' and 'defined benefit sub-fund' have the meaning given in SPS 160.

Subject to the requirements of SPS 160, an RSE licensee has the flexibility to structure its business operations in the way most suited to achieving its business objectives. Not all practices outlined in this PPG will be relevant for every RSE licensee of a defined benefit fund and some aspects may vary depending upon the size, business mix and complexity of the RSE licensee's business operations.

Introduction

1. SPS 160 establishes requirements with respect to actuarial investigation, reporting, monitoring and, where necessary, restoration of the financial position of a defined benefit fund or sub-fund. These requirements aim to ensure that an RSE licensee's management of a defined benefit fund support the objective of achieving and maintaining a financial position that enables fund liabilities to be met as they fall due and for the value of assets to be sufficient to cover vested benefits.
2. The requirements are based on the triennial actuarial investigation and reporting approach formerly contained in the *Superannuation Industry (Supervision) Regulations 1994* (SIS Regulations). The requirements also provide for a formal restoration program in the event that the RSE actuary finds an unsatisfactory financial position. Further, the requirements outline provisions for an RSE licensee that is permitted to self-insure insured benefits.
3. Where the term 'defined benefit fund' is used in SPG 160, it should be read as 'defined benefit fund or defined benefit sub-fund' unless stated otherwise.
4. SPS 160 applies in respect of defined benefit funds, with certain exceptions. SPS 160 does not apply at all to the public sector schemes listed in Attachment A to SPS 160.
5. Certain requirements of SPS 160 do not apply to defined benefit funds that are part of a partially funded public sector scheme. By their nature, such funds would not normally have the level of net assets needed to meet liabilities in respect of vested benefits, with the shortfall usually made up by funding on an emerging basis by the relevant government guarantor of the scheme. Such funds are not required to report a satisfactory or an unsatisfactory financial position, or to set a shortfall limit, and consequently are not subject to the more frequent actuarial investigation and reporting requirements triggered by a breach of the shortfall limit, or to the implementation of a restoration plan.

Actuarial investigations

Timing and frequency when paying defined benefit pensions

6. SPS 160 sets out requirements for the timing and frequency of actuarial investigations. An annual investigation will replace the regular cycle of triennial investigations when a defined benefit fund commences to pay defined benefit pensions, and while those pensions continue.
7. APRA expects the ability of an RSE licensee to continue to pay pension benefits to be regularly reviewed by the RSE actuary. As part of the annual investigation, an RSE actuary must provide an opinion as to whether there is a high degree of probability that the pensions will be paid. A probability of at least 70 per cent has been taken to represent a high degree of probability for this purpose.[1]
8. A defined benefit fund with more than four members may approach APRA for relief from the annual investigation requirement. In determining whether to grant relief, APRA will have regard to the strength of the financial position of the fund and of the employer-sponsor(s), and to any proposal for an alternative to the annual investigation.
9. The strength of a defined benefit fund's financial position may be evidenced by the report of the most recent actuarial investigation and a statement by the RSE licensee or the RSE actuary about the financial position of the fund and any current or expected material changes that may impact on this position.

1 The Institute of Actuaries issued GN 465 – *Statements of Opinion Relating to Defined Benefit Pensions SIS Regulation 9.31* in December 2000.

10. In APRA's view, a strong financial position of a defined benefit fund would be evidenced by vested benefit and accrued benefit indices in excess of 100 per cent and a reasonable expectation that any known or expected changes would not prevent the indices remaining above 100 per cent. Other relevant factors, particularly where a fund's financial position is less than satisfactory, would include the RSE licensee's approach to governance and risk management, the size of the fund (considering both assets and number of members), the ratio of members in draw-down phase to members in the accumulation stage (which may impact on fund liquidity), the financial strength and willingness of the employer-sponsor(s) to meet the shortfall, and also any contractual guarantee by the employer-sponsor(s) to pay benefits or to meet a shortfall in the amount needed to pay the pensions.

11. APRA may review, amend or revoke a determination to grant relief from the annual investigation requirement in the light of changes to the fund circumstances that APRA considers have affected the actuarial assumptions. Such circumstances may include, for example, economic events or circumstances such as a restructure of the employer-sponsor(s) or a significant redundancy program.

Timing and frequency – interim investigation

12. If an RSE licensee is required to undertake an interim investigation in accordance with SPS 160, the RSE licensee may choose to bring forward the next regular investigation. Alternatively, the RSE licensee may choose to seek a report that, at a minimum, provides a reasonable estimate of the value of the defined benefit fund assets (excluding any amount held to meet the operational risk financial requirement (ORFR)) and whether the fund shortfall limit has been breached. If the next regular investigation is due within six months, APRA expects that a prudent RSE licensee would seek actuarial advice as to whether earlier action is required. An RSE licensee may decide it is not necessary to take either of these actions if a restoration plan under SPS 160, or a program under the SIS Regulations to return a technically insolvent fund to solvency, is already in place.

Appointment of a new RSE licensee

13. SPS 160 does not require an RSE licensee to have an actuarial investigation carried out when the RSE licensee is appointed as trustee to an existing defined benefit fund. However, APRA expects that a receiving RSE licensee's due diligence processes would include a recent or new report on the financial position of the fund or sub-fund. In the absence of a report within the last six months, a prudent RSE licensee would consider obtaining a new report as part of its due diligence.

Reporting on an investigation – when the report is to be given to an RSE licensee

14. SPS 160 sets out the matters to be addressed in an RSE actuary's report and the timeframe in which the report must be provided to an RSE licensee, including under transitional arrangements that apply until 30 June 2016.

15. An interim investigation may be based on a reasonable estimate of the value of the fund assets (excluding any amount held to meet the ORFR). The report of an interim investigation must be given to an RSE licensee as soon as practicable. APRA's view is that if the next regular investigation, with its more comprehensive scope, has been brought forward, the report will be due within the period that applies for a regular investigation. Otherwise, APRA expects that the report of an interim investigation would be given to the RSE licensee within three months of the later of:

    (a) the valuation date (where the valuation for the most recent actuarial investigation is used); or

    (b) the date the RSE licensee determined that an interim investigation was required, but in any event no later than six months from the valuation date.

Shortfall limit

Purpose and significance

16. APRA expects that market volatility may have an impact on the short-term outcomes of an RSE licensee's objective of managing a defined benefit fund so that a satisfactory financial position is achieved and maintained.[2]

17. The effect of market volatility on asset values may cause a fund to move in and out of a satisfactory financial position on a short-term basis. The requirement for a shortfall limit in SPS 160 allows for some fluctuation in the value of fund assets without automatically triggering the need for a restoration plan in the period between regular investigations. The intent of the requirement is to avoid the need for additional and perhaps unnecessary remedial action between regular investigations when a shortfall caused by market volatility is not material in the fund circumstances and it could be reasonably expected that the financial position would recover within a short period without intervention. In APRA's view, an immaterial fluctuation due to market volatility could be for a period of several months, but is more likely to be a period of days or weeks.

18. While factors other than market volatility, such as a change in timing of employer contributions or a failure to adhere to the funding plan, may contribute to a short-term unsatisfactory financial position, the shortfall limit is not designed to justify a reduction in the rate or amount of employer contributions to the fund. Factors such as an employer's readiness to pay contributions as recommended by the actuary in their report on a regular investigation, or in a restoration plan if applicable, would be expected to be addressed by the RSE licensee.

19. *Reporting Standard SRS 160.0 Defined Benefit Matters* sets out how the shortfall limit approved by the Board is to be calculated and expressed. The limit is the ratio of 'net assets available for member benefits (net of ORFR reserves) of defined benefit interests' to 'defined benefit interests in vested benefits' determined by the Board of the RSE licensee to be the shortfall limit within the meaning given in SPS 160, and designated as a percentage to one decimal place. If a defined benefit interest includes an accumulation component, it is acceptable to calculate and express the shortfall limit in terms of the defined benefit component of the defined benefit interest.

20. APRA expects that an RSE licensee would consider a range of factors when setting a shortfall limit. These could include factors such as the extent to which vested benefits exceed minimum benefits, asset mix, impact of fluctuations in market value of fund assets, whether the defined benefit fund pays pensions, membership profile, whether the fund is open or closed to new members, accrued benefits and the weighted average term of projected defined benefit liabilities. A prudent RSE licensee may also seek assurance of the support provided by the employer-sponsor(s). After determining a shortfall limit based on objective factors, the Board would be able to set the shortfall limit at a higher level if it had a concern about an employer-sponsor's financial ability or willingness to fund a possible restoration plan.

21. A Board may set a shortfall limit that triggers action if the funding level falls below a satisfactory financial position i.e. a vested benefits index (VBI) level of 100 per cent. Such a limit may, for example, be set for a fund where minimum benefits are close to, or equal to, vested benefits. APRA would expect that, in such circumstances, the Board's policy would include an outline of the actions to be taken if there was any deviation from the full funding of vested benefits, with the aim of preventing the defined benefit fund becoming technically insolvent.

2 Partially funded public sector schemes, by their nature, do not have the same objective.

22. A prudent RSE licensee may also set a funding buffer in excess of vested benefits. In these circumstances, the RSE licensee may decide to set a trigger for review and action above a VBI of 100 per cent. For example, a response may be triggered if the level of VBI falls below 105 per cent. In such circumstances, APRA would expect that Board policies and procedures would include action to be taken should the position deteriorate below the level set by the Board, even though the fund is not in an unsatisfactory financial position.

23. SPS 160 requires the Board to determine and implement a monitoring process so that deterioration in the defined benefit fund's financial position may be detected in a timely manner. In APRA's view, a monitoring process might include a regular estimate of vested benefits and of the value of fund assets. Alternatively, the process might be based on the regular monitoring of investment returns, with adverse experience triggering an estimate of vested benefits and the value of fund assets. The frequency at which such estimates are undertaken would be expected to increase with market volatility, and may also be related to the margin by which current and projected VBI exceeds 100 per cent. For example, an annual review may be adequate where the fund has a sufficient buffer above 100 per cent VBI, with the sufficiency of the buffer assessed after taking into account the extent to which vested benefits are linked to the investment return on defined benefit assets. Some form of stress testing may be needed to determine the potential impact of movements in investment markets on the fund's VBI level.

Breach of shortfall limit

24. The shortfall limit is an important risk management control to manage the financial position of the defined benefit fund between regular investigations.

25. If, during the period between regular investigations, it appears to an RSE licensee that the defined benefit fund is or may be in an unsatisfactory financial position and also is or may be in breach of its shortfall limit, SPS 160 requires that it appoint an RSE actuary to undertake certain actions. If the next regular investigation is not due for six months or more, it may be brought forward. Alternatively, an interim investigation could be undertaken that, at a minimum, must contain a reasonable estimate of vested benefits and of the value of fund assets and a finding as to whether that value breaches the shortfall limit. If the next regular investigation is due within six months, the RSE licensee must seek the advice of an RSE actuary as to whether earlier action should be taken.

Reporting obligation under the SIS Act

26. The reporting obligations imposed by s.130 of the SIS Act are not affected by the setting of a shortfall limit below 100 per cent VBI coverage. If an RSE actuary or RSE auditor forms the opinion that the financial position of a fund may be unsatisfactory, or may be about to become unsatisfactory, the obligation to report to the RSE licensee and/or APRA remains. There may be circumstances where the RSE licensee has already notified APRA about the fund's financial position, e.g. by reporting under SRS 160.0, so that the RSE actuary, in this instance, is relieved of the obligation to report under s. 130.

Restoration plans

When a restoration plan is required

27. The objective of a restoration plan is to set out the actions that will be taken to address an unsatisfactory financial position with the aim of restoring the fund to a satisfactory financial position, where assets are sufficient to cover vested benefits.
28. The requirement for a restoration plan is triggered when an RSE actuary makes a finding, in the actuarial report of an initial or regular investigation, that the fund is to be treated as being in an unsatisfactory financial position, or the financial position is likely to become unsatisfactory. A restoration plan is also triggered when an RSE actuary makes a finding in the actuarial report of an interim investigation that the fund is in an unsatisfactory financial position and is in breach of its shortfall limit.
29. Once a restoration plan is in place, it takes precedence over the shortfall limit for the duration of the plan, e.g. a breach of the shortfall limit during the currency of the plan will not trigger a further interim investigation.
30. SPS 160 sets out the minimum requirements for a restoration plan. Although an RSE licensee is ultimately responsible for its restoration plan, it is important that it develops its plan in consultation with the RSE actuary and employer-sponsor(s) to establish an appropriate contribution rate and payment plan. The actuarial assumptions behind the recommended contribution rate and payment plan would include appropriate assumptions about the impact of investment performance on the recovery of the fund and financial position.
31. The process for the development of a restoration plan may start with a recommendation by the RSE actuary about a contribution rate that could reasonably be expected to restore the fund to a satisfactory financial position. APRA expects that it would also include a review of the investment strategy. If an RSE licensee forms the view that it may not be reasonable and appropriate to implement the recommended contributions in full, it would be prudent to consider alternative or supplementary measures to address the deficit. For example, if the RSE licensee considers that the employer-sponsor's financial situation is such as to prevent regular contributions at the rate needed to overcome the deficit, it may determine a contractual commitment to fund benefit payments as they fall due to be acceptable as an initial and short-term measure.
32. SPS 160 sets the duration of a restoration plan as 'a time period that is reasonable in the circumstances of the fund but which must not exceed three years from the valuation date'.[3] A prudent RSE licensee would ordinarily consider circumstances such as the status of the fund (open or closed to new members), the membership profile, the extent of the deficit, expected timing and size of benefit payments and their potential to worsen the financial position of the fund for remaining members. Other considerations may include asset allocation and sensitivity of investments to market fluctuations, and the financial strength of the employer-sponsor(s).

3 If the restoration plan was triggered in response to an interim investigation, the duration of the plan must not exceed three years from the later of the valuation date and the date the RSE licensee determined the interim investigation was required.

33. Under SPS 160, APRA may determine that a different duration of a restoration plan would be appropriate. Factors to which APRA may have regard in considering whether it would be reasonable to permit a longer period to return the fund to a satisfactory financial position could include arrangements surrounding the contribution liabilities of the employer-sponsor(s), in particular where these are underpinned by legislation specific to the fund. Other factors may include the extent of the underfunding and the resulting cash flow or budgetary impact a three-year period may have on the employer-sponsor(s), and the financial strength of the employer-sponsor(s). A shorter period may be appropriate in other circumstances, such as when the strength of the employer-sponsor's financial position is sufficient to restore the fund's financial position over a shorter term and the level of contribution is necessary to ensure benefit payments continue as they fall due.

Monitoring and adjustments to restoration plans

34. APRA recognises that a restoration plan may end early, or may otherwise need adjustment during its course. For example, a restoration plan may need adjustment when market conditions have not been as expected and it is likely that additional funding will be required to restore the funding position by the restoration plan's target recovery date.

35. If a fund is restored to a satisfactory financial position on a sustainable basis prior to the end date of a restoration plan, the RSE licensee may regard the plan as ended. In these circumstances, an RSE licensee may make arrangements for the cessation of any future additional contributions that are no longer required.

36. APRA envisages that an RSE licensee would consult with the RSE actuary to implement triggers to enable them to identify, at an early stage, those circumstances where the restoration plan may require variation. Such triggers may relate to overperformance as well as underperformance.

37. In addition to any reporting requirements set by APRA at the commencement of the plan, APRA would expect early contact from an RSE licensee seeking a variation to the duration of the plan, or an early end to the plan.

Self-insurance

38. SPS 160 requires that an RSE licensee that is permitted to self-insure death and disability benefits maintain reserves or have other arrangements approved by APRA in place to fund current and future self-insurance liabilities and to allow for the inherent uncertainty regarding size and timing of claims.[4]

39. 'Other arrangements' referred to in SPS 160 and approved by APRA would typically include the arrangements that a public sector fund may have under its establishing legislation, e.g. arrangements whereby death and disability benefit payments are made directly by a relevant government or government agency rather than from the fund. Other arrangements might also include a regular assessment by the RSE actuary of the accrued self-insured claims (including incurred but not reported claims) which is taken into account in determining contribution levels, or an actuarial surplus or notional reserve built up through a buffer incorporated into the contribution rate recommended by the RSE actuary.

40. SPS 160 requires that an RSE licensee ensure that all self-insurance arrangements have actuarial oversight. In assessing the recommended level of self-insurance reserves to be held, or the adequacy of other arrangements, APRA expects an RSE actuary would consider, amongst other matters, the level of insurance cover, the risk profile of the insured group (based on, e.g. age, gender, type of employment etc.), possible catastrophe scenarios and past claims experience.

4 Refer to *Prudential Practice Guide SPG 222 Management of Reserves* for guidance on the management of reserves.

41. APRA expects the minimum level of actuarial oversight of self-insurance arrangements to be via the periodical (normally triennial) actuarial investigations. The range of factors that might demonstrate the adequacy of reserves or other arrangements would usually include information on the self-insured risks, as well as an explanation of the method for determining the risk reserve or provisions for self-insured claims (including incurred but not reported claims) and how potential variability in claims experience is catered for. The report would also be expected to include consideration of catastrophe risk, e.g. the extent to which geographical spread of members mitigates such risk, or whether catastrophe insurance should be taken out.

42. While the triennial review may provide the context and occasion for the minimum level of oversight, APRA also expects that an RSE licensee and an RSE actuary would identify events or conditions that would trigger an interim review of self-insurance arrangements, e.g. a large adverse movement in asset values leading to a sudden deterioration in the financial position of the fund, or a significant adverse claims event or experience.

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