Institute of Actuaries of Australia

10 June 2004

Senator the Hon Helen Coonan
Minister for Revenue & Assistant Treasurer
Parliament House
CANBERRA ACT 2600

Dear Minister

Superannuation Industry (Supervision) Amendment Regulations 2004 (No 2); CGT rollover relief for superannuation funds

The main purpose of this letter is to raise serious (and the Institute believes unintended) problems arising from some aspects of the amending regulations which were gazetted on 12 May 2004. The Institute of Actuaries of Australia (Institute) believes these issues require urgent attention.

The Institute also requests urgent clarification of the Government's proposal for Capital Gains Tax (CGT) rollover relief for funds merging as a result of the Superannuation Safety legislation.

Whilst the Institute appreciated the opportunity of having a representative at the meeting with industry on Monday 31 May 2004, our major concerns remain.

SIS Amendment Regulations 2004 (No 2)

In the Institute's view, these amendments:

- are, in a number of respects, unclear or do not achieve their stated aim;
- will, and are already, causing considerable problems for larger bona fide superannuation funds which have not been abusing the system. We expect that at least some of these problems are unintended consequences; and
- are creating significant difficulties for some funds that are attempting to merge or transfer, particularly those where the merger or transfer was to occur before 1 July this year.

More specifically:

- New sub-regulations 9.04D(1) and (2) are not worded correctly if the intention is that the 50 defined benefit member minimum for new defined benefit funds (or sub-funds) only applies at the time of establishment of the fund. With the

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current wording, major fund transfers that have been months in the planning cannot proceed.

- Even if sub-regulations 9.04D(1) and (2) are fixed, smaller fund transfers that have been months in the planning cannot proceed unless an APRA exemption is obtained via a process and guidelines that do not yet exist.
- Bona-fide corporate superannuation funds now cannot admit a new defined benefit member if they will still have less than 50 defined benefit members. New employees who would have joined these funds are left in limbo with no insurance cover while their employers try to put in place other arrangements or apply to go through an APRA exemption application process that does not yet exist. This is totally unsatisfactory.
- The Institute is concerned with the reasoning behind the restrictions on defined benefit funds with less than 50 members.
- The Institute also believes there is considerable uncertainty over whether new Regulation 9.04B will achieve the stated intention of avoiding circumvention of new Regulation 9.04D through the use of master and hybrid fund arrangements. Similar concerns apply to Regulation 9.04G with reference to Regulation 9.04F.
- The Institute considers that the wording setting out the grandfathering provisions in Regulation 9.04F(b) is open to a variety of interpretations. Unless the Regulation is clarified, preferably by amending the Regulation, this is likely to lead to confusion and disputes in future.
- The Institute understands that the new wording of sub-regulation 5.04(2) aims to require full vesting of accumulation benefits but in our view is totally unclear. Furthermore in our view new sub-regulation 5.08(2) will not achieve the stated intention of allowing existing employee retention schemes to be grandfathered. This leaves bona-fide corporate superannuation funds with vesting conditions in the position that they have been unable since 12 May 2004 to determine with any certainty the correct amount of any relevant benefit that is now due for payment.

Detailed comments on the above problem areas in relation to corporate funds are set out in Appendices 1 and 2. Appendix 3 addresses a number of further issues relating to the new contribution allocation provisions for accumulation funds. Appendix 4 provides further comments on the issues relating to the impact of the regulations on self-managed superannuation funds (SMSFs).

The Institute believes that prompt action is necessary to amend the new regulations to correctly reflect the intended requirements and remove the unintended consequences.

APRA will also need to urgently advise funds how to apply for an exemption from the new requirements and the details necessary to support the application. We note that decisions on these applications will, in many cases be necessary almost immediately (in the case of new members of defined benefit funds) or well before 30 June this year (an almost impossible task) to enable funds currently in the process of winding up to complete this process. In these circumstances we would strongly recommend that, as an interim arrangement, APRA or the Government urgently announce that:

- sub-regulations 9.04D(1) and (2) will be amended to make clear that the 50 defined benefit member minimum for new defined benefit funds (or sub-funds) applies only at establishment;
- exemptions from sub-regulation 9.04D(1) and (2) will automatically be given (without the need for an exemption application) for new defined benefit funds or sub-funds resulting from successor fund (or member agreement) transfers of defined benefit members (at least those up to 1 July 2004 and preferably 1 October 2004);
- exemptions from sub-regulations 9.04D(3) and (4) will automatically be given (without the need for an exemption application) for new defined benefit members who satisfy pre-existing eligibility conditions (eg. employment category and length of service) for joining the defined benefit fund or category (or at least those who join on or before 30 September 2004).

The Institute believes that the problems caused by these amendments are so severe and urgent that, unless they are satisfactorily remedied by the Government, these amendments may face disallowance in the Senate.

The Institute would be willing to work with the Government and its advisers to determine an approach that would better achieve the Government's intention of stopping abuse whilst not imposing additional problems and barriers for the majority of funds that are not abusing the system.

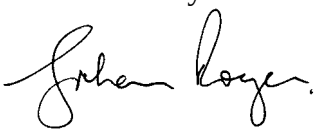
CGT Rollover Relief

The Institute is pleased that the Government has decided to allow rollover relief, however we are very concerned that at this stage, no real detail is available. Trustees, particularly where the fund is about to wind-up, need to know whether their fund will qualify for the relief. The Institute urges the Government to quickly release details of the proposal so that Trustees can make informed decisions. More detail on our concerns is included in Appendix 5.

For the reasons discussed, we believe the Government should seriously consider allowing CGT rollover relief on all fund wind-ups after 12 May 2004.

We would be happy to arrange further discussions on these issues if required. Please contact Catherine Beall, Chief Executive on (02) 9239-6106 or via email: catherine.beall@actuaries.asn.au should you require further information or wish to arrange a meeting.

Yours sincerely



Graham Rogers
President

cc: Senator N Sherry (ALP)
Senator J Cherry (Democrats)

APPENDIX 1: 50 defined benefit member rule – impact on APRA regulated funds

The following comments are based on our interpretation of the legislation.

Requirements for new funds:

1. Any new defined benefit fund (or sub-fund) must have at least 50 defined benefit members when it is established unless it has an exemption from APRA;
2. Any new defined benefit fund (or sub-fund) must continue to have at least 50 defined benefit members. If the number of defined benefit members falls below 50 it must either obtain an exemption from APRA or cease providing defined benefits to its existing members.

We understand that there is at least some doubt in regard to the second point above. If that is not the intention, then we believe that the regulations should be amended to clarify the intention.

It also appears clear from the regulations and the Explanatory Statement that the intention is that a new fund or sub-fund would also include any existing accumulation fund that wished to set up a defined benefit category of membership or a new defined benefit sub-fund.

However the definition of sub-fund appears open to interpretation and some of our members believe that it may be totally ineffectual – in particular, condition (b) of new regulation 9.04G could be read as not applying where there are conditions in the master fund rules which affect the determination of a sub-fund member's interest. Again the doubt needs to be removed by appropriate amendments to the regulations.

The Institute suggests that the Government amend the definition of sub-fund to more adequately reflect the intention.

Requirements for existing funds:

Many existing funds are also immediately affected because they are in the process of transferring to other funds, including to master trusts where they would be in a "new" sub-fund or currently have less than 50 defined benefit members.

Immediate problems for transferring funds (less than 50 defined benefit members)

At the moment many funds are in the process of winding up. In many cases, it is intended that members be transferred out of the fund, either using the successor fund transfer provisions or by obtaining member consent to the transfer **before 1 July 2004.**

Arranging the transfer and the wind-up before 1 July is critical for many of these funds as delaying past that date will incur an additional APRA levy, the need to prepare a set of accounts for an additional year, another audit fee and other ongoing administration costs. These costs can be significant and will result in a reduction in members' benefits being available for transfer.

In addition, some of these funds have already obtained exemptions from ASIC from certain requirements (such as the issue of a PDS) that is only effective if the members are transferred out by 30 June 2004. If the transfer does not occur by that date, then these funds will incur even greater costs as it will be necessary to produce a PDS urgently for any new members that have joined from 11 March 2004. This will be an expensive and wasteful exercise which will also reduce the amount available for members' benefits.

Due to the gazettal of the new regulations, where the transferring fund has less than 50 existing defined benefit members, the receiving fund (or sub-fund) will normally need to apply to APRA for exemption from the 50 member rule. (This may not be necessary if the receiving fund already has defined benefit members – however this will generally not be the case.)

With only a matter of weeks before 30 June, we consider it highly unlikely that there will be sufficient time for APRA to set guidelines, trustees to lodge applications and APRA approval to be formulated and given in time for these transfers to proceed.

We also note that the Government's Explanatory Statement states: *"It is envisaged that exemptions will only be granted from regulation 9.04D in limited circumstances such as where a fund is to be established as a successor fund, or made available to new members following the acquisition or merger of a business. In these circumstances the Regulator would need to be satisfied that there were adequate arrangements in place to fund member benefit entitlements and that the members and the trustee of the fund were at arms-length."* It is unclear what is meant by the term *"adequate arrangements to fund member benefit entitlements"*. However we would be concerned if the intention were to decline exemption applications for transferring funds on the basis of the funding position of the fund or the financial status of the employer. It is unlikely that the transfer will worsen the position. If an exemption is denied, because of a poor level of funding, this may leave the employer no option but to wind up the existing fund with the result that member benefits will be reduced.

A similar problem can arise for larger funds where member agreement is required to transfer. In particular, not all members may agree to transfer at the same time or some members may decide to transfer to an accumulation category leaving less than 50 defined benefit members in the new fund.

The Institute suggests that the Government or APRA immediately announce that exemptions from sub-regulation 9.04D(1) and (2) will automatically be given for new defined benefit funds or sub-funds resulting from successor fund (or member agreement) transfers of defined benefit members up to at least 1 July 2004 and preferably 1 October 2004 or indefinitely.

Immediate problems for transferring funds (50 or more defined benefit members)

Whilst it may appear that these funds may transfer to a new fund without any immediate impact of the new regulations, we believe that the new regulations will effectively make it impossible for any defined benefit member to be transferred on a successor fund basis. The reason is that the regulations effectively require a new fund

to have at least 50 defined benefit members at all times. Thus if the number of defined benefit members in the new fund reduces to below 50 for any reason, the fund must cease providing defined benefits unless an exemption from APRA is obtained. As this requirement does not apply to an existing fund, it is arguable that the members' rights would be diminished on transfer (since continuation of the members' defined benefits is less certain under the new fund). Trustees may have difficulty in agreeing to effect/accept a successor fund transfer in view of the potential reduction in members' rights. Hence a successor fund transfer would not be possible without an exemption.

This would mean that even funds with 50 or more defined benefit members will need to obtain an exemption from APRA before proceeding with a successor fund transfer. The likely delays in transfer resulting from these regulations will create similar problems for these funds as outlined above for smaller defined benefit funds.

The Institute suggests that APRA immediately clarify that there is no requirement for new funds to cease providing defined benefits to existing members if the membership falls below 50 and that the regulations be amended to reflect this.

Ongoing problems

The new requirements will also cause difficulties for employers who currently operate funds with less than 50 defined benefit members and wish to continue to offer (lump sum) defined benefits to some or all future employees and are prepared to continue the financing and compliance obligations this already entails to provide such benefits which genuinely target a member's retirement benefit needs. Some examples might be:

- a large multinational company with a defined benefit fund for its executive group or other groups of employees, consistent with their worldwide retirement benefit policies
- a small Australian company that still provides defined benefits for employees.

These employers will need to find another superannuation arrangement for any new employee from 12 May – including those where employment offers have been made and accepted on the basis of existing defined benefit arrangements. Not only will these employers need to find a new fund, they will need to determine a new benefit strategy for new employees. This could cause problems due to the provision of different benefits for 2 employees who are both doing the same job. Alternatively the employer can apply to go through an APRA exemption application process that does not yet exist.

Most importantly, in the meantime any such new employees who would have joined these funds are left in limbo with no insurance cover. Cover which would have been automatically provided under the employer fund is now not available because the Trustee cannot admit them to the fund.

It is totally unsatisfactory to invalidate existing arrangements for such critical matters as insurance and superannuation without allowing sufficient lead time for employers to put other arrangements in place – say at least 3 months.

The Institute suggests that the Government or APRA immediately announce that exemptions from sub-regulations 9.04D(3) and (4) will automatically be given (without the need for an exemption application) for new defined benefit members who satisfy pre-existing eligibility conditions (eg. employment category and length of service) for joining the defined benefit fund or category on or before 30 September 2004.

The Institute is also concerned with the reasoning behind the restrictions on defined benefit funds with less than 50 members. In our view, a defined benefit fund can operate effectively irrespective of the number of members. Any fund is subject to investment risk. The investment risk is largely independent of the number of members. In any event, it can be controlled by an appropriate investment strategy. Likewise, whilst we acknowledge that there are some issues involved in managing longevity risks with small pools of pensioners, this is relevant to very few corporate funds, with the vast majority having benefit designs whereby mortality risks can be readily controlled by an appropriate level of insurance.

In the corporate sector small defined benefit funds usually arise from multinational employers who sponsor defined benefit funds around the world and executive schemes of (generally large) Australian companies. The very fact that these funds are small in relation to the size of the employer actually reduces the over-all risk profile for members.

The Institute is concerned with the reasoning behind the restrictions on defined benefit funds with less than 50 members. The Institute suggests that the Government reconsider the need for these restrictions.

Other issues

1. The meaning of defined benefit member for this purpose is unclear. There are already 2 definitions of defined benefit member in SIS. One definition (that inserted by Modification Declaration 23) specifically includes reference to members receiving a defined benefit pension. This definition is only applicable in certain circumstances. The other definition (in Reg 1.03 (1)) does not specifically refer to pensioners. Nevertheless, many actuaries are of the opinion that this definition would still include defined benefit pensioners. This would mean that no fund with less than 50 defined benefit members could issue a new complying pension. We do not believe that this is the intention and clarification is required.

2. As indicated above, the definition of sub-fund in 9.04B is badly worded. If this definition is retained we consider that it would be very easy to "avoid" this provision. Funds would be able to set themselves up with a sub-fund structure however due to technical deficiencies in the definition would not be treated as sub-funds for this purpose.

APPENDIX 2: New vesting provisions – impact on APRA regulated funds

On our reading, there appear to be some major drafting defects in relation to the amendments to regulations 5.04 and 5.08.

In particular, it is totally unclear as to what is meant by "all of the member's benefit in the fund". For example, is this the member's death benefit, retrenchment benefit, resignation benefit or some other amount?

We assume that the intention is that this means the total of all of the member's account balances. However, where an account balance is not fully vested, it would certainly be unusual to term that as the member's benefit. Some of our members believe that, as written, the regulation does not require a member's account balance that is not yet fully vested to be treated as a minimum benefit as it only becomes a "benefit" when the member satisfies a specified condition, such as completing 10 years of service.

It is important that these drafting issues in relation to the amendments to regulations 5.04 and 5.08 be clarified by further amending the regulation.

However, on the assumption that the Government's intention is to treat all unvested accounts as a minimum benefit, we are very concerned with this change.

We point out that for an accumulation fund winding up in an unsatisfactory financial position, this change in the regulations may result in the realignment of the assets amongst members. The unvested benefits will now have equal priority to the mandated benefits. This may mean that some members' mandated benefits will need to be reduced because the trustee is now required to pay out voluntary benefits that members had not qualified for and, until 12 May, had no right to.

We note that there is an attempt at providing an exception in Regulation 5.08. We assume that the intention was to protect existing bona fide vesting arrangements. However, in our view, the provisions are so badly drafted that they will rarely apply.

In particular, it is unusual for there to be a written agreement between the employer and the member. It would be even more unusual for the agreement to specify the details as set out in Regulation 5.08.

If there is an agreement, it is more likely to be between the member and the trustee. Alternatively the agreement could be between the union and the employer. Such agreements may specify the fund that will be used but are unlikely to specify the vesting terms. The vesting terms are more likely to have been set out in the Product Disclosure Statement or member information booklet given to the member on joining the fund, as well as in the trust deed.

The implications of these amendments are severe for those funds that provide partially vested benefits. Firstly, the trustee will need to determine whether or not there is such a written agreement before being able to make a benefit payment or before issuing the member's next benefit statement. Yet, determining whether an appropriate written agreement exists and then going through a possible legal dispute as to whether it

meets the terms specified in the Regulation is likely to be a time consuming and costly exercise for the trustee. These higher costs will in many cases flow through to higher fees for members.

If the exception provisions were intended to be as narrow as we read them to be, we also have strong concerns about the philosophy of this change. Because of the ineffectiveness of the exception provisions, the new regulations effectively, on a retrospective basis, change the terms of any implied contract between the employer, the trustee and the member. We submit that this is unreasonable and unfair to employer sponsors and, in some cases as outlined above, to other members who are only entitled to mandated contributions. We also suspect that this action will discourage employers from making contributions for employees over and above the minimum SG requirements in future.

If an employer is willing to contribute additional amounts over and above the minimum requirements for SG purposes, this should be encouraged. It should also be possible for the employer to put conditions on the benefits resulting from those voluntary contributions. For example, they could be used to promote employee retention. It is likely that many employers currently making voluntary partially vested contributions will cease or reduce those contributions if they have to be fully vested.

The Institute also suggests that arm's length vesting provisions that are clearly set out in advance should continue to be allowed for both existing and new members.

The difficulties with these changes to the regulations are such that we believe that they can only be fixed by rescinding and replacing this part of these regulations. Even then there is a possible legal argument that partially vested benefits have already become minimum benefits, even in bona fide funds with long standing and well understood and communicated vesting arrangements. We are not sure whether this can be undone by a further amendment to regulation 5.04. The only other alternative might be to insert a new regulation that gives trustees the power to reduce minimum benefits in these circumstances.

APPENDIX 3: New allocation provisions – impact on APRA regulated funds

These changes will also have a serious impact on bona fide APRA regulated funds.

Many employers have been prepared to meet some or all of the administrative and insurance costs involved in the running of a superannuation plan for their employees. The necessary contributions are made to the superannuation plan and then paid out to meet those expenses. Under the new regulations, this will become a much more difficult process. Rather than being merely paid out by the fund to meet the expenses, these amounts will now need to be broken up and allocated to each members' account before they are again immediately deducted from members' accounts again.

The new requirements appear to achieve little other than additional costs of administration for those funds and a more complex product.

In many cases, the fund has already included a share of these payments in the surchargeable contribution reported for each member so there is no avoidance of surcharge.

In the short term, the trustee may not have the power under the trust deed to either credit or deduct these amounts from member accounts. Costs will then be incurred in amending the trust deed. It will also be necessary to advise members of the change in the method of recouping expenses and to amend the only recently prepared Product Disclosure Statements. Significant changes to administration systems will also be required. These changes will involve further significant cost.

The change to the regulations will also cause delays in paying suppliers, perhaps resulting in trustees being forced to breach contracts with those suppliers.

Where the employer pays the insurance costs in addition to its basic contributions, these insurance costs are not normally allocated to member's accounts (although many bona fide funds include the amount as part of surchargeable contributions). These changes will create difficulties for trustees in paying the insurance premium to the insurer, resulting in a potential loss of insurance cover.

The Institute urges the Government to further amend these regulations so that any contribution that is used to pay an expense or premium within 12 months, does not need to be allocated to members. Greater clarification of the surcharge legislation should ensure that these amounts are properly taken into account for surcharge purposes where they are not already.

APPENDIX 4: new pension rule – impact on SMSFs

The Institute is sympathetic to Government initiatives to reduce tax avoidance.

However, we have several concerns about the manner by which the Government has sought to achieve this.

These concerns include:

- The ambiguous drafting of the new regulations;
- Poor drafting which will enable some of these abuses to continue;
- The restrictions that will make it much more difficult for people to arrange for a complying pension until the new market linked pensions are available in September; and
- The imposition of additional restrictions and cost across all funds, including the majority of funds which are not currently abusing the system.

As indicated in Appendix 1, it is unclear whether a defined benefit pensioner is a defined benefit member. Some of our members believe that this is the case and that therefore no SMSF can issue a new defined benefit pension as it will be "creating" a new defined benefit member when it has less than 50 defined benefit members. This would apply irrespective of whether the fund's rules already allow defined benefit pensions or not.

We are also concerned with the wording setting out the grandfathering provisions in Regulation 9.04F(b). These words are open to a variety of interpretations. Whilst we understand that the Government intends issuing a clarification of the intention, we consider that, unless the Regulation is amended to reflect the actual intention, this is likely to lead to confusion and disputes in future.

The Institute believes that it is important that the issues listed above be clarified by further amending the regulation.

Early this year, the Government announced new policies to apply from 20 September i.e. the introduction of market linked complying pensions and a change to the asset test exemption for new complying pensions issued from 20 September. To now change the rules so that it becomes far more difficult or expensive to purchase a complying pension prior to 20 September seems to be inappropriate. If restrictions on issuing defined benefit pensions are to be applied, it would be better to do this at the same time as a suitable alternative becomes available (e.g. market linked pensions).

We note that many people set up self managed funds because they are not eligible to join a public sector or large employer sponsored fund that will provide a complying pension and the annuity market in Australia is not effective (due to many reasons including low competition in a small market, high risk premium margins for investment and mortality risks and the need to lock into fixed interest assets).

The Institute would be willing to assist the Government in devising a more appropriate method of achieving the Government's aim of controlling abuse.

APPENDIX 5: CGT rollover relief

The Institute is pleased that the Government has decided to allow rollover relief, however we are very concerned that at this stage, no real detail is available.

Many trustees are considering winding up funds and merging with a larger fund due to the ever increasing costs of running a fund, in particular with the Safety in Super legislation about to take effect.

Getting the timing right on any merger is a critical part of the process. For example, many funds are attempting to wind-up before 1 July 2004, in order to avoid another APRA levy and the costs of another set of annual accounts and annual audit. Trustees of these funds need to know, almost immediately whether they will be eligible for rollover relief if they delay their merger until after 30 June. Acting in the interest of members, they will need to consider whether the benefits of rollover relief outweigh the other costs involved. This will be impossible until the Government clarifies the conditions that will attach to rollover relief.

In particular, it is unclear whether the Government intends that rollover relief be restricted to those funds that are wound-up under the terms of Part 18 of SIS. We note that we would be concerned if this were the case. Firstly, it would be inconsistent with the rollover relief provided when SIS came into force (where it was available to all merging funds). Secondly, it would encourage delays in mergers with trustees deliberately not applying for a licence under the Safety in Super legislation so that the merger under Part 18 could eventuate.

For these reasons, the Institute believes the Government should seriously consider allowing CGT rollover relief on all fund wind-ups after 12 May 2004.