THE INSTITUTE OF ACTUARIES OF AUSTRALIA
A.B.N. 69 000 423 656

GUIDANCE NOTE 455

Pre 1 July 1988 Funding Credits (PJFC)

APPLICATION

This Guidance Note is to be applied by actuaries in the determination of a superannuation fund's entitlement to PJFC at 30 June 1988 (or at such other date as may be approved); in the procedure for transfers of PJFC; and in the procedure for reporting Prescribed Events, in accordance with Section 342 of the *Superannuation Industry Supervision Act* (SIS) and related legislation.

LEGISLATION

Section 15D of the *Occupational Superannuation Standards Act* previously covered the application for, and granting of, a PJFC for a fund, and Part 3B of the *Occupational Superannuation Standards Regulations* previously covered the determination of the initial PJFC. Part 12 of the SIS Regulations now covers that determination. References to the Regulations in this Guidance Note are thus references to the SIS Regulations.

Sections 275A and 275B of the *Income Tax Assessment Act* (ITAA) cover the application of the PJFC.

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CLASSIFICATION

Compliance with the provisions of this Guidance Note is mandatory.

1 PURPOSE

1.1 The purpose of this Guidance Note is to provide guidance to actuaries on the calculation of the initial PJFC for a fund, adjustment for subsequent ‘prescribed events’ and transfers of PJFCs. The PJFC will be calculated at 30 June 1988, or such other date as applies under Regulation 12.20.

1.2 The Treasurer's supplementary statement on Superannuation Tax Reform (Press Release 60, 20 June 1988) introduced the concept of non-taxed contributions to ‘discharge funding requirements in respect of benefits accrued relating to service prior to 1 July 1988, subject to the provision of satisfactory actuarial evidence to the Insurance and Superannuation Commissioner’.

1.3 Subsequent announcements relating to PJFCs were made in:

- Treasurer's Press Release (No.82) 11 August 1988;
- ISC Information Circular 15 (Interim arrangements) March 1990;
- Treasurer's Press Release 10 October 1991;
- SIS Regulations which replaced the OSS Regulations, and altered the application date introduced by Statutory Rules 1994, No 432.

1.4 Part 12 of the Regulations specifies the manner of calculation of the initial credit. Regulation 9.32 requires a statement to be included in an actuarial report under that Regulation if a prescribed event has occurred.

Essentially the initial credit is the lesser of:

- unfunded liabilities at 30 June 1988 on the fund actuary's chosen valuation basis (generally based on the basis used for the latest actuarial investigation completed prior to 25 May 1988); and
- unfunded liabilities at 30 June 1988 on a control basis

plus any ‘late payments’ of outstanding contributions (if any) as at 30 June 1988 (‘late payment amounts’ are as defined in Regulation 12.02 - refer Section 7 below).

ISC Circular 35 issued in July 1993 provided further details of the application process.

1.5 The benefits valued are to be those which applied as at 30 June 1988 based on the rules governing the fund as at 25 May 1988, unless the benefits had been reduced by 30 June 1988. If benefits were subsequently altered in a manner which reduced accrued benefits at 30 June 1988, the provisions governing prescribed events are relevant. (Refer Section 5 below).

2 ACTUARY'S CHOSEN BASIS

2.1 The unfunded liability on the actuary's chosen basis is determined as:

> the value of accrued benefits at 30 June 1988 (referred to as Value A in the Regulations) less the actuarially determined value of fund assets as at 30 June 1988 (calculated in a manner consistent with the latest actuarial review completed prior to 25 May 1988),
>
> multiplied by
>
> the ratio of net market value of assets to the actuarially determined value of assets as at 30 June 1988.

2.2 Except as provided in paragraphs 2.3 to 2.5 below, the actuarial basis used for the latest actuarial review of the fund completed prior to 25 May 1988 is to be used to value benefits. The date of completion for this purpose is the date the report is signed.

2.3 The variation required to the actuarial basis previously used is that no death or disablement decrements are to be used.

The Government's view is that this is appropriate due to the deductibility of insurance costs under Section 279 or 279B of the ITAA.

In limited circumstances, other assumptions may be used in place of one or more of those adopted in the actuarial review completed prior to 25 May 1988. Such cases must be referred to the Commissioner (refer Regulation 12.05(6)).

2.4 Accrued benefits at 30 June 1988 are to be determined on the basis used in the last completed actuarial review prior to 25 May 1988.

If accrued benefits were not determined for that review, or if the actuary believes that the basis used is not appropriate for this purpose, the actuary should refer the preferred basis to the ISC under the provisions of Regulations 12.05 (4) or (6).

Features the actuary should consider when determining the approach used include:

- whether the rate of accrual of retirement (or withdrawal) benefits has been increased or decreased for some or all members at some date prior to 25 May 1988;

- whether members have changed benefit categories prior to 1 July 1988, with a consequent change in the rate of accrual of retirement benefits;

- whether any member has transferred into the fund prior to 1 July 1988 a transfer amount (whether applied to direct or indirect purchase of a period of past service, or applied to an accumulation only).

This list of circumstances is not intended to be comprehensive. The actuary should consider the significance of any feature which may alter the value of accrued benefits (and consider whether the control basis value is likely to apply) before embarking on extensive recalculation of accrued benefits at 30 June 1988.

2.5 Benefits are to be valued as follows:

- allowing for the assumed rate(s) of salary escalation.

- (if benefits are not salary related) allowing for any benefit increases in a manner consistent with past practice.

- applying early retirement and withdrawal decrements in the usual manner.

- applying other decrements (e.g. ill-health, but not death or total permanent disablement), except where part of the relevant benefit is implicitly or explicitly insured and the cost is deductible under Sections 279A and 279B or 279C of the ITAA. (Thus, if any part of an ill-health benefit is self-insured, and deductions are claimed for the certified cost, relevant ill-health decrements may not be used.)

- converting pension benefits to lump sum equivalent values at the date of pension commencement (in a manner consistent with that used in the latest investigation completed prior to 25 May 1988).

- reflecting discretionary pension increases only if increases have been made to all pension benefits on at least 3 occasions prior to 1 July 1988, including at least once in the three years to 30 June 1988.

- making no allowance for the tax on investment income introduced by the 25 May 1988 Statement.

- allowing for withdrawal benefits which are related to accumulated member contributions with interest using either:

    - the vesting factor at 30 June 1988, or
    - the vesting factor at assumed exit date,

  and applying this to the accumulated member contributions at 30 June 1988, together with accrued and subsequent interest additions.

2.6 Where a fund has not had an actuarial review prior to 1 July 1988 or has had a review prior to that date which was completed on or after 25 May 1988, the basis is to be referred to the ISC (under Regulation 12.05(4)). The actuary should select a basis which is consistent with the approach detailed in Section 2.5 of this Guidance Note.

This requirement can apply to new funds, and funds which were segregated from larger funds. In this latter case, the basis used for the previous actuarial review of the larger fund should be used as the starting point for the valuation basis of the fund. Any variation (e.g. to salary increase rates) should be justified by the actuary by referring if possible, to identifiable actual experience of the segregated group of members.

2.7 The value of accrued benefits for each member is subject to a minimum of the vested benefit at 30 June 1988. Any regular exercise of discretion should be used to determine the vested benefit (e.g. on early retirement) except for `associated employees' (as defined in the ITAA).

3 CONTROL BASIS

3.1 A control basis is specified for determining the value of accrued benefits (‘Value B’ in Regulation 12.06), and the resulting unfunded liability (using net market value of assets) is applied as the maximum value of the shortfall-in-assets component of a PJFC in Regulation 12.03.

The Government considers that, without the control basis, an overly conservative valuation basis may have been used in some cases, resulting in an unreasonably large tax concession.

3.2 The unfunded liability on the control basis is calculated as:

the value of accrued benefits as at 30 June 1988,
less
the net market value of fund assets as at 30 June 1988.

3.3 The economic components of the valuation basis are:

fund earning rate 10% p.a.
salary escalation rate 8½% p.a.
CPI increases 7% p.a.

The fund earning rate is to be used to discount expected benefit payments. No adjustment to the rate may be made for tax on earnings, or investment management expenses. It should also be used for amounts which accumulate with interest (e.g. member contributions).

The salary escalation rate is to be used to project salaries from 30 June 1988. No further allowance is to be made for promotional increases.

The CPI increase rate is to be used to project future benefits where the amounts of such benefits are not salary based, and the fund's past experience shows that benefit levels are reviewed from time to time in light of changes in the costs of living.

3.4 No decrements should be used except for normal retirement. Thus, no allowance should be made for death, disablement, ill health or early retirement, or withdrawal decrements (refer Regulation 12.06(2)(a)).

3.5 Accrued benefits are to be calculated on a proportionate basis only, using membership to 30 June 1988 divided by membership to date of assumed exit. In general, membership is to be measured from the date the member joined, or last joined, the fund (refer Regulation 12.07).

For the purpose of this Guidance Note, the Institute interprets a period of fund membership as including allowance for a period of fund membership of a former fund to which the member belonged, where an amount has been transferred into the current fund in respect of former fund membership and has been converted into an additional period of membership, or an additional multiple of final salary or final average salary. The allowance should be based on the additional period of membership granted (either explicitly or implicitly by way of the additional multiple).

Where the amount transferred is accumulated with interest and payable in addition to other benefits in the current fund, the amount of the accumulation at 30 June 1988 should be deducted from the asset values used, and no allowance should be made in the Value A or Value B of accrued benefits for the benefit which is so payable.

3.6 Pensions are to be valued using 10% p.a. interest.

Where the fund allows for adjustments to pensions at the discretion of the Trustees, increases in pensions should be based on the average annual percentage increase in pension benefits (if any) over the period 1 July 1985 to 1 July 1988, subject to a maximum of 7% p.a.

Where the fund allows for adjustments to pensions other than at the discretion of the trustees, increases in pensions to compensate for increases in the cost of living are to be assumed at the rate of 7% p.a.

Where the fund allows for adjustment of benefits in accordance with the amount or rate of salary of members, increases in salary are to be assumed at a rate of 8.5% p.a.

3.7 In limited circumstances, other assumptions may be used, on application to the Commissioner (refer Regulation 12.06(4)).

4 ASSET VALUATION

4.1 Asset values for the Control Basis are to be determined at net market value at 30 June 1988. In determining net market value the actuary should take account of any charges incurred in the normal course of operation of the fund (e.g. when assets are realised to meet benefit payments and regular costs such as insurance premiums and management fees).

Investment termination penalties (e.g. for Life Office `Capital Guaranteed' contracts) would not normally be taken into account.

4.2 Asset values for the actuary's chosen basis are to be determined using a method that is consistent with the method used in the relevant actuarial investigation prior to 25 May 1988.

The resultant unfunded liability is adjusted for the ratio of net market value to actuarially determined value, to give the shortfall-in-assets component of the PJFC (refer Regulation 12.03(1)).

5 PRESCRIBED EVENTS

5.1 Actions relating to prescribed events, as defined in Regulation 12.10, are detailed in paragraph 342 of the SIS Act.

5.2 In terms of Regulation 12.10, a prescribed event is essentially any alteration to benefits which reduces the pre 1 July 1988 benefit entitlement of members for whom a PJFC has been granted or transferred. Where a PJFC arises as a result of transfer of members from another fund, the reduction of PJFC to be determined under Regulation 12.10(1) should assume that the relevant members were members of the fund as at 30 June 1988 with benefit entitlements identical to those which gave rise to the transferred PJFC.

5.3 If a prescribed event occurs, the actuary should determine the reduction in the value of accrued benefits as at 30 June 1988 for the affected membership (which may not be the same as the actual 30 June 1988 membership).

The reduction should be calculated in the manner detailed in section 2 or 3 of this Guidance Note, using the basis which generated the fund's actual PJFC at 1 July 1988 (e.g. on the actuary's basis only if the PJFC was determined as the amount in Regulation 12.03(1)(a)) and, if appropriate, after allowing for the adjustment for the actuarially determined value of assets referred to in section 4.2.

The value of the reduction calculated at 30 June 1988 should be adjusted with subsequent indexation in accordance with Regulation 12.10(2).

5.4 The intention of the Government is that only a reduction in benefits accrued prior to 1 July 1988 should give rise to a prescribed event.

A reduction in the rate of accrual of retirement (or other) benefits accruing after 1 July 1988 may appear to give rise to a prescribed event under Regulation 12.07. This is a result of the proportioning approach specified for the control basis, which would reduce the calculated accrued benefit at 30 June 1988.

This is not the intended effect, and the Government Actuary has agreed that an alteration of benefits after 1 July 1988, which does not affect the calculation of benefits relating to service prior to 1 July 1988, does not result in a prescribed event.

6 TRANSFERS

6.1 Transfer of PJFC between funds is covered in Regulations 12.12 to 12.15. An actuary's certification of the amount of PJFC to be transferred is required under Regulation 12.15.

6.2 As a primary consideration, the actuary is required to ensure that the transferring and remaining members, to whom any PJFC relates, are treated equitably within the limits imposed by the Regulations. This is evidenced by the actuary's certification that the amount of PJFC transferred is reasonable having regard to the amount of unfunded pre 1 July 1988 liability being transferred in relation to the amount remaining.

6.3 The actuary is also required under Regulation 12.15(e) to certify that sufficient information is available about the accrued entitlements of transferred members at 30 June 1988 to enable calculations to be made about possible subsequent prescribed events.

6.4 The Institute interprets the requirement described under Regulation 12.15 to mean that the amount of transferred PJFC may be based on the formula:

$$\text{PJFC Transfer} = \frac{\text{Pre 1988 liability - transferring members}}{\text{Pre 1988 liability - all current members}} \times PJFC$$

where:

PJFC denotes the current (indexed) balance of the transferor fund's PJFC at the date of transfer, being the amount of PJFC after allowance for amounts previously applied;

the numerator in the above ratio denotes the benefit liability in relation to pre 30 June 1988 service for transferring members, calculated under the actuary’s chosen basis or control basis as appropriate; and

the denominator in the above ratio denotes the benefit liability in relation to pre 30 June 1988 service for all members of the transferor fund at the date of transfer, whether transferring or remaining, and calculated under the appropriate basis.

The assumption made in taking the above ratio of pre 1988 liabilities to indicate the extent of *unfunded* liabilities is that assets covering these liabilities as at 30 June 1988 may be notionally allocated between remaining and transferring members in the same ratio.

6.5 The Institute considers that certification of the PJFC to be transferred as the amount set out above satisfies *prima facie* the requirements of Regulation 12.15(a). By definition this amount cannot exceed the PJFC balance in the transferring fund immediately before the transfer, thereby partly satisfying the requirements of Regulations 12.12(3) and 12.13(3). However there is an additional requirement to limit the amount of PJFC transferred to the liability in relation to the pre 1 July 1988 benefits being transferred.

6.6 Notwithstanding the amount of PJFC to be transferred as set out above, amounts derived on other bases may be certified by the actuary where there is agreement between the trustees of the transferor fund and the transferee fund, and where the level of assets to be transferred and other relevant considerations have been taken into account in determining whether the amount of PJFC to be transferred is reasonable under Regulation 12.15.

7 LATE PAYMENT AMOUNTS

7.1 Regulation 12.02 refers to an amount of contribution in respect of a member who is ‘an associate of the employer-contributor’ which that employer-contributor was obliged to pay as at 30 June 1988 in accordance with the determination of an actuary.

7.2 In determining what the fund's outstanding contribution for such members was at 30 June 1988, the actuary should have regard to the contributions recommended for such a class of members at the latest actuarial investigation, or time of any other actuarial advice relating to those members (e.g. on the establishment of a new fund).

8 ACCUMULATION BENEFITS

8.1 Accumulation style funds may have been in deficiency at 30 June 1988 (measured against vested benefits or full retirement credits).

Regardless of the extent of any such deficiency, a PJFC arises for these funds only under the late payment amount definition in Regulation 12.02.

8.2 To be consistent with the approach detailed above, if a defined benefit fund has a subsection of accumulation based members, for whom an identifiable asset value is available (e.g. via a separate body of assets, or a sub-account in a pooled fund) any deficiency in such a subsection should not be included in the fund's PJFC, unless it meets the definition of a late payment amount in Regulation 12.02.

To effect this, the asset values used should be net of the amounts identifiable for these members. If assets are not separately identifiable, the retirement credits at 30 June 1988 should be taken as the value of accrued benefits.

9 MISCELLANEOUS

9.1 An actuary providing a certification of a PJFC should note the requirements of Regulation 12.19, and confirm in the certification given that the method used was in accordance with this Guidance Note and with Part 12 of the SIS Regulations. The actuary should state whether the data upon which calculations were based was considered reliable.

9.2 A certificate detailing the fund's PJFC should include:

- the name of the fund;

- the effective date of the calculation (usually 30 June 1988);
- the amount of the PJFC, separated into ‘late payment amount’ and ‘shortfall-in-assets amount’ together with a statement that the ‘shortfall-in-assets amount’ is not greater than the maximum allowed under the control basis;
- the assumptions used in the actuary's chosen basis, the amount of the Value A of accrued benefits, the actuarially determined value of fund assets, and details of any variations from the assumptions used in the latest Actuarial Investigation completed prior to 25 May 1988;
- the net market value of the fund assets at 30 June 1988;
- the date of the last actuarial investigation completed prior to 25 May 1988, and the date of the completion of that report;
- the name, business address, qualifications and signature of the actuary;
- the date of signing of the certificate.

END OF GUIDANCE NOTE 455