17 February 2003

Mr Darren Kennedy
Treasury
Langton Crescent
Parkes, ACT 2600

Dear Darren,

The Institute of Actuaries of Australia (IAAust) appreciates the opportunity of commenting on particular aspects of the portability proposals including member protection and defined benefit funds.

The IAAust is in general agreement with the two proposals on these issues set out in your email of 5 February 2003. Our reasoning and more detailed comments on these issues are set out below.

One of the IAAust's main concerns with the implementation of any new initiative is that of cost. Initiatives should be designed in a manner that minimises the cost impact on funds, members and employers. Consequently, we would also like to take the opportunity to make a further suggestion that would give trustees the opportunity of minimising costs and simplifying portability.

In order to minimise the costs of portability to funds, and hence the remaining members, we recommend that any requirements (for both accumulation and defined benefit members) should allow:

- Trustees to limit the number of transfer requests from any member to no more than say, once a year; and
- Trustees to refuse requests for partial transfers - ie any request must be for the total withdrawal benefit at the time; and
- Trustees and employers to impose rules that further contributions be made to another fund following the transfer to another fund.

Whether a trustee of a particular fund imposes such restrictions should be a matter for the trustee.

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(We note that the restrictions proposed above are consistent with the Consultation Paper's stated aim of reducing multiple superannuation accounts. To allow a partial transfer or a full transfer where the member continues to accrue future service benefits in the original fund after transferring, in our opinion, is counter-productive to this aim.)

Member protection

We consider it inappropriate that members should be entitled to member protection where that entitlement has arisen because the member has previously elected to transfer part of his/her benefit to another fund. If member protection is applied, then this will adversely impact on the remaining members of the fund (ie interest crediting rates will need to be reduced to cover the member protection costs).

We therefore agree with the proposal that member protection should not be required in such cases. However, even if member protection is not mandatory in these circumstances, we expect that many funds will still apply member protection to such members because it may be too difficult or expensive to modify existing systems to remove it. However it should be left to individual funds to make that choice.

Defined Benefit Funds

We recommend that portability should not apply to funded defined benefit members (with the exceptions set out below). This recommendation (including the proposed exemptions) is consistent with the proposition put in your email of 5 February. Our reasons are as follows:

1. Complications due to benefit adjustments

If a defined benefit fund is required to transfer part of a member's benefit under any portability requirement it will be necessary to adjust the member's benefit. Most defined benefit funds will find it very difficult to make such an adjustment in a manner that is both equitable and perceived to be equitable, to the member, the employer and the remaining members.

Similar adjustments already need to be made when the fund is assessed for surcharge and where there is a split of a benefit for the purposes of Family Law, particularly where that split cannot be effected immediately.

In relation to surcharge adjustments, by far the most common approach has been to set up a "surcharge debt account" which accumulates with interest. The member's eventual benefit is then reduced by the accumulated surcharge debt account. This is the only method which enables the cost of the surcharge to be borne by the member without, except in extreme situations, impacting on the costs to the employer or on other members. This approach has, however, come under considerable criticism from many members who perceive it to be inequitable, particularly in times where the surcharge debt account increases more quickly than the member's benefit. Whilst it is the only appropriate adjustment method available in many cases, it can produce very significant reductions in benefit which are perceived to be inequitable by many members.

For Family Law purposes, a similar approach is effectively mandated in instances where the split of the benefit cannot be effected immediately. In this case the interest rate is set at AWOTE + 2.5%. To date, there have been few cases which have arisen, but many trustees are very concerned that this will produce inequitable results and they will have great difficulty in explaining the impact to members.

In summary, the experience of adjusting benefits for surcharge and the expectations for Family Law, indicate that defined benefit funds will have considerable difficulty operating under a portability regime. Further, where a member chooses to transfer benefits under portability, it is likely that this will normally involve a considerably greater portion of the accrued benefit than under surcharge or Family Law. This will magnify any problems.

2. Impact on funding

In the current climate, the funding of some Defined Benefit plans is marginal others may be in an unsatisfactory financial position due to negative returns from equity markets. Unless APRA freezes portability temporarily as foreshadowed in the consultation paper, a 'run' on member transfer payments (under portability) will place considerable pressure on employer short-term funding requirements and/or reduce the security of other members' benefits. Freezing portability is unlikely to promote confidence in those plans (even though the Defined Benefit plan may deliver higher longer term benefits).

3. Basis of transfer and information requirements

The consultation paper notes that in some cases the transfer amount (which is to be the resignation benefit) is more than the actuarial reserve. This will adversely impact on the employer sponsor and potentially require additional employer contributions to meet the shortfall.

In other cases the transfer amount will be less than the actuarial reserve, meaning that a member may leave valuable future entitlements behind on transfer. We are concerned by the level of information required to adequately communicate this information on a case by case basis, particularly if this has to be available on demand.

To ensure members make informed decisions, it would be necessary to provide an extensive range of information including benefit comparisons and projections to enable members to make an informed choice. This raises a number of issues:

- It would not normally be possible for either the employer or the trustee of the current fund to provide comparative information as they will not be aware of the details of the proposed fund;
- The requirements of the FSR legislation will mean that employers and many trustees will be unable to provide advice as they will not have the appropriate licence;
- In our opinion, it is unreasonable to expect that the employer, the trustee of the current fund or the remaining members of the current fund should be required to meet the costs of providing complex information for the benefit of a member who wishes to transfer out;

- Another difficulty is that the transfer amount will, for most funds, be different to the value determined in accordance with the method under the Family Law Act. Confusion is bound to arise over the two different amounts.

Any information requirements would therefore need to be extremely simple and capable of being expressed in a manner that does not constitute advice.

4. Superannuation Guarantee

Allowing defined benefit members to transfer benefits under portability requirements is likely to increase the requirements of employers to make Superannuation Guarantee contributions. The Consultation Paper notes that employers should not be required to pay further superannuation guarantee contributions where a member has accrued the "maximum benefit accrual".

In order to protect employers, we agree that an exemption of this type would be necessary. However we are concerned that the exemption proposed under the Superannuation Legislation Amendment (Choice of Superannuation Funds) Bill 2002 does not provide adequate protection for employers and that the similar exemption proposed for portability may also not provide adequate protection. In particular, it is our understanding that, where a member chooses another fund immediately prior to reaching maximum benefit accrual, employers would not be protected under the Choice exemption. The IAAust would welcome the opportunity of assisting in the drafting of relevant exemptions if the Government does not adopt our preferred approach of exempting defined benefit members from the portability requirements.

5. Impact on investment strategy

A higher level of liquidity may need to be maintained, leading to a less efficient long-term investment strategy. This is likely to have a greater adverse impact on smaller funds than larger funds.

The Consultation Paper notes that "… retail funds already operate on the basis that members can transfer funds at short notice, as do other managed investments. This does not appear to affect the investment performance of these funds." However, the recent APRA survey of Fees and Returns, indicates a significant underperformance by retail funds. The analysis included in this survey is not sufficient to determine whether the underperformance is at least partly due to this liquidity requirement or is due to other factors such as poorer investment choices made by members of such funds.

Exceptions

Where an employee has left the service of the contributing employer (and is not currently employed by an associated employer which is continuing to contribute to the fund), there is generally no reason why portability should not apply. In practice, almost all corporate funds already offer portability in these circumstances.

If portability is required for defined contribution funds, there is generally no reason why portability should not also apply to members of defined benefit funds who are being provided

with defined contribution benefits. It could also apply to any accumulation component of a defined benefit member's benefit where the accumulation component is payable in addition to and not related to any defined benefit component.

We would be happy to arrange further discussions on these issues if required. Please contact Catherine Beall, IAAust Chief Executive on (02) 9239-6106 to arrange a meeting.

Yours sincerely

Christopher Lewis
President