THE INSTITUTE OF ACTUARIES OF AUSTRALIA
A.C.N. 000 423 656

GUIDANCE NOTE 461
FUNDING AND SOLVENCY CERTIFICATES

APPLICATION

This Guidance Note applies to the preparation of Funding and Solvency Certificates required by certain defined benefit regulated superannuation funds, and control of all technically insolvent funds used for Superannuation Guarantee purposes.

LEGISLATION

The relevant legislation is Part 9 of the Superannuation Industry (Supervision) Regulations (made under subparagraph 31(1) of the Superannuation Industry (Supervision) Act 1993). Division 9.3 relates to the funding and solvency of defined benefit funds used for Superannuation Guarantee purposes.

CLASSIFICATION

Compliance with this Guidance Note is mandatory.

HISTORY

This Guidance Note first issued December 1994.

1. FUNDING AND SOLVENCY CERTIFICATES - SOLVENT FUNDS

1.1 SIS Regulations

Relevant Regulations are as follows:

9.05 Specifies which defined benefit funds fall under Division 9.3.

9.08 Requires employers to contribute at no less than the rate specified under Regulation 9.10.

9.09 Requires Trustees to obtain a funding and solvency certificate, and supply a copy to each relevant employer -sponsor.

9.10 Specifies the contents of a funding and solvency certificate, including the minimum contribution rate(s), and certification of solvency.

9.15 Defines a minimum benefit index. This regulation, in conjunction with Regulation 1.03 defines "minimum requisite benefit" (used in determining the index) as the minimum requisite benefit certified in a relevant benefit certificate.

Other regulations relate to timing of certificates and action to be taken in the event of technical insolvency.

1.2 Abbreviations and terms used in this Guidance Note

FSC : funding and solvency certificate
MRB : minimum requisite benefit
AMBI : adjusted minimum benefits index (refer Regulation 9.15 (2))
initial date : the earliest date from which an FSC applies in relation to a particular fund (refer Regulation 9.15 (2))

1.3 Prudential Framework

An FSC is one leg of the framework which supports the security of superannuation guarantee entitlements in defined benefit funds. The Institute understands that the intention of the package of measures available to the actuary under the Regulations is that the actuary may target solvency at the expiry of the certificate 'beyond reasonable doubt', without setting contributions which are likely to result in overfunding. In considering these issues, the actuary should recognize as much as possible the employer's attitude towards the funding of benefits. The actuary should also bear in mind the potential cost of frequent review.

In an FSC the actuary certifies "solvency" (as defined in the SIS Regulations) at a particular date, specifies minimum contributions designed to maintain solvency, and defines circumstances under which the fund should be re-examined (prior to the normal expiry of the certificate).

Separate requirements concern funds which are found to be, or expected to soon be, in an "unsatisfactory financial position" - The Institute's Guidance Note 460 is relevant for these cases.

The solvency measure being certified is the coverage of MRBs by net assets. This guidance note does not deal with more general measures of solvency, which are addressed elsewhere (e.g. GN 460 and PS 400).

The key responsibility of an actuary in preparing an FSC is to specify the minimum contributions estimated to secure the solvency (as defined) of the fund on the expiry date of the certificate. In practice this will normally require the actuary effectively to specify the minimum employer contributions. The minimum contributions specified in an FSC must be adequate to provide full coverage of the funded MRBs at the date of the expiry of the certificate under reasonable expectations for future experience.

(Note : The funded MRB is the component of the MRB from time to time which had accrued at the initial date multiplied by the AMBI at the initial date, plus the full amount of the MRB which has accrued after the initial date.)

1.4 Minimum Contributions

1.4.1 Certification Required

The principal certification being provided is the level of contributions which are expected to result in the fund being solvent (as defined) at the expiry date of the certificate. The Institute believes that the actuary's role in these funds is to ensure that the probability of the fund failing to meet its obligations to members is kept to relatively low levels, i.e. if a fund is wound-up for any reason it is unlikely to be insolvent (as defined in the Regulations). While technical insolvency of an on-going fund itself may generate some concerns for Trustees and members, there remains the period of actuarial control before wind-up is required.

1.4.2 Assumptions - "Best Estimate"

The actuary should start with "best estimate" assumptions for the period for which the certificate will apply (subject to 1.4.4 below). This reflects the need to provide proper estimation of the required contributions, rather than make overly conservative estimates which may result in overfunding by the employer. In particular, it is appropriate to recognize that, over time, the MRBs in a fund are likely to become the major component of benefits, as SG levels rise.

1.4.3 Other elements of control mechanism

While use of "best estimates" may imply that there is as much chance of being insolvent as being solvent at the expiry date of the certificate, the other control mechanisms available to the actuary may be used to detect cases where the fund is moving towards insolvency. In particular, the actuary should specify notifiable events which will allow detection of such a movement. In addition, the actuary may use shorter duration certificates if there are particular concerns about a fund.

1.4.4 Other than "Best Estimate Minimum Contributions"

The actuary may, after discussion with the employers, specify rates in the certificate which are in excess of those likely to be required (on a "best estimates" basis) to provide coverage only of funded MRBs.

This may be appropriate for example where the employer is prepared to contribute at the rate specified by the actuary in the regular actuarial review of the fund to provide full benefits, rather than just minimum requisite benefits, thus obviating the cost of a separate projection of funded MRB coverage only.

The certificate should state that this approach has been adopted.

1.4.5 Benefits Assumed

In projecting coverage of MRBs at the expiry date of the certificate, the actuary should reflect the total benefits expected to be payable over that period, not just the MRB component of benefits. If a benefit payable is subject to options which may alter the amount or the value of the benefit payable (e.g. a pension or lump sum at member's option), the actuary should make assumptions (which should be disclosed in the certificate), about the proportions who exercise the various options.

1.4.6 Sensitivity Testing

In all cases, the actuary should consider testing how sensitive the projections are to the assumptions (including asset values - note 1.7 below). The results of this testing may also be used in determining what events should be notifiable as discussed below.

1.4.7 Initial Date prior to 1 July 1994

For certificates which commence prior to 1 July 1994, the specified contributions for the period up to that date may be based on the recommendations in the latest actuarial review, or the contributions actually paid, provided the actuary is satisfied that the basis for these contributions is reasonable given the financial position of the fund, the rate of accrual of MRBs over the period, and events which have occurred during the period. The contributions specified for the balance of the certificate's life should be determined in accordance with this Guidance Note.

If the initial date precedes the effective date of the benefit certificate which defines the MRB, the AMBI should be calculated at the commencement date of the benefit certificate.

1.5 Minimum Contributions - AMBI less than 1.

Funds which have an AMBI less than one will have some automatic funding of the 'deficiency'. This will arise because the projection of fund assets to the expiry of the certificate will allow for the fund's full benefits to be paid to members assumed to exit over that period.

However, the actuary may wish to specify contribu tions which are explicitly designed to amortize any shortfall of assets (to MRBs) at the initial date over whatever period that the actuary considers appropriate to the fund. This approach may require discussion with the Trustees and employer so that the reason for contributions higher than the 'minimum' are well understood.

1.6 Notifiable Events

1.6.1 Nature of Notifiable Events

An FSC must specify any events which should be advised to the actuary during the duration of the certificate. The SIS Regulations are explicit in requiring that an FSC include relevant notifiable events, being events which, if arising, "..should, in the opinion of the actuary, require the certificate to cease to have effect and (require) a new certificate to be obtained." (Refer Reg. 9.10(1)(c)).

Such an event should be one which could have a significant adverse effect on the fund's financial position, and could, in the opinion of the actuary, warrant replacement of the certificate. A notifiable event may be used as a mechanism to identify a wide range of circumstances, not necessarily all requiring a major revision of certified contributions (e.g some merely require an amendment to the list of notifiable events itself).

A "notifiable event" is defined as including an amendment to the governing rules of a fund that affects the level, or method of calculation, of benefits of the fund, or such other events as the actuary specifies in a funding and solvency certificate.

The importance of any particular type of event will vary between funds, over time, and with the occurrence of coincident events. The duration of the certificate will also be of importance in determining events which may be significant.

1.6.2 Power to Withdraw Certificate

An actuary who has experience of a fund's operation, and has access to relevant data, may consider that the ability to withdraw a certificate (under Regulation 9.12 (2)(e)) means that few events need to be explicitly specified in the certificate as a Notifiable Event, as intervention is possible if the fund's emerging experience is adverse.

However, as the certificate has a defined 'expected' duration, the continuing involvement of the actuary should not be relied upon as a means of control (except for special FSCs). The Institute considers that the obligations imposed on the actuary under Regulation 9.10 require an approach to notifiable events which errs on the side of safety. Therefore it is more acceptable to re-issue an unaltered FSC than to allow a fund to become insolvent through a failure to specify the relevant notifiable events.

1.6.3 "Generic" Notifiable Events

Actuaries may also adopt an approach which adds to the flexibility of control by specifying as a notifiable event any event advised to the Trustees (by the actuary) during the course of the certificate. Effectively this gives the actuary the right to expand the range of notifiable events at any time during the currency of the certificate.

The actuary has the ability under Reg. 9.12 (2) (e) to withdraw a certificate under certain circumstances (relating to an opinion formed while performing an actuarial function under the Act or Regulations). If the actuary feels that this provision may be too limiting in its scope, it may be appropriate to strengthen the control over the fund by requiring regular, less formal, certification of the fund's solvency. (Note, this could be effected by including as a notifiable event the actuary's failure to certify - annually say - that the certificate should continue to have effect.)

1.6.4 Relationship of notifiable events to assumptions, duration

The degree of conservatism in the assumptions used in setting contributions, or the margin between specified contributions and 'absolute minimum' contributions, should also be considered in determining notifiable events.

The duration of a certificate may also be varied as an additional measure of control. For funds where the solvency is marginal, a shorter duration certificate may be a means of reducing the length of the list of notifiable events.

1.6.5 Indicative Notifiable Events

The list of Notifiable Events may include (but are not limited to) items of the following nature :

- significant numbers of early retirements
- significant numbers of retrenchments
- significant numbers of withdrawals in a fund where the assets are less than the vested benefits
- significant salary increases
- a significant investment loss
- a significant change in investment policy
- an increase in benefits
- the expiry or replacement of the Benefit Certificate which specifies the MRBs applying to the fund
- significant exercise of a discretion to pay enhanced benefits other than as assumed in the certification

The events detailed in the certificate should be specific and quantified. Use of terms such as "significant" in the certificate is not appropriate, as the interpretation of such a term is subjective, and the actuary's responsibility to determine what is significant must not be delegated to the Trustees.

In considering what constitutes `significant', the actuary should consider the likely effect of the event on the fund, assuming that contributions are paid at the minimum specified rate only. In particular, the actuary should consider the assumptions adopted in setting the certified contributions and how variation of experience from those assumptions will affect the coverage of funded MRBs.

Combinations of events should also be considered. Combinations of such events may become significant, even where individual events may not be.

1.6.6 Index Measures as Notifiable Events

Use of indices such as the coverage of vested benefits (which is likely to be available annually), or AAS25 "Accrued Benefits" values (less likely to be available annually) may be useful measures of the direction of any change in a fund's financial position. Thus, a possible notifiable event may be a fall in vested benefit coverage to less than "x"%. However such measures should not be used as the only notifiable events, as the measures are not continuous (for example, not reacting to a fall in asset values until the date benefits are recalculated), unless the actuary is satisfied that measurement of the index is sufficiently frequent that the probability of undetected technical insolvency occurring between measurements is low enough to accord with the principles in section 1.4 of this Guidance Note. The actuary should also be satisfied that a resulting index of less than "x"% will be properly notified to the actuary, either directly or via the Trustees.

1.7 Asset Values

The Regulations refer to the relevant asset value as "net realisable value" of the assets of the fund.

Where the accounts of the fund are relied upon in deriving a value of assets, the actuary should be satisfied that the valuation methods applied to individual items in the accounts are appropriate. Particular attention should be paid to items that are vulnerable to changes in circumstance including future income tax benefits, reserves for capital gains or other tax, assets dependent on the continuing operation of the employer, assets whose value is contingent on certain events, and any assets which represent a significant proportion of the total fund assets. Assets whose values are subjective, such as property and unlisted shares, should be given careful consideration.

In determining the relevant values, the actuary should note the relevant definitions in the SIS Regulations as they apply to different circumstances of funds (Reg. 9.15 for net realisable value of the assets for a normal certification, and Reg. 9.21 for the value for a fund on wind-up).

1.8 Former Members - Benefit Entitlements

Regulation 9.15 defines "BEF" as the value of benefit entitlements for former members, and requires that this amount be subtracted from the asset values before determining the solvency measure.

Some funds may classify ex-employees who have not taken their benefit as continuing members of the fund. In measuring solvency under this Guidance Note, actuaries should consider the benefit applying to members who have ceased employment, and consider whether such members should be treated as "former members" for this purpose (regardless of the wording used in the fund's governing rules).

2. TECHNICAL INSOLVENCY - DEFINED BENEFIT FUNDS

2.1 An Insolvent Fund

A defined benefit fund (used for SG purposes) which becomes technically insolvent is subject to actuarial control during a period of actuarial management. Regulations 9.16 to 9.19 inclusive apply to such funds.

2.2 "Technical Insolvency"

"Technical Insolvency" is effectively defined in Regulation 9.06 (3) as a condition where the MBI is less than 1.

2.3 Special FSCs

A special funding and solvency certificate with a duration of up to twelve months is required for these funds (Regulation 9.18). Consecutive special FSCs are permitted covering a period of up to 5 years.

2.4 Control Period

The actuarial control period is intended to permit the fund an opportunity to return to solvency. The actuary should discuss options with the Trustees and the employer, but ultimately must take responsibility for the program.

2.5 Means of Control - Contributions and Benefits

Under the Regulations the employer must make the contributions specified in the relevant FSC. The Trustees may only make payments from the fund subject to actuarial approval.

Options may include, but are not limited to:

- requiring the employer to meet a proportion of the benefit payments arising during the period of control by way of additional contributions to the fund (subject to the provisions of the fund's governing rules);

- requiring that benefits be paid in instalments over a period of time (subject to the provisions of the fund's governing rules);

- requiring that benefit entitlements be retained within the fund until solvency is established.

2.6 Means of Control - Investment Policy

While investment policy is not explicitly mentioned in Part 9 of the Regulations, the actuary should consider whether continuing certification should be subject to some recommended constraints on the investment policy.

2.7 Means of Control - Insurance Policy

While insurance policy is not explicitly mentioned in Part 9 of the Regulations, the actuary should consider whether continuing certification should be subject to some recommended constraints on the insurance policy.

2.8 Change of Responsible Actuary

An actuary responsible for the control of a technically insolvent fund may be replaced by another actuary under Regulation 9.19.

An actuary who is requested to take the place of an existing responsible actuary should consider the need to confer with that existing actuary to ensure that there is no professional reason why the appointment should not be accepted. While this applies generally under The Institute's Code of Conduct, it may be of particular importance in situations where a fund's "solvency" is of concern.

3. TECHNICAL INSOLVENCY - ACCUMULATION FUNDS

3.1 Application

Accumulation funds are also required to be placed under actuarial control during a period of technical insolvency, under Division 9.6 of the regulations.

3.2 Approach

The approach adopted to manage these funds out of insolvency may be similar to that applied to defined benefit funds. In particular, the options shown under section 2.5 above are relevant to these funds also.

The actuary should investigate the causes of the insolvency, and consider whether any changes are desirable to reduce the chances of a recurrence. Options may be to vary administrative practices (e.g. concerning the treatment of fund expenses), to revise the policy of determining crediting rates, or to alter the reserving policy.

4. MISCELLANEOUS

4.1 Miscellaneous

An FSC should normally not have a duration which extends beyond the expiry date of the relevant Benefit Certificate which specifies the MRBs for the fund. This may cause some timing difficulties due to the replacement timing requirements detailed in the Regulations (e.g. where a Benefit Certificate has a term less than the 5 years permitted under the SG Regulations due to the lack of a decision on how a future increase in the Superannuation Guarantee level is to be accommodated).

The Institute believes that it would be reasonable for an FSC to specify an assumed MRB basis for the period after the expiry date of a current Benefit Certificate and within the duration of the FSC, provided that the FSC includes as a notifiable event the failure to issue a Benefit Certificate on the assumed basis when that time comes. If an MRB basis is assumed as described above, the assumed MRB should be defined in the FSC as precisely as it would be in a Benefit Certificate.

The actuary should take all reasonable steps to review the fund experience from the effective date of the certificate until the date of signing it, so that any statement under Regulation 9.11(4) is likely to be reliable in the light of such experience

4.2 Contents of certificates

A certificate detailing the fund's solvency, and specifying the minimum contributions should include

- the name of the fund
- the effective date of the certificate, and its expiry date
- the solvency certification
- the minimum rate or rates of contribution for the duration of the certificate, and manner of payment (e.g. by instalments)
- a statement in terms of regulation 9.11(4) if relevant
- the date of the Benefit Certificate which specifies the Minimum Requisite Benefits to which the FSC relates, as well as the actuary's name and the expiry date of the Benefit Certificate
- specification of any 'notifiable events'

- any recommendation in regard to investment strategy or insurance policy

- in a special funding and solvency certificate, requirements as specified in Regulation 9.18

- in a special funding and solvency certificate, any scheme for payment of benefits in terms of Regulation 9.19.

- the name, business address, qualifications and signature of the actuary

- the date of signing of the certificate.

The certificate should state that it has been prepared in accordance with this Guidance Note.

END OF GUIDANCE NOTE 461