14. Surpluses and reserves

Introduction

14.1. There has been considerable attention paid to the issues of surpluses and reserves in recent years. The existence, creation and ownership of surpluses and reserves raise issues of equity and legality. The Review considers that it is important, especially in the light of the increasingly important role of superannuation, that these issues be resolved. This chapter makes recommendations to clarify, where possible, current uncertainties relating to surpluses and reserves.

Surpluses

Defined benefit schemes

14.2. *Two types of surplus.* There are two types of surpluses in defined benefit schemes: an actual surplus of assets over liabilities on termination of a scheme or an actuarial surplus, estimated for an on-going scheme. An actuarial surplus is the actuarially assessed excess of the assets of a scheme over its estimated liabilities. That is, it is simply an estimate of the degree to which existing investments will be more than enough to provide for accrued benefits.[1] There is no simple rule for determining the existence of a surplus, because its calculation is largely dependent on the underlying actuarial assumptions.

14.3. *How a surplus occurs.* A surplus may arise in a defined benefit scheme for several reasons. For example, the scheme might have a more favourable investment performance than was allowed for when the employer's contribution was calculated, or there may have been a lower than expected rate of inflation. Alternatively, the employer may have contributed more than necessary, either inadvertently or as the result of a deliberate policy to minimise tax by directing money into the superannuation scheme.[2] Alternatively, there may have been a

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1. Where a fund is on-going the alleged surplus is a purely notional one: *Re Imperial Foods Ltd's Pension Scheme* [1986] 2 All ER 802; see also Lord Browne-Wilkinson *Equity and its relevance to Superannuation Today* 1.20.
2. Contributions in excess of those required to fund the scheme are taxed at the same concessional rate as those required to fund the scheme. If they are subsequently repatriated to the employer as part of a surplus, the employer is not required to pay the difference between the 15% contributions tax and the 39% corporate tax. From 1995, however, employers will not be able to minimise tax in this way. When concessionally taxed contributions are returned to the employer, the employer will be required to pay the additional 24% tax.

higher than expected attrition rate of members before their interests vested fully. This may occur because of redundancies, retirements or as a result of corporate strategy involving retrenchment of employees before their interests vest.[3]

14.4. *Ownership of the surplus.* There are no clear guidelines, under existing law, as to how surpluses in defined benefit schemes are be to distributed between sponsor and members. There are a number of possibilities:

- contribution holidays, that is, use the surplus to reduce or suspend employer or member contributions
- improve benefits to members
- transfer some or all of the surplus to another scheme with a group of outgoing members
- return all or part of it to the employer while the scheme is continuing
- leave it indefinitely, in anticipation of a future economic downturn or relaxation of benefit limits.[4]

Deeds or other instruments constituting schemes rarely make provision in this regard. The most relevant usual provision is that, upon partial or complete winding up of the scheme the assets should be, on the advice of an actuary, equitably apportioned among the members as at the date of winding up and held in trust for them. The deed is often silent as to the ownership of any actuarial surplus that may arise from time to time. Given the failure of many trust deeds to address the issue of disposal of an actuarial surplus adequately, legislative direction may be necessary to clarify these issues and to avoid further litigation and the need to amend trust deeds.

14.5. *Ownership of the surplus overseas.* In the USA, specific legislation allows the actuarial surplus in a defined benefit scheme to revert to the sponsoring employer primarily when the employer has over-contributed because of a mistake of law or fact or an actuarial error[5] and provided the plan specifically allows such a surplus to be returned to the employer. In addition, any amendment providing for this return is not effective until five years after it is adopted. In the UK, ownership of an actuarial surplus is not determined by legislation. The case law in the US tends to the view that, in a defined benefit scheme, the employer has a moral claim to the actuarial surplus; however, the matter ultimately depends upon the drafting of the deed.

3. Schemes in which this occurred were known as 'cherry picker' schemes. The practice was eliminated some time ago.
4. Bakel 'Superannuation Fund Surpluses: To Whom do they Belong' (1991) *Australian Business Law Review* 404, 423; see also E Slater *Superannuation Fund Surpluses* 12,411-2.
5. This does not include the situation where the employer used the fund as a tax shelter.

14.6. ***Proposal.*** In DP 50 the Review proposed that deeds for defined benefit schemes should be required to include provisions to deal with the distribution of surpluses while the scheme is operating and on its winding up. It proposed that provisions should be subject to guidelines established by the regulator about how a surplus is to be established and how it should be distributed. For accumulation schemes, the Review proposed that deeds should provide for the distribution between remaining members of surpluses created by members leaving non-vested employer contributions behind when they leave a scheme.[6]

14.7. ***Submissions.*** It appears from submissions that there is considerable uncertainty regarding the treatment of surpluses in superannuation schemes. ASFA agrees that many deeds fail to address adequately the issue of the disposal of a surplus, even on a winding up. There seems a general concern that any attempt to clarify the situation may be too restrictive and work to the disadvantage of the employer. Some submissions suggested that, if legislation prevented the return of 'excess' funds to the employer, there would be a strong disincentive to provide any level of funding higher than the minimum necessary to provide the defined benefit.[7] Others went even further.

> Such action would almost ensure that employers underfund rather than overfund their defined benefit plans. As a result, while some members might gain some access to existing surpluses in the short term, the medium to long term effect would be to significantly reduce the security of members' benefits in such funds.[8]

14.8. ***Recommendation.*** An actuarial surplus is only an estimate arrived at by an actuary. It is for this reason that great care should be exercised in dealing with such a surplus. As was acknowledged in many submissions, actuarial surpluses can quickly vanish, for example, if there is a sharp drop in the value of the scheme's investments.[9] The Review is strongly of the view that there should be restrictions on how an actuarial surplus can be used. It should not automatically be returned to the employer at its discretion. It is true that employers bear the investment risk in defined benefits schemes. But there is always the possibility that an employer will be unable to pay the promised benefit when the time comes. For this reason, the Review's attitude is that employers should not be able to repatriate an entire surplus. The Review therefore recommends that an

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6. These contributions are known as forfeited benefits. OSS Regulations reg 17A a reallocation of amounts previously held for particular members. The application of such forfeited benefits for any purpose approved by the ISC is also allowed. Such purposes have included repatriation to the employer.
7. See, eg Institute of Actuaries of Australia *Submission* February 1992.
8. ASFA *Submission* March 1992.
9. See eg ASFA *Submission* March 1992.

employer should only be able to repatriate up to 50% of a surplus in any accounting period, and only with the agreement of the responsible entity. Further, before any repatriation, members must be advised about the cause of the surplus and about how it is proposed to deal with it. An employer should, however, be able to repatriate more than 50% of a surplus with the approval of the regulator. The approval of the regulator is a more appropriate check than the agreement of members because it will take the issue out of the industrial arena. The regulator may be in a better position to assess the liquidity of the scheme and its ability to withstand the repatriation of more than 50% of the surplus. Finally, the Review recommends that any inconsistent provisions in the governing rules of a defined benefit scheme should be void.

Recommendation 14.1: Surpluses not to be repatriated

The law should provide that it is an offence for the responsible entity for a superannuation fund to pay a person who is liable to make contributions to the fund, except a member, any amount representing the whole or some of a surplus in the fund except as follows:

- **an actuary has certified that there is a surplus in the fund**
- **the amount, or the sum of the amounts paid since the certificate was given, must not be more than 50% of the amount certified by the actuary as the amount of the surplus unless the regulator, subject to review by the AAT, has given written approval to making the payment**
- **the responsible entity must have given to the members of the fund written notice of its intention to make the payment not less than 2 months before the payment is made.**

Recommendation 14.2: Deeds etc. to make provision for surpluses

The law should provide that a provision in the deed or other instrument constituting a superannuation fund that makes provision inconsistent with Recommendation 14.1 is void to the extent of the inconsistency.

14.9. *Deficits in defined benefit schemes.* Every three years an actuary must make an assessment of the contributions that are needed to enable the scheme to pay the benefits promised under the deed. Actuaries usually recommend a range of amounts within which the employer can choose to contribute. If employers do not have to make these contributions they may, whilst reaping the benefits in good times by repatriating the surplus, be able to avoid contributing appropriately to the scheme. The Review notes that the Accounting Standards Board has proposed that deficits in employer sponsored defined benefit schemes

should be recorded in the organisation's balance sheet as a liability.[10] By requiring shareholders and creditors to be advised of this 'obligation' the Board is reflecting the general community expectation that the employer's commitment to fund its defined benefit superannuation scheme is genuine. Failure to meet the commitment to the scheme will be reflected in the valuation of the firm. The members of the scheme, as well as the shareholders and the market generally, should be informed directly if the employer does not propose to make any of the actuarially determined contributions. The responsible entity should be required to ask the employer about its intentions and report the results to members in the next annual report. There is a further precaution that ought to be required. Any deficit in a defined benefit scheme should be reported to the regulator with a statement by the responsible entity as to how it proposes to fund the deficit. Opposition to these proposals stressed that superannuation provided voluntarily by employers in excess of the SGL legislation requirements should not be subject to this kind of regulation. To the extent that this concern reflects the view that employers should have the right not to fund benefits in defined benefit schemes,[11] when they are able to do so, it is rejected by the Review. The Review does not accept that such promises, made in the context of the contract of employment, should be able to be made worthless at the employer's election without just cause. In principle, these recommendations should apply equally to both the private and public sectors. It is acknowledged, however, that several government provided defined benefit schemes have significant deficits and that the governments sponsoring them would be unable to pay immediately the contribution required to fund the actuarial deficit. A lengthy transition period may therefore be required for those schemes.

Recommendation 14.3: Employers to disclose intention about deficits in defined benefits schemes

The law should provide that, if an actuary certifies, in relation to a single employer defined benefit superannuation scheme, that the employer must make a particular contribution, or a contribution of not less than a particular amount, to the fund to ensure that benefits reasonably likely to become payable by the scheme will be able to be paid

- **the responsible entity for the scheme must, without delay, request in writing from the employer advice as to whether the employer proposes to make such payments**
- **the employer must give a written reply containing that advice within 3 months after the request is given**

10. Australian Accounting Standards Board, ED 53 *Accounting for Employee Entitlements.*
11. Also known as benefit promise schemes.

- **the next annual report to members must include a statement of the effect of the actuary's certificate, and a copy of the employer's response.**

Failure to comply should be an offence.

Recommendation 14.4: Deficits in defined benefits fund to be reported

The law should provide that, if an actuary certifies to the responsible entity for a defined benefit fund that there will be a deficit in the fund, the matter must be reported without delay to the regulator, and the responsible entity must inform the regulator how it proposes to deal with the matter. Failure to comply should be an offence.

Reserves

Background

14.10. *Creating reserves.* Reserves are created when some of a scheme's investment returns are not allocated to members' accounts but instead credited to a separate reserve account. Reserves are designed to protect against years when investment returns are low or negative and to enable a scheme to provide, during such a time, benefits comparable to those paid to members who retired when yields were higher. Because reserving involves holding back investment income from members' accounts, a question arises whether, as a matter of policy, schemes should be permitted to create reserves.

14.11. *Reserves and trust law.* The creation of reserves may, arguably, be a breach of trust, as the benefits paid to members who resign or retire during periods of high return are diminished to subsidise others. Opponents of the right to create reserves also argue that their existence may make the responsible entity less vigilant because it is able to use reserves to declare a return on investments that it would not otherwise have achieved.

14.12. *Reserves and investment strategy.* A responsible entity may have an obligation under the deed not to declare a negative earnings rate. There is in any event a natural disinclination to declare such an earnings rate. It may therefore invest conservatively to ensure a positive rate of return every year. The scheme will, therefore, earn a lower overall rate. This is significant because, even a small reduction in the earnings of the scheme will result in a very significant reduction in the payout to members on resignation or retirement.[12] A conservative policy

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12. eg the difference between a 12% and 13% earning rate on $1000 per year for 30 years has been calculated to make a difference of 23% to the final sum: Bankers Trust Australia Limited *Submission* December 1991.

will, in effect, disadvantage all scheme members, including those who leave the scheme during times of high investment returns. If, on the other hand, a policy of allowing reserves to build up is permitted, the fund is able to pursue more aggressive but not more risky investment strategies which will in turn result in a more volatile rate of return. Such a strategy will also tend to yield a higher average rate of return over time, which is clearly in the interests of all members. The Treasurer's proposals for improved disclosure includes the reporting of a scheme's reserving policy to its members.[13] This seems to indicate that Commonwealth policy accepts reserving as an acceptable management strategy for superannuation schemes.

DP 50 proposal

14.13. It seems appropriate that to remove any doubt about the legality of reserving, legislation should provide that reserving by the responsible entity should not constitute a breach of trust. In DP 50 the Review proposed that the law be amended to clarify whether the establishment of reserves is a breach of a responsible entity's fiduciary obligations.[14]

Response to discussion paper

14.14. A small number of submissions recommended the prohibition of reserves. For example, the Reserve Bank saw no reason for reserves in accumulation schemes.

> [R]eserves in such funds may lead to inequitable treatment between fund members over time, and reserves might be used to obscure the actual performance of the fund.[15]

The overwhelming majority of submission, however, support reserving.[16]

> [T]he fluctuations in results which would occur if there were no reserves are likely to be less acceptable to superannuation scheme members than any deferral of receipt of investment returns implicit in the establishment of reserves. More importantly unless there is reserving many responsible entities will find it

13. Treasurer's statement, paper 2 para 10(h).
14. DP 50 proposal 10.4.
15. Reserve Bank *Submission* March 1992; see also Australian Friendly Societies Association *Submission* February 1992.
16. See eg KPMG Peat Marwick *Submission* February 1992; ASFA *Submission* March 1992; AMP Society *Submission* February 1992; Mercer Campbell Cook and Knight *Submission* February 1992; Australian Retirement Fund *Submission* February 1992; ACTU *Submission* March 1992.

necessary to adopt short-term investment strategies, quite probably to the long-term disadvantage of the members of superannuation funds, and the Australian community in general.[17]

Recommendation

14.15. The Review agrees that reserving should be permitted subject to the general fiduciary principles underlying the obligations of the responsible entity. Any disadvantage to members is outweighed by the overall benefit of the higher returns that are possible when trustees adopt less conservative investment strategies in the knowledge that there are reserves to smooth any negative returns. Accordingly, the Review recommends that the law should make it clear that the establishment of a reserve will not of itself constitute a breach of trust. However, the Review does not recommend that reserving be required.[18]

Recommendation 14.5: Reserving not to be a breach of trust

The law should provide that a responsible entity for an eligible scheme does not contravene their fiduciary obligation to the members imposed by law, merely because the responsible entity credits amounts to reserves in the scheme in accordance with a policy that itself is prudent.

17. Institute of Actuaries of Australia *Submission* February 1992.
18. The Review also recommends that a scheme's reserving policy, the amount credited to reserves and the source of the amount be disclosed to members annually: recommendation 10.20.