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FAMILY LAW FINANCIAL SERVICES

## KNOW WHAT A DEFINED BENEFIT SUPERANNUATION IS AND THE PROFESSIONAL RISKS THEY POSE FOR YOU AND YOUR PRACTICE?

This article will discuss:

- What defined benefit funds are;
- The valuation techniques and their shortcomings;
- The dangers faced by you and your clients; and
- Ways to solve these issues and protect yourself

## DEFINED BENEFIT FUND VALUATIONS – IGNORANCE IS BLISS (PART 1)



It has been over three years since the family law superannuation splitting laws commenced. Since this time, how many of you have actually taken the time to sit down and think through the workings of the most basic defined benefit valuation formulas, that is, the formula for valuing a defined benefit fund in the growth phase where the benefits of the fund are paid out entirely as a lump sum. The formula itself is as follows:

$$\text{Gross value} = A \times F_{y+m}$$

The formula as you can see is really quite simple. The letter “A” represents the product of the member’s salary at the appropriate date<sup>1</sup> and an accrued benefit multiple, both figures provided by the appropriate Trustee in their Form 6 response. The  $F_{y+m}$  represents a discounting factor which is based on the member’s age at the appropriate date and the relevant fund’s official member retirement age. Using the number of years and months that a member has to their official retirement from the appropriate date a discounting percentage figure is determined. The formula for this is a little more complex however all the necessary figures are initially supplied by the Trustees and then read off the appropriate table in the Regulations.

The final result is an official valuation for family law purposes of a member’s superannuation entitlement at the appropriate date. With a

formula as simple as this who wouldn’t be tempted to simply rely on it and formalise their splitting or offsetting instructions on the basis of this calculation.

### STOP!

*If you would prefer to continue accepting valuations at their face value, remaining oblivious to issues that may expose your practice to professional risks do not read on.*

### GO!

*If you would like to be able to **identify** and **solve** the risks faced by your practice when dealing with defined benefit funds please read on.*

<sup>1</sup> The ‘appropriate date’ is the date at which a valuation is performed and is generally the date both parties separated, divorced, got married or any other date at which a valuation is required.

## DEFINED BENEFIT FUND BACKGROUND



Defined benefit funds, even in their simplest form are the most complex type of superannuation fund and the most difficult to value. Quite simply these funds do not hold a running balance of a member's accrued benefits as at any time. Prior to the member triggering a condition of release their benefits **do not exist**.

A defined benefit fund as its name suggests, defines every possible benefit by way of a specific set of calculations for each and every form of member release. That is, there are formulas for a member's resignation, termination, disability payments, early retirement and normal retirement. Each defined benefit fund has its own set of unique formulas. However, at the heart of every formula is the member's income stream at the time the member triggers a release and in some cases during each year of their membership of the fund.

If we consider a fund which pays only a lump sum at retirement such as the benefit payable under the *State Authorities Non-contributory Superannuation Act 1987* ("SANCS") we find the following applicable superannuation payment formula (lump sum benefit):

$$\text{Benefit payment} = 0.03 \times F \times Y$$

This formula essentially means, where a member is retiring over the age of 55 then the lump sum benefit payment amount is determined by multiplying the number of years by the **final average salary** and this is then multiplied by 3%.

Without getting into the technical definition of this fund's meaning of final average salary it suffices to say that it involves the salary at the time the member retires. The majority of defined benefit funds work in this same manner. *The final superannuation payment is based entirely or in part with the final or final average salary at the time of retirement.*

To summarise so far:

1. Defined benefit fund's do not technically have a member balance at any time prior to the member satisfying a condition of release i.e. retirement;
2. Each fund has its own unique formulas to determine a member's retirement benefit payment; and
3. The calculation of a member's benefit at retirement generally revolves around the salary payable at this time or over the few years prior to retirement or over the entire employment/membership period.

# INTRODUCTION OF FAMILY LAW SUPER SPLITTING LAWS AND ITS CHALLENGES



The Family Law, super splitting laws aim to split the superannuation benefit payment, not the interest as it stands at any time prior to the member receiving their benefit, either as a lump sum or pension payment.

Hence, the first challenge faced by the Family Law, super splitting laws is how to determine an appropriate valuation of an interest in a defined benefit fund.

This seems to have been solved in the following manner.

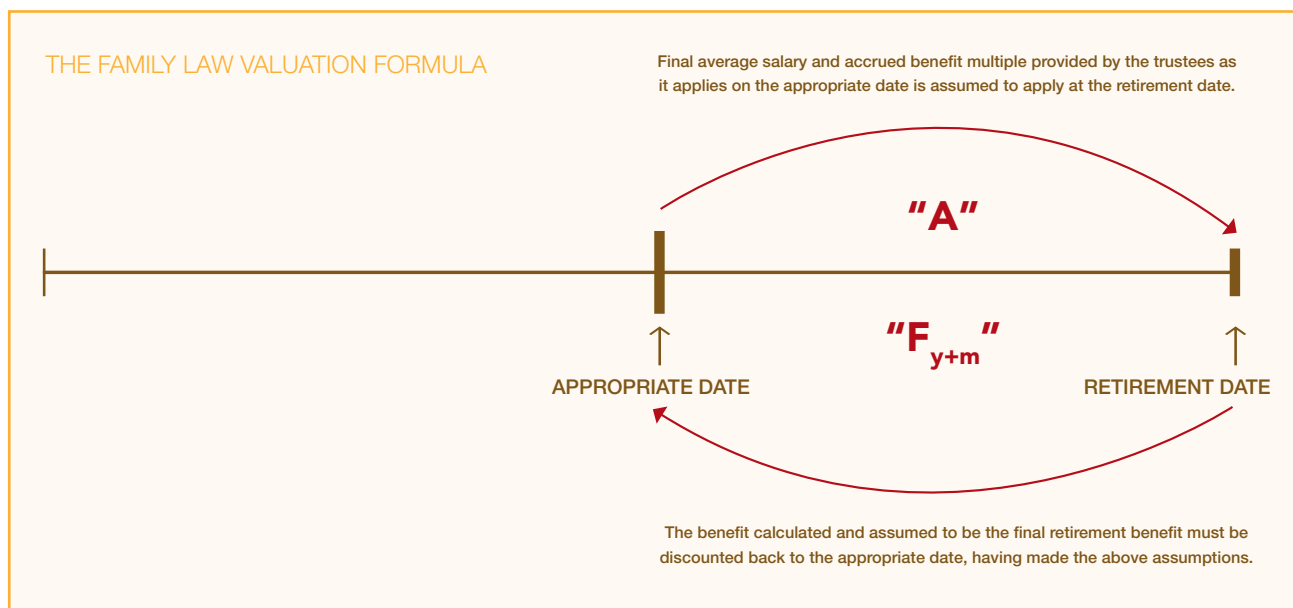
1. The member's final salary at retirement is assumed to be the final average salary at the appropriate date;
2. The accrued benefit multiple, at the appropriate date is also assumed to be the same accrued benefit multiple at the time the member retires;

*Note: these first two points are the assumptions made in calculating "A"*

3. As there seems to have been an assumption that the calculation in determining "A" was done at retirement, it must now be discounted back to the appropriate date i.e. discounted back for the number of years the member between the appropriate date and the fund's officially stated retirement age.

*This last point gives rise to the " $F_{y+m}$ " in the family law Regulation formula  $A \times F_{y+m}$ .*

If you find this confusing, please refer to the following graphical depiction of the family law valuation formula for a fund that pays a lump sum benefit only at retirement:



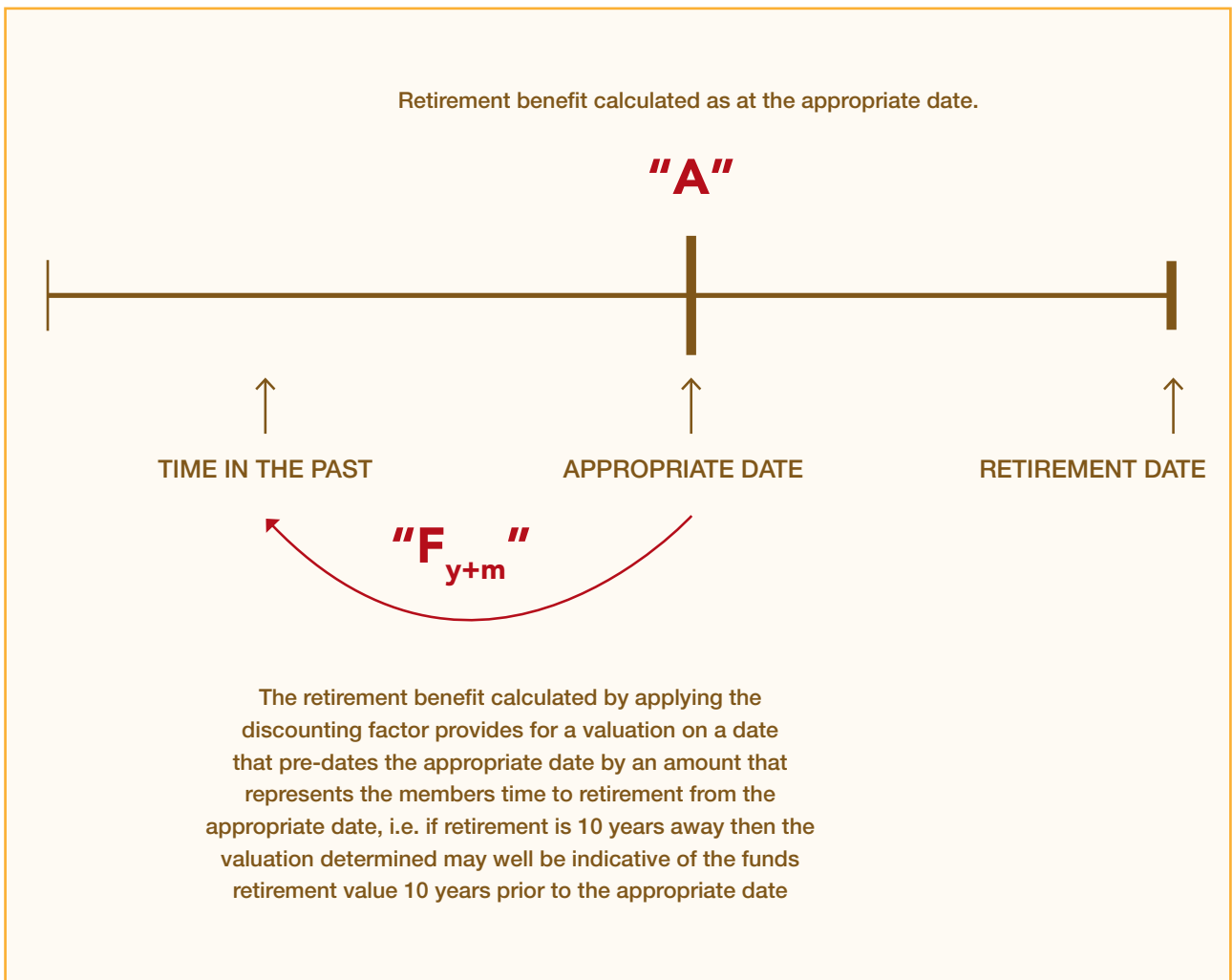
## CRITICAL ISSUES ARISING FROM THE VALUATION FORMULA

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1. Salary Assumptions: There is no way that anyone can determine or guess with any level of accuracy what a member will be earning at the time they retire. Given that the level of income at retirement is such a major contributor to the final benefit payment is it wise to assume that the income at the appropriate date is exactly the same income at retirement? I would suggest not, depending on the time to retirement income streams may grow quite significantly especially where further promotions are possible. It is also likely, although less so, that incomes may fall.
2. Accrue Benefit Assumptions: Once again there is no way of knowing what the level of accrued benefits are likely to be at retirement. Depending on each fund these accumulate in various ways, gradual, stepped and some even have a ceiling. Once again I do not think it wise to make an assumption on what the accrued benefit multiple is likely to be at retirement and I dare say that depending on the time to retirement it could be vastly different.
3. Discounting: If the trustees have provided us with the final average salary and accrued benefit details as at the appropriate date have we not actually performed a retirement calculation at the appropriate date. It therefore stands to reason that we have in fact determined a valuation as if the member retired at the appropriate date and then discounted this valuation back by the same number of years until retirement. This cannot certainly provide a fair indication as to what the value of the fund is at the appropriate date.

# PRACTICAL IMPACT OF THE VALUATION FORMULAS



## DANGERS THAT ARISE



### **1. Undervaluations:**

- a. Splitting or offsetting based on a valuation that does not truly reflect the real value of the fund at the appropriate date may leave the non-member spouse out of pocket by a considerable sum.
- b. An eventual introduction of fund specific methods and factors may highlight this point further and may force reapplications to be made by the non-member where settlement was initially based on the current Regulation formula, especially where the differences are significant. It should not be a surprise to anyone that significant differences have existed between the original Family Law Regulation valuation and one done on the basis of an approved scheme specific Family Law valuation.

### **2. Interplay of other events, assuming all members will remain with the fund until they qualify for retirement:**

- a. The risks for a member spouse may include the fact that if they are taken ill and can no longer work, are retrenched or resign their benefits may be valued at a lower amount than that calculated by the family law formulas, the reason for this is that normal retirement formulas are the most generous and provide the greatest benefit, a resignation withdrawal benefit taken by a member may mean that they lose one or more employer funded components and could significantly reduce the value of their final benefit.

### **3. Fund retirement not matching normal retirement:**

- a. Some funds have under their Trust Deed a formal retirement age of 65, however, there may also exist a normal retirement age of say 60 at which age many members leave the fund and crystallise their benefits. Where this anomaly exists, the family law valuation is essentially discounting a valuation for an additional five years that practically may not apply. This additional discounting on top of the issues already raised further undermines the Family Law valuation methodology.

### **4. Indexation of non-member's amount does not provide a solution:**

- a. Where a superannuation split occurs based on the current formulas and the fund is unable to immediately split the member's interest, an indexation amount is applied to the non-member's entitlement until the funds are released. This only occurs where a dollar value is given as the 'base amount'. Given that the value under the family law formulas is already placing the non-member in a difficult valuation position the indexation process purely serves as a means of attempting to bring the split amount up to where it should have possibly been in the first place rather than ensuring that the split amount continues to grow and keep pace with inflation. Where a more accurate valuation method exists, then the indexation applied would serve its purpose.

## PRACTICAL EXAMPLE

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I recently valued a fund where the member was aged in their fifties and the fund provided for a retirement age of 65. The official valuation as determined under the family law formulas was about \$470,000. Where the member decided to resign and take their benefits at a time only a few months later, they stood to receive about \$640,000 (a resignation benefit, not a retirement benefit payment, one would expect the retirement benefit to be greater). This is a marked difference and one where consideration of the final superannuation benefit would only lead to a greater difference in valuations. This is not an uncommon occurrence and can be seen in most valuations with varying degrees of magnitude between the Family Law valuation at the appropriate date and what might be estimated as the real superannuation benefit payment at the member's retirement.

Therefore some serious questions you should ask yourself include:

- Would you be comfortable representing the non-member spouse and instructing them to accept this difference in value by relying on the family law valuation?
  - Would you want more information about how this difference came about?
  - Should you be concerned about these differences?
  - Is the Regulation formula providing a suitable and accurate valuation?
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# SOLUTIONS



## 1. Valuation reports

Ensure that the valuation report you are ordering includes additional information, especially information providing comparisons between likely current resignation benefits, given that these are calculated on a less generous formula and are provided by the Trustees in the Form 6 response. Where there are any differences further investigations should be made as to why and how these have come about.

## 2. Take heed of the statement on the Family Court web site

*“The Attorney-General’s Department is currently going through the process of approving the necessary scheme specific factors and methods. Funds affected are likely to advise their members that they have applied for approval of such methods and factors and suggest that non-member spouses await the results of those applications.*

*Applications for adjournment of proceedings may flow in such situations.”*

Source: Family Court Web Site: From home page go to: → step by step guide → property & money matters → Superannuation – Defined Benefit Funds

If the Family Court sees fit to suggest to non-member spouses to wait for scheme specific methods and factors to be approved, where approval has been sought, surely this is an indication that there may be an issue with the family law formulas and it may be in the best interest of the non-member spouse to wait and see the outcome of a valuation carried out under a scheme specific formula. Have you made your client’s aware of this statement?

## 3. Understand how the Trustee’s splitting process

Each defined benefit fund that is able to split an interest immediately has its own separate process. These processes can have significant impacts on the member’s and the non-member’s future superannuation balance.

Depending on whether you were acting for the member or non-member it may be prudent to re-visit any matters where at the time of settlement the Trustee was not able to immediately split a superannuation interest and now they can. You may find that agreement in such a matter was settled on the basis of a particular valuation i.e. under the original Family Law valuation formulas or based on certain income or benefit expectations i.e. a pension that is regularly indexed. Now that the Trustees are able to effect an immediate interest split, which may coincide with the approval of scheme specific methods and factors, a very different valuation may exist and for those clients expecting a reliable, annually indexed income stream, they suddenly find themselves without such income certainty.

## 4. Educating Clients

With regard to ensuring that the most appropriate outcome is achieved, both parties need to be made aware of all the issues specific to the defined benefit fund in their matter. Client’s need to be made aware of at least the following issues:

## SOLUTIONS (CONTINUED)



- The valuation process and its pitfalls;
- The implications of the pitfalls;
- Options available to both parties regarding valuations;
- The implications of offsetting against a family law valuation;
- An explanation of the risks faced by offsetting or splitting a superannuation interest;
- The methods the trustees employ to split a fund; and
- The implications to both parties stemming from the fund specific splitting process.

Both parties in the possession of this information can then make an informed decision as to how they may be willing to proceed with regard to splitting or offsetting against a defined benefit fund valuation either in the growth or pension phase.

### CONCLUSION

Finally it is important to understand that the Family Court will accept valuations done in accordance with the appropriate Regulations whether these are the original Family Law Regulation formulas or the subsequent fund specific approved methods and factors and make decisions based on these valuations.

Having seen the significant discrepancies that exist between the likely fund valuation when the member actually retires and the valuation determined for family law purposes it is our position that whilst the Family Court will accept these valuations additional consideration needs to be given to whether or not the valuation

makes sense and really results in a fair indication of what the member's superannuation interest is likely to be valued at, at the appropriate date. You may also find that the most reasonable approach to issues arising from defined benefit funds is to accept that there is no real way of knowing what the fund will be valued at, at time the member retires or even whether or not they will actually still be employed by the employer with which the defined benefit fund is associated. In which case alternate methods need to be canvassed with regard to finding a solution:

1. Flag the interest and deal with it when the member satisfies a condition of release;
2. Adjust the payment split amount to the non-member to take account of any disparities in the valuations;
3. Use a Superannuation Agreement instead of an Order, whereby the parties can agree on a valuation method suitable to the defined benefit fund in question; and
4. Adjourn proceedings until the scheme specific methods and factors are approved.

There may be other suitable courses of action however each of these including those listed above will have certain implications and will need to be assessed on their merits and the objectives of your clients in each matter separately.

If you require assistance with any superannuation matters please feel free to visit Aspley Jandera Super Specialists at our web site, [www.ajsUPER.com.au](http://www.ajsUPER.com.au) or alternatively give us a call on 1300 79 10 69.

## PART 2 – WHEN A FUND FINALLY HAS THEIR METHODS AND FACTORS APPROVED



One of the largest defined benefit funds in NSW has been waiting about 2 years for its own specific methods and factors to be approved. Late last year they got a step closer to formalising their splitting intentions with the NSW parliament passing certain Regulations allowing this fund to split member interests. In our next article we will look at the likely implications of this fund enforcing splitting Orders and Agreements retrospectively as well as the implications faced by clients that did not split and instead offset the family law regulation valuation against other assets.

Is their cause for concern? **Find out next time.**



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