



Centre for International
Finance and Regulation

Towards Financial System Integrity

Research Working Paper Series

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**WORKING PAPER NO. 004/2014
MARCH 2014**

www.cifr.edu.au

This research was supported by the Centre for International Finance and Regulation (project number E045) which is funded by the Commonwealth and NSW Governments and supported by other Consortium members (see www.cifr.edu.au).

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RESTORING A LEVEL PLAYING FIELD *for defined benefits superannuation*

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After declining worldwide since the late 1980s, defined benefits plans will not recover their previous dominance in Australia because they can only be offered by large and stable organisations. Since 1992 Australia has had compulsory superannuation that is mostly privately managed. In addition, several policy measures have unduly weakened defined benefits schemes, especially in the private sector. Rescinding these measures would revitalise defined benefits, and produce a deeper market for privately managed lifetime annuities. An earlier version of this paper was presented to the 2013 Australian Centre for Financial Studies' Melbourne Money and Finance Conference.

In defined benefits superannuation plans, retirement benefits are calculated partly by reference to the salaries of plan members. Since the late 1980s these schemes have declined worldwide relative to defined contributions (accumulations) superannuation. By June 2012 defined benefit balances in Australia stood at just 21 per cent of accumulation plan balances and these schemes will not recover their previous dominance here. The main reason is that defined benefits can only be offered by large and stable organisations. With compulsory superannuation in Australia since 1992, which is (mostly) privately managed, accumulation plans are the only viable options for the small- and medium-sized enterprises which are our main employers. By the same token, several policy measures since the late 1980s have weakened defined benefits, especially in the private sector. Rescinding these measures would revitalise defined benefits, with a by-product being a deeper market for privately-managed lifetime annuities.

One adverse tilt of the playing field was the introduction in 1988 of 15 per cent taxes on superannuation fund earnings and employer contributions. Next, the mid-1990s saw ownership of surpluses in defined benefit plans being shifted from plan sponsors to all 'stakeholders' in the enterprise, including plan members. A trustee seeking to repay fund surplus to an employer became effectively obliged to use part of the surplus for the purpose of enhancing employee benefits. Moreover, after 1995, enterprises were no longer allowed to claim a refund of the 15 per cent tax on employer contributions when they drew down surpluses. These measures made defined benefits more expensive to operate. They also discouraged over-funding of a defined

benefit plan, which serves the dual purpose of protecting members and buffering financial shocks to a business. Yet another tilt of the playing field during this period was compulsory vesting of employer-funded benefits accrued in defined benefit plans over and beyond the percentage of salary mandated by the superannuation guarantee. Most defined benefit plans have involved higher employer contributions than the prevailing compulsory rate of employer contributions.

At the same time, defined contribution plans have been encouraged, both in Australia and worldwide. Two factors were particularly important in Australia: the introduction of mandatory superannuation in the form of a compulsory employer contribution and the increasing concern about public sector deficits. The latter led to a large-scale transition, starting over 25 years ago, from defined benefit pensions largely funded on a pay-as-you-go basis to defined contribution plans paying lump sums at retirement. For new entrants, only the military and the judiciary retain publicly-funded defined benefit pensions (Bateman and Piggott 2011). Internationally, the trend (most prevalent in the United States and the United Kingdom) has been driven by the move to market-based accounting changes and an increased regulatory burden as well as funding pressures due to the long-term decline in interest rates, along with increasing longevity (Broadbent et al. 2006; OECD 2011).

Of course, no particular type of fund is unambiguously dominant. However, in the case of large and stable enterprises, defined benefits offer several appealing features that can be shared by

Defined benefits simplify decisions faced by people saving for retirement. The notion of a target replacement rate remains popular. Accumulations superannuation requires non-trivial calculations to translate a lump sum into an equivalent flow of income for the duration of a household's retirement, particularly when estimating the volatility of that flow (i.e. not just its expected level.) Defined benefits, by contrast, typically delegate such decisions and calculations to the plan sponsor. This eases the computational burden on households.

employers and long-serving employees. Defined benefit plans cross-subsidise long stayers at the expense of job switchers: long stayers enjoy better vesting of their benefits, and often also enjoy 'back-loading' whereby the benefit formula delivers a higher internal rate of return to them. Loyal and farsighted people therefore become more likely to self-select for job vacancies. Benefits that are strongly linked to final salaries motivate employees to strive for promotion, thereby becoming more productive. A maximum span for contributing to a defined benefit plan (typically 30 years) helps to motivate timely retirements on the part of elderly employees with declining productivity. Finally, risk-averse employees may accept substantially lower salaries in exchange for a retirement benefit promising a measure of income replacement for the duration of a household's retirement.

Defined benefits plans ease the burden on taxpayers. They are particularly suitable vehicles for providing private retirement benefits in the form of lifetime annuities, thereby lightening the burden of providing public longevity insurance. Current policy does little to discourage 'double dipping' whereby lump sum retirement benefits that have been accumulated in a tax-concessional environment end up being used for things such as extensions to a family home whose residents claim the age pension. Indeed, even when defined benefits were more popular in Australia, it was often possible to commute the benefits to lump sums, and this option was often exercised by retiring workers.

Defined benefits facilitate the sharing of investment risk across different cohorts of the population. Take the 'retirement risk zone' that spans the last few years of working life and the first several years of retirement. An accumulation fund member, accepting the conventional industry advice to maintain a high lifelong exposure to growth assets, runs the risk of events such as the global financial crisis while traversing the retirement risk zone. They could end

up scrimping and saving rather than making the most of the active period of retirement. Harmer (2009 p. 15) noted: 'Age pension applications in December 2008 were around 50 per cent higher than the number recorded in October of the same year'. Retirees and taxpayers alike were the losers.

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For these reasons we propose rolling back the policy changes late last century that tilted the playing field against defined benefits. In doing so, we are not advocating a universal return to defined benefits, but rather a policy shift to remove the barriers to the provision of defined benefit plans by large and stable firms at their discretion. As we have argued previously, within the context of defined contributions, workers could be gradually allowed to build up accounts taxed only in retirement and at the marginal income tax rate of the retired worker. This would gradually remove two tax disincentives from building up surpluses in defined benefit funds: the 15 per cent tax on employer contributions, and the 15 per cent tax on fund earnings. Surpluses could again become a tax-efficient source of financial slack to large enterprises, thereby promoting financial stability of the economy as a whole. The Superannuation Industry Supervision Act 1993 could be changed so as to confer on sponsors clear ownership of surpluses in defined benefit funds. Finally, a short stayer with an enterprise could be entitled to vesting of employer-financed benefits only up to the level where the benefit would have stood had they been in an accumulation fund paying the minimum compulsory employer contribution.

We would not envisage a big difference from these rollbacks in the short term. Rather, they would promote stronger and more numerous defined benefit plans in the long term, and could be seen as part of a long-term effort to promote lifetime private annuities in Australia.

Defined benefits in decline

Broadbent et al. (2006) and Turner and Hughes (2008) comment on the decline in defined benefits around the world. The former paper examines Australia, Canada, the United Kingdom and the United States. The latter paper considers the same group except that Ireland replaces Australia. In all

cases the decline in defined benefits dates from the mid-1980s. Canada appears to have experienced the least sharp decline.

The common causes of this decline are: increased job mobility; more women in the paid workforce (entailing less family attachment to particular employers); fewer workers in unions; lower interest rates (entailing higher defined benefit liabilities, especially for defined benefit plans offering pensions); and increased longevity.

Turner and Hughes emphasise that new regulations (adopted internationally) have also made life more difficult for sponsors of defined benefit plans. Compliance has become more expensive. The rise of the 'stakeholder' perspective on enterprises saw surpluses treated as being jointly owned by plan sponsors and beneficiaries rather than sponsors alone. Increasing concerns about tax expenditures saw limits on permissible overfunding. The time given to a sponsor to amortise a deficit tended to shorten. Accounting rules changed. For example, there was a shift to mark-to-market principles for valuing corporate assets and liabilities. As a consequence, sponsors of defined benefits faced increased volatility in their earnings statements. This was at odds with the well-known preference, by managers and shareholders alike, for smooth earnings.²

The decline of defined benefits in Australia followed a similar timetable to the declines in Canada, Ireland, the US and the UK. Moreover, the reasons were similar. The biggest difference was our introduction in 1988 of a 15 per cent tax on employer contributions and fund earnings.³ Accumulation plans can readily pass on the new taxes to members. By contrast, the short-term incidence of a tax on established defined benefit plans falls largely on plan sponsors. They naturally considered closing down plans to new members, and the legal and industrial consequences of shifting employees into new schemes, generally accumulation ones. Continued threats to the stability of our front-end superannuation taxes suggest that allowing new employees to join existing defined benefit plans looks increasingly courageous.

The Australian Prudential Regulation Authority (2007) indicated that 82 per cent of members belonged to defined benefit funds in 1982-83. Twenty years later, less than 2 per cent of members belong to 'pure' defined benefit funds. At June 2012, only 30 of the 352 large (APRA regulated) superannuation funds were 'pure' defined benefit funds, while only 17 per cent of superannuation assets of large superannuation funds were held by so-called defined benefit members (see Table 1 which summarises Table 16 in Australian Prudential Regulation Authority (2012)).

The Occupational Superannuation Standards Act (1987), replaced by the Superannuation Industry (Supervision) Act (1993), raised the bar for the vesting of benefits arising from employer and employee contributions. This made defined benefits more expensive to operate, as short stayers no longer cross-subsidised other plan members to the same extent.

In the mid-1990s, further regulatory changes created adverse consequences for sponsors of defined benefit plans.⁴ One was the introduction of maximum deductible contributions whereby tax deductions allowed for employer contributions were capped. Another involved a push by unions to ensure part of any repaid fund surplus was used to upgrade employee benefits, via the Industrial Relations Commission rather than the regular courts.⁵ The government chose not to intervene, instead allowing the new industrial case-law to stand. The SIS Act instituted new hurdles for employers seeking to repay fund surpluses to shareholders. In 1995 funds became legally ineligible for a rebate of the 15 per cent tax on employer contributions if they repaid fund surpluses to stakeholders, even though the 1988 15 per cent tax on fund earnings was already actively discouraging fund surpluses.

Stronger Super (Australian Treasury 2010b) considered the sorry state of defined benefit funds. It noted the decline in defined benefits over the past three decades. It noted also that APRA had taken a 'rather "light touch" enforcement role' (p. 176),

TABLE 1: Structure of retirement benefits, Australia, \$ million

Year (June)	Actual assets by fund structure			Estimated assets by member benefit type	
	Accumulation	Defined benefit	Hybrid	Accumulation	Defined benefit
1995	71,164	35,216	56,108		
2000	179,375	24,262	147,689		
2005	270,480	49,585	225,132		
2010	357,037	57,870	379,925	654,995	139,838
2012	340,721	63,630	513,080	758,958	158,473

Source: Australian Prudential Regulation Authority (2012), Table 16.

Notes: Numbers in the right-hand column are estimates. Defined benefit assets include defined benefit members who may also have an accumulation component. Entities with four members or less are excluded.

In the push for universal coverage of accumulation superannuation plans, some valuable characteristics of defined benefits have been overlooked. These advantages include scope for efficiency gains in bargains between employers and employees, certainty and simplicity of retirement benefits, and better management of investment and longevity risk. As mentioned at the outset, we are not advocating an across-the-board move back to defined benefits. Rather, we advocate the restoration of a level playing field, by reversing a number of policy measures that were introduced over the past quarter of a century.

having concerned itself primarily with ensuring that minimum requisite benefits⁶ are covered, rather than actual vested benefits. Yet minimum requisite benefits are typically less than actual vested benefits and are not reported to plan members.

The Super System Review (Australian Treasury 2010a), in line with an argument put to it by the Institute of Actuaries of Australia, noted: 'the current focus in the SIS Act on solvency and minimum requisite benefits does not help trustees who undertake the process of negotiating higher employer contributions' (p. 177). Following the conventional view of Australia's official family, however, the Review said without comment or explanation that 'it is desirable that large surpluses not be created' (p. 177).

Stronger Super recommended that APRA issue a prudential standard that focused on the protection of vested benefits rather than minimum requisite benefits. The review responded that it did 'agree in principle' (p. 43). The review recommended also that the SIS Act be amended so that a defined benefit fund which is technically insolvent yet not on track to restore solvency should be barred from accepting contributions stipulated by the superannuation guarantee. The review responded: 'The Government notes the recommendation' (p. 44). The government is starting to address these matters with the development of prudential standards on defined benefit matters.⁷

Options analysis of 'stakeholder' defined benefits

A number of analytical contributions decompose the balance sheets of standard defined benefit funds into an exchange of options between members and the plan's sponsor.⁸ Assets less liabilities constitute

the surplus of the fund. In effect, the sponsor grants members a put option on the risky assets underlying the scheme, insuring members against investment risk. The 'put' is in the money whenever the surplus is negative. A run of low returns generally obliges the employer to make extra contributions.⁹ Effectively, members grant the sponsor a call option on the surplus. The 'call' is in the money whenever the surplus is positive, making the scheme cheaper to operate; a run of high returns on fund investments entitles the sponsor to a contributions holiday or a return of the scheme's surplus.

'Stakeholder' defined benefits grant members a share of surpluses without removing downside protection. Retirement benefits become call options on the sponsor that are 'in the money' whenever the surplus is positive. Plans modified in this way become more expensive to operate (see Figure 1).

In Figure 1 the horizontal axis measures the market value of the assets underlying the scheme. The vertical axis measures the present value L of retirement benefits owed to members of the scheme, also known as its projected benefit obligation. Retirement benefits are ordinarily unaffected by market fluctuations in asset values, hence the invariance (in principle) of the schedule DB with respect to assets in the DB fund. If the surplus is always maintained at zero, the call C and the put P will both have zero value.

Now consider 'stakeholder' defined benefits whereby members participate in surpluses. The sponsor is worse off. Members are better off, but without gaining one-for-one from rises in the prices of risky assets. The associated payoff profile is roughly analogous to that of a collar whereby investors go long in a risky underlying asset and a put, and short in an out-of-the-money call. Bateman (1997) investigates designs for accumulation funds with investment risk managed by collars. She found that such strategies are surprisingly conservative; expected lifetime returns are surprisingly low. That is, investors forego valuable upside if they pay for put protection partly by selling out-of-the-money calls.

Restoring a level playing field

Within the context of accumulations superannuation, we have previously argued for a new kind of superannuation account.¹⁰ It would co-exist with the familiar accounts paying lump sums to retirees. These new accounts would be reserved for the purchase of life annuities. Like existing accounts, they would be subject to contribution limits. But these limits would initially be low, to protect the budget in the short term. Unlike existing accounts, the new accounts would be tax free until retirement, at which point their annuity payments would be subject to the regular personal tax scale. Progressive back-end

taxes would resolve the recent wrangles on how to get the right amount of progressivity into taxes on superannuation. Once annuitised, exposure to growth assets within the new accounts would be capped at 50 per cent. This cap would cut the risk of paying hefty super taxes through the accumulation stage and then retiring on a meagre income in the wake of a market crash on the cusp of retirement. Superannuation contributors could open either or both types of account, paralleling recent initiatives in the United States and Canada.

These new accounts would also suit stakeholders in defined benefit plans. An increasing option not to pay taxes on employer contributions and fund earnings would encourage sponsors to overfund defined benefit plans. This would gradually mitigate the credit risks increasingly faced by members of defined benefit plans in Australia. Defined benefit plans (at least in overseas jurisdictions) traditionally pay benefits in the form of an income stream. People enjoying a stable private income stream for the duration of a retirement are less likely to qualify for an age pension at some point, so government outlays would fall: future budgets would be better off, admittedly at a cost to near-term budgets,

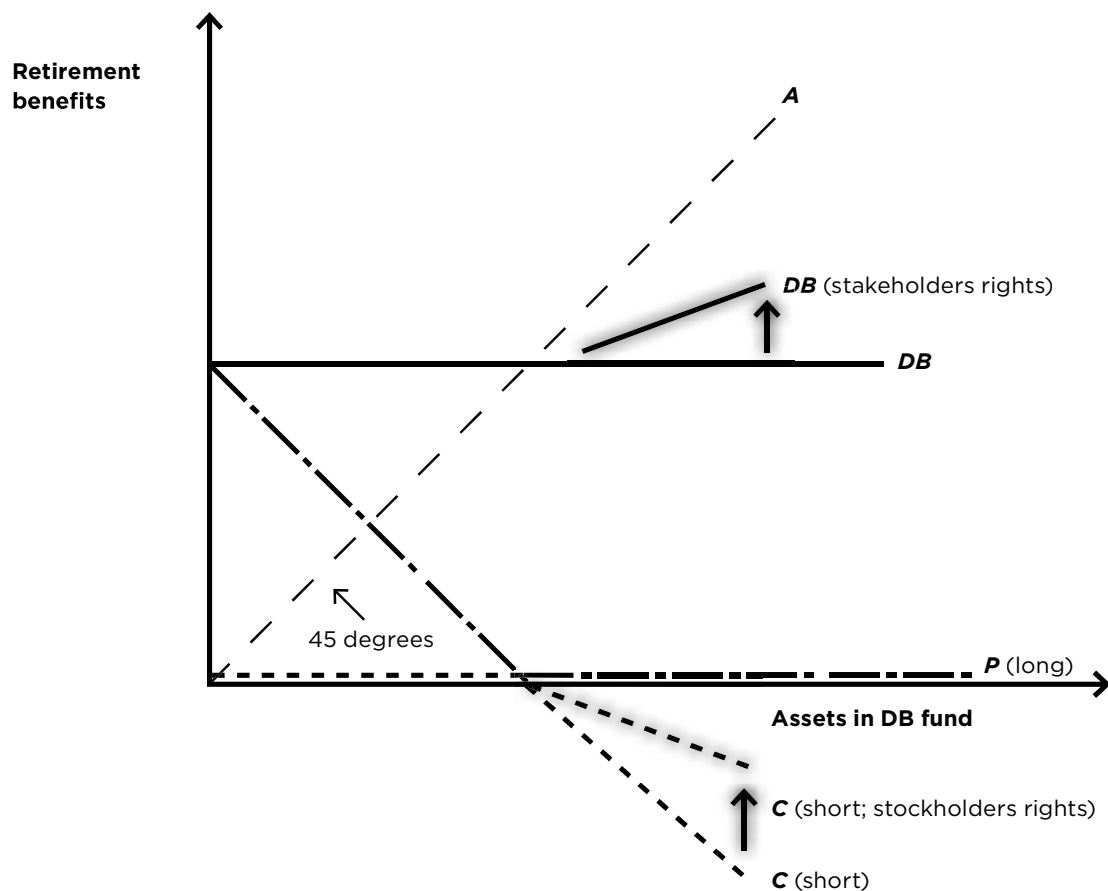
which benefit from the current 15 per cent taxes on employer contributions and fund earnings.

The SIS Act could be amended so as to restore a limited measure of cross-subsidisation of defined benefit funds by short stayers. Specifically, employers could be granted the option of vesting employer contributions on behalf of new members who end up with less than 10 years' service — at the amount the departing member would have received had his employer benefit been limited to the amount mandated by the superannuation guarantee over the relevant period.

We could roll back the mid-1990s measures designed to encourage 'stakeholder' defined benefits and discourage fund surpluses. In particular, the SIS Act could be amended so as to grant full ownership of surpluses to shareholders. It could also be amended to ensure independent trustees with actuarial qualifications on the boards of trustees of defined benefit schemes. Finally, maximum deductible contributions could be increased.

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FIGURE 1: Options analysis of 'stakeholder' defined benefits



advantages include scope for efficiency gains in bargains between employers and employees, certainty and simplicity of retirement benefits, and better management of investment and longevity risk. As mentioned at the outset, we are not advocating an across-the-board move back to defined benefits. Rather, we advocate the restoration of a level playing field, by reversing a number of policy measures that were introduced over the past quarter of a century. ■

Notes

1. Bateman and Kingston would like to thank the Australian Research Council for research support under DP120102239, and Kingston would like to thank the Centre for International Financial Regulation for research support under EO45. We would also like to thank Shauna Ferris for helpful discussions.
2. Australia has partly followed this trend. The Australian equivalent of the international accounting standard IAS19 is AASB119 which became mandatory for private sector company financial reporting periods commencing 1 January 2005 or later. Prior to AASB119 the cash contributions paid to a plan were reported as an expense but there was no need to recognise the funded status of the plan on the balance sheet. Effective 1 January 2013, there was a tightening up of the relevant accounting standard. Enterprises must immediately recognise all actuarial gains and losses as part of 'other comprehensive income — i.e. outside the profit and loss' (KPMG 2011).
3. This policy drew inspiration from New Zealand, where there has historically been strong support for the notion that lower taxes on income from capital represent unacceptable 'tax concessions', even in the case of households with modest lifetime resources. However, there are signs New Zealand is reconsidering this philosophy. Another distinctive factor in the case of Australia was large-scale closure of defined benefit plans to new members in the public sector, starting in the late 1980s, owing to concerns about levels of public sector debt.
4. See Trahair (1994) and Ferris (2006).
5. Trahair (1994) details three major cases.
6. Minimum requisite benefits refer to minimum benefits arising from the superannuation guarantee (Ferris 2006).
7. See, for example, APRA (2013).
8. See, for example, Blake (2000).
9. The qualification 'generally' is necessary if only because remarkably, Unisuper is not legally obliged to make additional contributions in the event of a shortfall (Ferris 2006).
10. See Bateman and Kingston (2010a, 2010b).

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