Practice Guideline 499.08

Shortfall Limit Required under APRA Prudential Standard SPS 160

March 2023

Contents

1 INTRODUCTION

1.1 Application

1.1.1 This Practice Guideline applies to a Member providing advice about a Defined Benefit (DB) Fund's Shortfall Limit in accordance with APRA Prudential Standard SPS 160 Defined Benefit Matters. It is intended to assist Members providing advice to a Trustee in relation to determining an appropriate Shortfall Limit or forming an opinion as to whether or not an adopted Shortfall Limit should be reviewed. It does not cover the broader requirements placed on actuaries by SPS 160.

1.1.2 This Practice Guideline also applies to Members who support another Member in providing advice about a DB Fund's Shortfall Limit in accordance with this Practice Guideline, as relevant to their contribution to the Services.

1.1.3 Legislation and other requirements or guidance which may be relevant to the work covered by this Practice Guideline include:

(a) APRA Prudential Standard SPS 160 Defined Benefit Matters;

(b) APRA Prudential Practice Guide SPG 160 Defined Benefit Matters;

(c) the Superannuation Industry (Supervision) Act 1993 (Cth);

(d) the Superannuation Industry (Supervision) Regulations 1994 (Cth); and

(e) Institute Professional Standard 400 Investigations of the Financial Condition of Defined Benefit Superannuation Funds.

1.1.4 A Member who provides advice under this Practice Guideline as an RSE Actuary in accordance with SPS 160:

(a) must be an Eligible Actuary; and

(b) must exercise his or her independent professional judgement and give impartial advice.

Members providing advice under this Practice Guideline, but not as an RSE Actuary, and Members supporting the Member providing advice as an RSE Actuary under this Practice Guideline are not required to be an Eligible Actuary.

1.1.5 All work performed under this Practice Guideline, whether by the Member providing advice or by a Member supporting the Member providing advice, is designated as an Applicable Service. As such, the Member's attention is directed towards Practice Guideline 1 (General Actuarial Practice). In the case of a Member supporting the

Member providing advice, Practice Guideline 1 applies as relevant to their contribution to the Services.

1.1.6 There are no previous versions of this Practice Guideline. It replaces Information Note: Shortfall Limit in Superannuation Prudential Standard 160 (July 2020).

1.2 About this Practice Guideline

1.2.1 This Practice Guideline:

(a) has been prepared in accordance with the Institute's Policy for Developing Professional Practice Documents; and

(b) is to be applied in the context of the Code.

1.2.2 This Practice Guideline is not mandatory. Even so, if this Practice Guideline covers the Services a Member provides, then the Member should consider explaining any significant departure from this Practice Guideline to the Principal, and record that explanation.

1.3 Relationship to Practice Guideline 1

1.3.1 Compliance with Practice Guideline 1 is a pre-requisite to compliance with this Practice Guideline References in Practice Guideline 1 to 'the applicable Professional Practice Document (PPD)" or "all applicable PPDs" should be interpreted as applying equally to this Practice Guideline, as appropriate.

1.4 Other relevant documents

1.4.1 This Practice Guideline must be applied in the context of the relevant legislation, regulation and accounting standards. If there is a conflict in wording, then the legislation, regulation and accounting standards take precedence over this Practice Guideline.

1.4.2 In this context, legislation, regulation and accounting standards include laws, regulations, prudential standards, subordinate standards, rules issued by government authorities and standards issued by professional bodies which have the force of law. Also included are relevant modifications or substitutions of these. Similarly, a reference to a Professional Standard or Practice Guideline includes any modification or replacement of that Professional Standard or Practice Guideline.

1.4.3 Apart from the Code or a Professional Standard, from legislation or from regulatory standards, no other document, advice or consultation can be taken to modify or interpret the requirements of this Practice Guideline.

1.4.4 This Practice Guideline does not constitute legal advice. Any interpretation or commentary within this Practice Guideline regarding specific legislative or regulatory requirements reflects the expectations of the Institute but does not guarantee compliance under applicable legislation or regulations. Accordingly, Members should seek clarification from the relevant regulator and/or seek legal advice in the event they are unsure or require specific guidance regarding their legal or regulatory obligations.

2 COMMENCEMENT DATE

This Practice Guideline commences on 1 May 2023.

3 DEFINITIONS AND INTERPRETATION

3.1 In this Practice Guideline:

'**Applicable Services'** means Services that are designated in an Institute Professional Standard or Practice Guideline as being Applicable Services.

'**APRA**' means the Australian Prudential Regulation Authority.

'**Code**' means the Code of Conduct of the Institute.

'Eligible Actuary' means:

(a) a Fellow or Accredited Member of the Institute; or

(b) a Member who is eligible to act in an actuarial capacity pursuant to a requirement under legislation.

'**DB Fund**' has the same meaning as applies to 'defined benefit fund' for the purposes of SPS 160.

'**DB Fund Member**' means a member of a DB Fund.

'**Minimum Benefit**', has the same meaning as in PS 400.

'Operational Risk Financial Requirement' or **'ORFR'** has the same meaning as in SPS 160.

'**PS 400'** means Institute Professional Standard 400 Investigations of the Financial Condition of Defined Benefit Superannuation Funds.

'RSE Actuary' has the same meaning as in section 10 of the SIS Act.

'RSE Licensee' has the same meaning as in section 10 of the SIS Act.

‘**SIS**’ means the SIS Act and SIS Regulations together.

‘**SIS Act**’ means the Superannuation Industry (Supervision) Act 1993 (Cth).

‘**SIS Regulations**’ means the Superannuation Industry (Supervision) Regulations 1994 (Cth).

‘Shortfall Limit’ means the Shortfall Limit set by the RSE licensee in accordance with SPS 160.

‘**SPG 160’** means APRA Prudential Practice Guide SPG 160 Defined Benefit Matters.

‘**SPS 160**‘means APRA Prudential Standard SPS 160 Defined Benefit Matters.

‘**Trustee**’ has the same meaning as an RSE Licensee.

‘**Unsatisfactory Financial Position’** and ‘**Unsatisfactory**’ are as defined in SPS 160.

‘**Vested Benefit’** has the same meaning as in PS 400.

3.2 A word that is derived from a defined word has a corresponding meaning.

3.3 Other capitalised terms used in this Practice Guideline have the same meaning as set out in the Code.

4 SPS 160 AND THE SHORTFALL LIMIT

4.1 SPS 160 requires a Trustee of a DB Fund to set a Shortfall Limit for the fund, and to determine and implement a monitoring process to detect when the fund has, or may have, breached the Shortfall Limit and/or moved into an Unsatisfactory Financial Position.

4.2 If the DB Fund is, or may be, in breach of its Shortfall Limit, SPS 160 outlines a range of actions that will need to be performed, which may include conducting an actuarial investigation.

4.3 The Shortfall Limit is currently defined in paragraph 10 of SPS 160 (July 2013) as:

> *“… the extent to which an RSE licensee considers that a fund can be in an unsatisfactory financial position with the RSE licensee still being able to reasonably expect that, because of corrections to temporary negative market fluctuations in the value of fund assets, the fund can be restored to a satisfactory financial position within one year.”*

4.4 Consistent with paragraph 12 of SPS 160, paragraph 19 of SPG 160 (November 2013) states that Reporting Standard SRS 160.0 (Defined Benefit Matters) (“SRS 160.0”) sets out how the Shortfall Limit is to be calculated and expressed:

"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."

4.5 Accordingly the Shortfall Limit essentially represents a specified level of the defined benefit Vested Benefit Index ("VBI"), expressed as a percentage to one decimal place; e.g. 97.0%.

4.6 While paragraph 19 of SPG 160 provides some flexibility, usual practice is for the Shortfall Limit to be determined in respect of the defined benefit component of a defined benefit member's benefit entitlement (that is, the defined benefit interest, excluding any purely accumulation add-on benefits).

5 ACTUARIAL INTERPRETATION

5.1 There are a number of aspects of the definition of Shortfall Limit that are open to interpretation – for example, the meaning of phrases such as "reasonably expect" and "temporary negative market fluctuations".

5.2 In relation to the intent of the Shortfall Limit requirements and the issue of temporary market fluctuations, guidance in SPG 160 paragraph 17 states:

"The effect of market volatility on asset values may cause a fund to move in and out of an unsatisfactory 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."

5.3 Both SPS 160 and SPG 160 indicate that the Shortfall Limit is to be established principally by reference to volatility of investment returns. Whether or not the Shortfall Limit is breached, of course, will also be affected by factors other than investment returns (for example, the level and adequacy of contributions, salary increases and (potentially) aspects of the DB Fund's benefit design such as where members become entitled to a lifetime pension or salary-related defined benefits only on reaching a certain age and/or service threshold etc).

5.4 The final sentence in paragraph 20 of SPG 160 suggests that, after determining a Shortfall Limit based on objective factors, a Trustee 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. Common practice is for the Shortfall Limit recommendation made by the Member to reflect the objective assessment mentioned in this paragraph, with the Member's advice drawing the Trustee's attention to the SPG 160 guidance that the Trustee may wish to set a higher Shortfall Limit in the specified circumstances.

5.5 There is no single method that should be applied to determine a Shortfall Limit. Key factors for Members to take into account in advising Trustees on Shortfall Limits include:

- the investment strategy:

  The expected volatility of investment returns is typically a function of the proportion of the DB Fund's defined benefit assets invested in growth-oriented investments (for example, shares and property). In general, the higher the allocation to growth-oriented assets, the greater the expected volatility of investment returns. Hence, all other things being equal, a DB Fund with a higher allocation to growth-oriented assets would generally have a lower Shortfall Limit (for example, say, a VBI of 95.0%) than the Shortfall Limit of an "equivalent" DB Fund with a lower allocation to growth-oriented assets (being, say, a VBI of 98.0%).

- the defined benefit component of the Vested Benefit design:

  DB Funds may have benefit designs that are purely defined benefit in nature (where the Vested Benefits are not influenced by investment returns) or benefit designs where Vested Benefits may be either the greater of a defined benefit and an accumulation benefit, or accumulation in nature up to a certain age or service threshold. A DB Fund with a pure defined benefit Vested Benefit design would be expected to experience greater volatility in its VBI position compared to a DB Fund that has accumulation elements (the value of which is linked to the fund's actual investment returns) in its Vested Benefit design.

  Hence, all other things being equal, a DB Fund with a pure defined benefit design would generally have a lower Shortfall Limit (for example, say, a VBI of 95.0%) than the Shortfall Limit of an "equivalent" DB Fund with a benefit design that has both defined benefit and accumulation components (being, say, a VBI of 98.0%).

- the relationship between the Vested Benefits and the Minimum Benefits:

  A DB Fund's solvency is measured by the coverage of its Minimum Benefits by its net assets. Paragraph 11 of SPS 160 requires that the Shortfall Limit must not be such that a DB Fund could become technically insolvent before the Shortfall Limit is breached. Hence the nature of the Minimum Benefits, and their relationship to the Vested Benefits, needs to be taken into account in setting the Shortfall Limit.

5.6 SPG 160, in paragraph 20, identifies other factors that may be considered when setting the Shortfall Limit such as whether the DB Fund pays pensions, the membership profile, whether the fund is open or closed to new members, accrued benefits and the weighted average term of projected defined benefit liabilities. Usually these factors will not materially influence the choice of Shortfall Limit because the Shortfall Limit is primarily concerned with short term variations in funding arising from the volatility of investment returns.

5.7 In advising on the determination of a Shortfall Limit it is expected that the Member should take into account any significant projected changes in the defined benefit liability profile over the period until the need for a review of the Shortfall Limit would be considered (usually the next actuarial investigation) – in particular projected changes in the second and third key factors referred to in Clause 5.5.

6 POTENTIAL SHORTFALL LIMIT METHODS

6.1 Potential methods for determining the Shortfall Limit include:

- using the expected return and volatility characteristics of the investment strategy to make an assessment of the probability of achieving a required return over a time period of up to one year (based on the definition of Shortfall Limit in paragraph 10 of SPS 160). Adoption of a Shortfall Limit of less than 100% is likely to require acceptance of a probability of achieving the required return in the range of 30% to 50%;
- examining the volatility of investment returns for a relevant investment strategy over short time periods, to make an assessment of the likelihood of the recovery of any negative returns over a reasonable time period (up to one year).

6.2 For DB Funds with purely defined benefit Vested Benefits, proprietary modelling has shown that Shortfall Limits of the following order may be reasonable:

Growth oriented investments*	Shortfall Limit
85% or more	96.0%
65% to 84%	97.0%
35% to 64%	98.0%

10% to 34%	99.0%
9% or less	100.0%

* Typically equities, property and return seeking alternative investments.

6.3 The percentages in the table do not take into account the DB Fund's solvency position. As required by paragraph 11 of SPS 160, the Shortfall Limit must be set at a level at which Minimum Benefits would at least be 100% covered.

The results in clause 6.2 are provided for Members' information, not as recommendations. Members may use these results in advising on Shortfall Limits, as long as they have considered the specific circumstances of the DB Fund and have made any adjustments required for each DB Fund's circumstances (for example, the extent to which Vested Benefits are linked to investment returns, having regard to Minimum Benefits etc) but are not compelled to do so. It is quite possible that Shortfall Limits different from those indicated in clause 6.2 may reasonably be produced depending upon the circumstances of the DB Fund and the methodologies employed.

7 REVIEWING THE SHORTFALL LIMIT

7.1 SPS 160 requires a report on an initial or regular actuarial investigation of a DB Fund to include a statement on whether, in the opinion of the DB Fund actuary, the Shortfall Limit should be reviewed.

7.2 This requirement can be satisfied by reviewing the Shortfall limit in an initial or regular actuarial investigation and recommending either a new Shortfall Limit, or maintenance of the existing Shortfall Limit, in the investigation report. PG 499.08 applies to such reviews and recommendations.

7.3 However, it is not always necessary to review the Shortfall Limit. Reasons for considering that the Shortfall Limit should be reviewed include a change to one or more of the following that is significant enough to mean that the current Shortfall Limit may no longer be appropriate:

- the investment strategy;
- the expected return or volatility characteristics of the investment strategy or the probability of achieving a certain return over a period of up to one year;
- the relationship (or projected relationship) between Vested Benefits and Minimum Benefits;

- the proportion (or projected proportion) of Vested Benefits that are linked to the fund's actual investment returns;
- a significant change to the membership profile or the closing of a fund to new entrants.

7.4 Whilst not a requirement of SPS 160, changes in a DB Fund's circumstances, such as those referred to in the preceding clause, may lead to a Member recommending a review of the Shortfall Limit in between regular actuarial investigations.

End of Practice Guideline 499.08