



Macquarie University ResearchOnline

This is the author version of an article published as:

Ferris, Shauna and Gillies, Peter 2010 'The Legal obligations of superannuation fund trustees : the VBN v APRA litigation' *Journal of banking and finance law and practice*, Vol. 21, No. 3, p.214-244

Copyright: Thomson Reuters

The legal obligations of superannuation fund trustees: The VBN v APRA litigation

Shauna Ferris and Peter Gillies *

The Administrative Appeal Tribunal's decision in VBN v Australian Prudential Regulation Authority focused on decisions made by the corporate trustee of the AXA Australia Staff Superannuation Plan and by extension its directors (who represented the staff and the employer). The AAT set aside disqualification orders made by APRA against seven of these directors pursuant to the Superannuation Industry Supervision Act 1993 (Cth). This decision is of value in its consideration of the extent to which superannuation (and other) trustees – and in turn those who may be made liable for its conduct – can be held legally accountable for (frequently difficult) decisions made in the management of a fund's affairs. Issues considered include non-disclosure of relevant information to members, lack of due care and skill, and partial decision-making as between classes of members. The decision also considers in some detail the principles to be observed by an appellate tribunal or court in conducting a merits review of a trustee's exercise of discretion.

<DIV>INTRODUCTION

Pension fund trustees in Australia have a range of statutory duties to the fund beneficiaries. The *Superannuation Industry (Supervision) Act 1993 (Cth)* (SISA) provides for a range of duties in the core provision, s 52. The key covenants in s 52 echo the general law obligations imposed upon trustees, in imposing duties to act honestly, to exercise care, skill and diligence, and to ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries. The general law duties prevail to the extent that they are not, and would not appear to be, inconsistent with these statutory duties.¹

Sections 126G-126J (replacing s 120A) of SISA provide for the disqualification of a range of persons, such as trustees of a superannuation fund regulated by the Act or the

* Shauna Ferris, Senior Lecturer, Actuarial Studies, Macquarie University. Peter Gillies, Professor of Business Law, Macquarie University.

¹ See the discussion in *VBN v Australian Prudential Regulation Authority* [2006] AATA 710 at [268]ff (*VBN v APRA*).

directors of a corporate trustee of a fund in this category, by reference to a range of matters including that the trustee has contravened the Act having regard to the nature and seriousness of the contravention or contraventions, or that in the case of an individual, the latter is not a fit and proper person for the role in question. In the case of individuals, the court may have regard to the individual's conduct in relation to the management, business or property of any corporation, or to any other relevant matter. It follows that the director of the corporate trustee of a fund may be disqualified in reliance upon the trustee's contravention of the Act.

The former s 120A provided for disqualification by the Australian Prudential Regulation Authority (APRA) of a person by reference to factors similar to those in ss 126G-126J; while the new regime provides that a disqualification may only be effected by order of the Federal Court on application by the regulator.² The change in the legislation was partly motivated by dissatisfaction with the outcomes of the case described below.

In 2005, APRA decided that the corporate trustee of a superannuation fund had contravened s 52. On the basis of this determination, APRA disqualified seven of the nine directors of the fund pursuant to the then operational s 120A. In doing this, it was relying upon contraventions of SISA by the corporate trustee, rather than by the individual directors. APRA was dissatisfied with certain decisions made by the trustee, including a decision to credit a low interest rate to the accounts of certain fund members; a decision to supply information, which was alleged to be inadequate, to the members in relation to an offer to transfer from a defined benefit plan to an accumulation pension plan; and on the basis of inadequate management of conflicts of interest. APRA also alleged that two of the seven directors were not fit and proper persons. The crediting rate decision will be the primary focus of this article.

The disqualified directors appealed to the Administrative Appeals Tribunal (AAT). After considering the evidence, the AAT concluded in its decision in *VBN v Australian Prudential Authority*³ (*VBN v APRA*) that:

- The crediting rate decision made by the trustee breached its duty to comply with the trust deed. It breached its duty because the deed did not provide for the crediting of a negative crediting rate. Notwithstanding this, it was unnecessary to consider whether,

² The Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) or the Commissioner of Taxation, depending on which of them is administering the provision/s in question: *Superannuation Industry (Supervision) Act 1993* (Cth), s 10 (SISA).

³ *VBN v APRA* [2006] AATA 710 at [268]ff.

for the purpose of disqualifying the directors pursuant to s 120A, the trustee had breached any s 52 covenants because APRA had not relied upon this as a basis for disqualification.⁴

- The trustee had deliberately withheld relevant information about the crediting rate policy from one class of fund members (the deferred benefit members), which was relevant to decisions by them relating to their position as fund members.⁵ Nonetheless, this omission had no legal consequences.
- Notwithstanding that in making the crediting rate decision the trustee had discriminated among classes of members, it had not breached the s 52 covenants including that in s 52(2)(c), that is, the duty to act in the best interests of the beneficiaries.⁶
- The trustee had not supplied certain information in connection with an employer offer to the class of members who were entitled to a defined benefit, to transfer to an accumulation benefit. Notwithstanding this, the trustee did not on the facts breach the s 52 covenants.⁷
- There being no breach of covenants by the trustee for which the directors were to be made liable, there was no basis for disqualifying them pursuant to s 120A.

Accordingly, the AAT set aside APRA's disqualification orders in relation to the directors. So legally, the trustee (for the most part) and the directors had acted properly.

No doubt this case was rather disconcerting to many other people who had entrusted their savings to the trustees of their superannuation funds. The decision reflects that pursuant to the present law, a superannuation trustee can discriminate among classes of fund members and fail to make proper disclosure to these members. On the other side of the ledger, the role of the trustee, even one acting carefully in good faith, is not an easy one, as the AAT noted. It will be of interest to examine the facts and the AAT's application of the law, as construed by it, to these facts.

⁴ *VBN v APRA* [2006] AATA 710 at [27]ff, 31ff; for the background to the trust deed see [39]ff.

⁵ *VBN v APRA* [2006] AATA 710 at [386].

⁶ *VBN v APRA* [2006] AATA 710 at [427].

⁷ *VBN v APRA* [2006] AATA 710 at [453]ff, [484].

This case is particularly interesting because the employer-sponsor was one of the largest life insurers in Australia – a company with more than 100 years of experience in managing other people’s money. Most of the trustee directors were people who had many years of experience in the financial services industry, and who had considerable expertise in managing financial risks. The trustee and the employer-sponsor also had the benefit of many expert advisors – specialists in both legal and actuarial aspects of fund management. Nevertheless, despite all this expertise, the outcomes for some members were far from satisfactory.

It would be desirable if, in the future, such unsatisfactory situations could be avoided. And thus this article addresses two questions:

- How did it happen?
- And what can be done to avoid such situations in the future?

This article is set out as follows:

- First, the article describes the key decisions and events which created the problem. It is a chronology of the fund from 1997 to 2002.
- Secondly, the article describes the trustee’s dilemma. In 2002, the trustee was faced with a fund which was in an unsatisfactory financial position; it faced strong pressure from the employer to minimise costs and it had to attempt to balance the competing interests of different groups of members. The article sets out the alternatives, the decisions made and the reasons for those decisions.
- Thirdly, the article describes the role of the regulator, APRA, in resolving the fact that many members were unhappy with the decisions made by the trustee in 2002. APRA was successful in obtaining a better outcome for members, but its attempt to disqualify the directors of the trustee was unsuccessful.
- Fourthly, the article describes the decisions made by the trustee in 2003 in relation to the employer’s offer to members. These decisions led to further controversy, followed by more intervention by APRA.
- Finally, the article includes some suggestions for avoiding similar problems in the future.

APRA’s intervention in this matter was controversial. In the aftermath of the AAT’s decision, and in response to criticism in the press, APRA’s powers were curtailed.

<DIV>A CHRONLOGY OF EVENTS LEADING TO THE CRISIS

<subdiv>Background: The employer-sponsor

The National Mutual Life Association was founded as a mutual life insurer in 1869. Over time, it grew to become one of Australia's largest life insurers. But by the early 1990s, National Mutual's financial strength had been undermined by aggressive growth during the 1980s, followed by the 1987 share market crash, the subsequent downturn in the property market and the economic recession of the early 1990s. By 1994, the company needed additional capital to fund future growth.

It is always difficult for a mutual organisation to raise new capital. So in 1995, the company was demutualised and giant international insurer AXA bought 51% of the shares of the company (a controlling interest). In 1999, the name of the holding company was changed to AXA Asia Pacific Holdings and several of the operating companies were also renamed to include "AXA".⁸ For the sake of simplicity, the company is referred to as AXA throughout this article.

<subdiv>Background: The fund and the trustee

The National Mutual Staff Superannuation Plan was established in 1947. It was a defined benefit plan set up for the benefit of the employees of National Mutual and related companies. The name of the fund was subsequently changed to the AXA Australia Staff Superannuation Plan (referred to as the AXA fund in this article).

At the time of the following events, the trustee was a corporate body. During the relevant period, the number of directors varied between eight and 10. The trustee complied with the equal representation rules of the SISA, ie half of the directors were appointed by the employer-sponsor (ie AXA) and half were chosen by the members. However, all directors had a fiduciary responsibility to the members and beneficiaries.

The trustee obtained advice from an actuarial consulting firm. Over the relevant period, several different employees of the consulting firm were involved in providing advice. The person primarily responsible for providing advice at any time is referred to as the plan actuary in this article.

⁸ National Mutual's company history is available at http://www.axaasiapacific.com.au/axaaph/axaaph.nsf/Content/Company_History viewed 1 July 2010.

<subdiv>A chronology of events

From 1997 to 1998, the trustee of the AXA fund made three significant decisions. Each of these decisions, taken separately, seemed quite reasonable under the circumstances prevailing at that time. But taken in conjunction, and allowing for interactions between these decisions and for the impact of subsequent events, these decisions ultimately led to financial problems for the fund.

<group>Decision 1: Improved benefits for members leaving service

As noted above, the fund's employer-sponsor was undergoing many changes during the 1990s. As a result of the change in ownership in 1995, it seemed likely that there would be increased staff turnover. In 1997, the employer proposed an improvement in benefits for long-serving members who resigned or were made redundant.

Prior to August 1997, employees who left service prior to early retirement age (age 55) were entitled to a lump sum benefit, but they were not eligible for any pension benefits.

Under the new rules, members leaving service with more than 10 years membership would be entitled to leave their lump sum in the AXA fund. The lump sum would be held in an account and interest would be added to the account. The member would be allowed to withdraw the accumulated amount (or part thereof) at any time. After attaining age 55, the member could convert the lump sum to a pension at fixed conversion rates.

Members who decided to leave their benefits in the AXA fund were classified as deferred benefit members.

What was the effect of this change on the AXA fund?

For each member who chose the deferred benefit option, the liability of the AXA fund was likely to increase – in some cases substantially – because the option to take a pension was quite valuable.⁹ The pension conversion rates were fixed under the trust deed

⁹ The AXA fund was originally a pension plan. It was later changed to provide lump sum benefits, but members were given the option to take a pension. The fixed conversion rates between pension and lump sum effectively gave the then existing members the opportunity to revert to their earlier defined pension benefits without loss of accrued benefits.

and they were quite generous.¹⁰ For example, the AXA fund rules stated that a lump sum of \$100,000 could be converted into a pension of \$8,333 per annum at age 55.¹¹ But according to the plan actuary's estimates, the average cost of providing such a pension was actually about \$128,800 (for a male) or \$127,500 (for a female).¹² That is, the pension was worth about 28% more than the lump sum (on average), using actuarial valuations.

This option was very attractive to many members. If they had taken their lump sum and purchased an equivalent annuity from an insurance company, it would have cost much more than \$100,000. Since commercial annuity rates include loadings for commission and profits, it might even cost as much as \$200,000 to buy such an annuity.

Looking at this matter from an employer's perspective, suppose the lump sum benefit at the leaving service date was \$L. Suppose a fund had assets of \$L available to pay this benefit.¹³ If these assets were invested by the fund to earn i per annum, and the member was eligible to retire in t years, then the accumulated assets at retirement would be:

$$L * (1+i)^t$$

The cost of the benefit liability would depend on the crediting rate c . If interest was credited at rate c per annum for the next t years, and the member opted to take a pension at that time, then the average value of a pension benefit payable at age 55 would be:

$$L * (1+c)^t * 1.28$$

Note that each extra dollar of interest credited would increase the pension liability by about \$1.28.

¹⁰ Generous pension conversion factors are not uncommon in some old defined benefit funds. In many cases, the pension conversion rates were fixed long ago, when life expectancies were much shorter. At the time the rules were established, there was a much smaller discrepancy between the value of the lump sum benefit and the pension benefit.

¹¹ *VBN v APRA* [2006] AATA 710 at [470]. Note that the pensions are indexed, with a spouse reversion and a guarantee period.

¹² Since females have a longer average life expectancy than males, rates for female annuitants are normally higher than rates for males. But these pensions include a spouse reversion, ie for married employees, a reduced pension is payable to the spouse after the member dies. Therefore, the value of the pension depends on the marital status of the members and the life expectancies of both the employee and his or her spouse. As a result, there is only a small difference between the rates for male and female employees.

¹³ In practice, a fund may have either more or less than this, depending on the level of funding.

The difference between the value of accumulated assets and the value of the liability represents the potential additional cost of the improved benefits for each employee leaving service:¹⁴

$$\text{Cost of benefit improvement} = L * [1.28 (1+c)^t - (1+i)^t]$$

Clearly, the crediting rate policy would have a crucial impact on the cost of benefits. On the one hand, if the credited rate c exceeds the actual earned rate i , this will substantially increase the cost to the employer. On the other hand, if the crediting rates are lower than the actual earned rates, then the savings will help to offset the higher cost of the pension option.

This impact is illustrated in Graph 1. Suppose a 45-year-old employee resigns and is entitled to a lump sum of \$100,000. The fund has assets of \$100,000 available to pay this benefit. Suppose that the assets are invested at 5% per annum, accumulating to about \$163,000 by age 55. However the cost of providing the pension at age 55 will vary depending on the crediting rate. The difference between the assets and liabilities reflects the additional cost to the fund in providing the improved benefits – and since this is a defined benefit fund, this cost will eventually be borne by the employer.

Graph 1: Impact of crediting rate on cost of benefits: Age 45

If the member is younger, then the crediting rate policy has an even greater impact on the ultimate cost of providing the benefit. Graph 2 shows the same calculations for a member who is age 30 when he or she is made redundant.

Graph 2: Impact of crediting rate on cost of benefits: Age 30

Note that in this case, if the annual crediting rate is 2% lower than the investment return of 5% per annum over the entire period of deferral, the fund might even make a profit. (That is, the accumulated value of the assets will exceed the cost of providing the pension.)

When the improved benefits were first introduced, the AXA fund members were told that the interest rate credited to their account (c) would be based on the actual rates of interest earned (i), smoothed over time. However, as discussed below, the employer

¹⁴ Since both the crediting rate and the earned rate vary from one year to the next, the following would be a more precise formulation of the additional cost: $L \prod_t (1 + i_t) - L * 1.28 \prod_t (1 + c_t)$

later applied pressure on the trustee to cut the crediting rate, and hence reduce the cost of providing the benefits.

The ultimate total cost of the improved benefits would depend on the number of people who chose to become deferred benefit members, the employee's age at withdrawal, the interest rates credited to the lump sum benefit and the number of employees taking the pension option at retirement.

When the improved benefits were first proposed, the employer and the trustee asked the plan actuary to comment on the additional cost of providing the improved benefits. According to the evidence provided to the AAT, the plan actuary advised that it would not be necessary to increase the company's contribution rate to fund the additional benefits. The AXA fund's experience had been better than expected,¹⁵ and the surplus arising from the favourable experience would be enough to cover the additional cost.

This advice was presumably based on the assumption that there would be only a small number of deferred benefit members and that they would be older employees; but as it turned out, this assumption was incorrect. Over the next few years, the number of deferred benefit members increased sharply.

As noted above, National Mutual was demutualised in 1995 and the international insurance giant AXA took a controlling interest in the company. For the next few years, the existing National Mutual management team remained in charge. But in 1999 the company announced a change in management. A new chief executive officer (CEO) from the United Kingdom was appointed.

The new CEO was very keen to improve the cost effectiveness of the company.¹⁶ In 1999, the company announced its intention to reduce staff numbers by 25% by 2001, ie roughly 1,000 jobs.¹⁷ Many of the people who lost their jobs (or resigned) were long-serving employees, hence eligible to become deferred benefit members.

¹⁵ Specifically, the number of retiring members who chose the pension option was lower than expected.

¹⁶ "New Boss Wants NatMut in Top Three in Markets", *Australian Associated Press* (29 September 1999).

¹⁷ Mellish M, "Reluctant Investors Want NatMut to Deliver Goods", *The Sydney Morning Herald* (23 October 1999); Paul S, "AXA to Focus on Retail Funds Growth", *Reuters News* (15 February 2000).

In the 1999 actuarial review of the AXA fund, the plan actuary noted that 80 members had chosen to become deferred benefit members and this was creating “a significant future liability in the plan”.¹⁸

In December 2000, the plan actuary wrote to the trustee to express his concerns. He pointed out that the number of members leaving their benefits in the AXA fund was increasing, and in particular the number of younger members leaving their benefits in the fund after being retrenched was greater than expected. The cost of funding the benefits had not been calculated on this basis.¹⁹ The plan actuary pointed out that the employer faced a substantial cost if the current arrangements were continued.²⁰

By June 2002, there were almost 300 deferred benefit members. The accumulation-type benefit liabilities amounted to roughly 35% of the AXA fund’s liabilities, ie more than \$100 million.²¹

As the deferred benefit liabilities grew, this meant that the crediting rate for the deferred benefit accounts would have a much greater impact on the solvency of the AXA fund, which would flow through to the employer’s contribution rate. The employer began to take a strong interest in the trustee’s crediting rate policy. As discussed below, during 2001 and 2002, the new CEO certainly made his wishes known in no uncertain terms: he wanted the trustee to change the crediting rate policy.

<group>Decision 2: The crediting rate policy

As noted above, the cost of the new improved benefits would depend on the amount of interest credited to the deferred benefit members’ accounts. So how would this rate be determined?

Even before the deferred benefit was introduced in 1997, some members of the AXA fund had accumulation-style benefits. Members were allowed to roll lump sums from other funds into the AXA fund, and members were also allowed to make additional voluntary contributions. These sums were held in separate accounts and accumulated with

¹⁸ *VBN v APRA* [2006] AATA 710 at [69].

¹⁹ *VBN v APRA* [2006] AATA 710 at [73].

²⁰ *VBN v APRA* [2006] AATA 710 at [74].

²¹ *VBN v APRA* [2006] AATA 710 at [399]; APRA and ASIC, “APRA and ASIC Accept Undertakings from AXA Australia Staff Superannuation Plan Trustee”, Joint Media Release (30 May 2005).

interest. According to the trust deed, the crediting rate on these accounts would be determined by the trustee after considering the advice of the plan actuary.²²

During the 1980s and 1990s, the trustee had decided that the crediting rate should be based on the rates earned on fund investments, but smoothed out to avoid fluctuations from year to year.

Such smoothing was, at the time, quite a common practice in superannuation funds. Superannuation funds often invest in asset classes, such as equities and property, which provide a higher long-term yield but are more volatile from year to year. Smoothing protects the fund members from volatility in returns and helps to avoid negative returns. There are several different approaches to smoothing, which are described in actuarial journals.

In May 1998, the plan actuary reviewed the crediting rate policy. He proposed the following method should be used for both the deferred benefit accounts and the other accumulation-based benefits:

- The crediting rate in any year would be based on a compound average of the actual earning rates over a three-year period.
- However, each year a minimum crediting rate would be set, based on the lesser of 50% of the cash rate and 50% of the net 10-year bond rates.
- When the minimum rate was applied, the current year's actual investment returns would be notionally increased and the next year's return would be notionally reduced by the same amount. The adjusted rates would be used to calculate crediting rates in subsequent years.

The trustee of the AXA fund decided to adopt the plan actuary's recommendation and the smoothing method described above was used to determine the crediting rate for financial years 1997-1998, 1998-1999, 1999-2000 and 2000-2001. As discussed below, the determination of the crediting rate in 2001-2002 would become quite controversial.

Smoothing does have advantages to members – essentially it allows investment risk to be diversified across different generations of members. But smoothing can also create difficulties. Graph 3 illustrates the effect of smoothing.

²² *VBN v APRA* [2006] AATA 710 at [55].

Graph 3: Smoothing policy

During periods of rising investment returns, the credited rate is generally below the earned rates. The excess investment returns are held in reserve, to be distributed later when returns are lower. During such periods, the fund is said to be under-crediting.

During periods of falling or negative investment returns, the credited rate generally exceeds the earned rates. The fund draws upon its reserves to supplement the low investment returns. During such periods, the fund is said to be over-crediting.

Any method of smoothing will redistribute investment returns among different generations of members, ie the smoothing process creates cross-subsidies between members. Those who are members during periods of over-crediting are benefiting from smoothing; those who are members during periods of under-crediting will receive lower benefits as a result of smoothing.

Trustees will often monitor the cumulative effect of under-crediting and over-crediting by creating a notional crediting rate reserve, which is equal to the cumulative earned rates less the cumulative credited rates.²³ For example:

- Suppose that in year 1 the earned rate is 5% and the credited rate is 3%. The notional crediting rate reserve would be +2%.
- Suppose that in year 2 the earned rate is 7% and the credited rate is 5%. The notional crediting rate reserve would increase by approximately 2%, to 4%.
- Suppose that in year 3 there is a share market crash and the earned rate is -2% but the credited rate is 3%. The notional crediting rate reserve is reduced by approximately 5%, to -1%.

Over time, the notional crediting rate reserve may fluctuate over quite a wide range and may be either positive or negative (a simulated example is shown in Graph 4). The size of the fluctuations varies depending on the volatility of the underlying investments and the method used for smoothing.

²³ The crediting rate reserve at the end of year t would be determined as $(A^* - A)/A - 1$, where $A^* = (1+c_1)*(1+c_2)* \dots (1+c_t)$ and $A = (1+i_1)*(1+i_2)* \dots (1+i_t)$, where c_t represents the crediting rate in year t and i_t represents the earned interest rate in year t . Also, in practice the smoothed rate uses the geometric average rather than the arithmetic average; for the purposes of illustration, the article uses the arithmetic mean which is simpler. This is a reasonable approximation for the purposes of illustration.

Graph 4: Crediting rate reserve

During the 1980s and 1990s, the method of smoothing used by the AXA fund had produced large variations on the crediting rate reserve. From 1988 to 1991, the fund had over-credited, producing a crediting rate reserve of -15%.²⁴ However, from 1991 to 1997, the fund had under-credited, so that the reserve increased back to about +4%.

This means that the cumulative credited rates during 1991-1997 were almost 19% below the cumulative earned rates (ie as the crediting rate reserve moved from -15% to +4%). As the AAT later pointed out, members who joined the fund in 1991 had been required to subsidise the high crediting rates offered to previous generations of members.²⁵

Naturally, members who are adversely affected by the smoothing process may be dissatisfied, especially when the cross-subsidies are large. Hence, equity problems may arise if a fund adopts a smoothing process which results in very wide swings in the crediting rate reserve.

When interest rates are falling, credited interest rates will often exceed earned interest rates: hence liabilities might increase more quickly than assets. As long as a fund is in surplus, this need not create any solvency problems – there will be a buffer of assets to absorb the mismatch between the assets and liabilities. Graph 5 shows an example of a fund which has initial assets of 120% of liabilities. Note that the assets exceed liabilities at all times.

Graph 5: Solvency with initial surplus of 20%

However, if the fund has only a small surplus, then the smoothing process may create solvency problems. Graph 6 shows a fund which has the same investment experience as above, but starting with assets of just 105% of liabilities. Clearly, from time to time, the three-year smoothing process can create a situation where the liabilities will exceed the assets. SISA defines this as an “unsatisfactory financial position”.

²⁴ During the period from 1984 to 1997, the smoothing method set a minimum crediting rate based on the rates offered to National Mutual’s capital guaranteed policyholders. During the late 1980s and early 1990s, the market for capital guaranteed products was very competitive. In an effort to increase market share, National Mutual had offered rather high rates on its capital guaranteed products – higher than the rates earned on the underlying assets. This had depleted the reserves of the insurer. Since the AXA fund used the same crediting rates, this resulted in over-crediting in the fund as well.

²⁵ *VBN v APRA* [2006] AATA 710 at [61].

Graph 6: Solvency with initial surplus of 5%

The solvency problems may be exacerbated by adverse selection – a problem which is explained in more detail below.

In summary, a smoothing method can cause equity problems when there are wide swings in the crediting rate reserve, and might create solvency problems if a fund has low levels of surplus.

So what was the level of funding in the AXA fund?

<group>Decision 3: The contribution holiday

In accordance with the trust deed and the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (Regulations), the funding levels of the AXA fund were periodically reviewed by an actuary (in this case, a member of an actuarial consulting firm).

The vested benefit index (VBI) is one measure of a superannuation fund's solvency. The VBI is the ratio of the fund assets to the total vested benefits; vested benefits are the benefits which members would be entitled to if they resigned or retired on the date of the valuation.²⁶

According to professional standards for actuaries, the VBI should generally be no less than 100%,²⁷ ie assets should cover the vested benefits. The plan actuary to the AXA fund recommended that it would be desirable to maintain a VBI above 115%, in order to provide a buffer against adverse experience. Historically, the fund's VBI had usually been between 115% and 130%.²⁸

However, in March 1998, the plan actuary reported that the VBI was 151% (most probably as a result of the prolonged share market boom during the 1980s). The surplus amounted to about \$60 million dollars.

²⁶ Under the definition in Professional Standard 400 issued by the Institute of Actuaries of Australia, the vested benefits include the actuarial value of pensions payable to already-retired members. A slightly different funding measure is used under the *Superannuation Industry (Supervision) Regulations 1994* (Cth) for determining technical solvency. The Professional Standard is available at <http://www.actuaries.asn.au> viewed 1 July 2010.

²⁷ See n 26.

²⁸ *VBN v APRA* [2006] AATA 710 at fn 141.

Under these circumstances, the plan actuary recommended that the employer could cease contributions – ie take a “contribution holiday” – for at least three years effective from 1 July 1998.

Naturally, as a result of the contribution holiday, the VBI of the AXA fund was expected to decrease for the next three years. However, as a result of adverse experience during this period, the decline was rather steeper than expected (as shown in Graph 7).

Graph 7: Vested benefit index at 30 June 1998-2002

As the VBI declined, the trustee directors became increasingly concerned. VBV, the chairman of the trustee’s board of directors, expressed these concerns to the employer in November 2000:

<blockquote>

VBV noted that there had been considerable discussion among the directors on the implications of a VBI which was much closer to 100% than had historically been the case. The issue for the Trustee was whether a VBI of less than 100% constituted a real or perceived risk to the members ... VBV observed that the vested benefits represented a major component of the members’ wealth and that those members saw the adequate coverage of the liability as the Employer’s responsibility.²⁹</blockquote>

The trustee suggested that the employer could consider ending the contribution holiday early. But the trustee does not determine the contribution rate. According to the trust deed, the employer decides on the level of contributions after considering the advice of the actuary.³⁰ In this case, the employer decided to continue with the contribution holiday.

The situation deteriorated even further after the 9/11 terrorist attack in 2001, which caused stock market losses all around the world. The AXA fund earned negative returns, and by June 2002 the VBI of the fund was about 86%. According to the Regulations, the AXA fund was in an unsatisfactory financial condition.³¹

As the financial status of the AXA fund declined, the trustee’s responsibility for determining the crediting rate became more difficult. If the trustee followed the normal

²⁹ *VBN v APRA* [2006] AATA 710 at [71].

³⁰ *VBN v APRA* [2006] AATA 710 at [49].

³¹ This is an approximation. The SISA definition of an unsatisfactory financial condition is more complex, allowing for priorities of payment for current and former employees, and transitional rules.

smoothing policy, then the crediting rate would exceed the earned rate for the year ending 30 June 2002. Such over-crediting would exacerbate the AXA fund's solvency problems – unless the employer was willing to pay additional contributions to cover the cost of over-crediting.

SISA and the Regulations allow the VBI of a defined benefit fund to fall below 100% temporarily – but they also require trustees to develop a plan for dealing with the matter.³² Trustees are expected to devise a plan which will remedy the shortfall within an acceptable timeframe (say three to five years).³³ This plan would often involve additional contributions from the employer.

Naturally, when devising such a plan, the trustees must consider the employer's willingness and ability to pay such additional contributions.

In 2002, after downturns in the share market, many funds were in an unsatisfactory financial position.³⁴ The AXA fund was certainly not the only fund which was seeking additional contributions from employer-sponsors. In a Guidance Note for trustees, APRA suggested that:

<blockquote>

Where solvency deficits are identified, employers should be willing and able to increase contributions – especially where funding margins are tight. APRA believes that funds that took advantage of good times to minimise contributions should recognise that the reverse applies when markets turn down.³⁵</blockquote>

However, many employers were either unable or unwilling to provide large additional contributions. Some employers hoped that the situation would automatically correct itself over time as markets recovered. Others were willing to pay off the deficits, but wanted to spread the payments over a longer period.

³² SISA and the Regulations are not specific about the action which should be taken in these circumstances.

³³ APRA's expectations are set out in APRA, *Defined Benefits Superannuation Funds Solvency: APRA Guidance Notes for Actuaries, Auditors, and Trustees* (June 2002), available at <http://www.apra.gov.au> viewed 1 July 2010.

³⁴ For example, APRA reported that in June 2008 about 16% of defined benefit funds were in an unsatisfactory financial position as a result of the global financial crisis: APRA, *Insight*, Issue No 2 (2009), available at <http://www.apra.gov.au> viewed 1 July 2010.

³⁵ APRA, n 33.

At the request of the trustee, AXA resumed making contributions in 2001-2002 and agreed to make some extra payments to improve the VBI of the AXA fund. However, the employer was quite adamant in opposing additional payments to cover the cost of any more over-crediting for deferred benefit members. In fact, the employer was not happy about past over-crediting either. The CEO argued that the cost of past over-crediting should be recouped from members as soon as possible by a change in the crediting rate policy.

<group>The employer's attitude

As noted previously, AXA's management changed in 2000 when a new CEO was appointed. The new CEO was determined to cut costs.

During 2001, the employer took a number of steps to control staff superannuation costs. In April 2001, the defined benefit fund was closed to new members – all new employees went into a defined contribution (accumulation) fund.

Soon afterwards, the employer began seeking legal advice about various proposals for reducing the costs of the defined benefit fund, including: (a) removing the deferred benefit option for members who were still in service; (b) reducing the pension accrual factors for future service; and (c) reducing the crediting rate for deferred benefit members.³⁶

In July 2001, AXA advised the trustee that it was unwilling to provide additional contributions for the benefit of deferred benefit members. The employer expressed the view that the interest crediting policy – ie adding interest based on the AXA fund's investment returns – was too generous to former employees (ie deferred benefit members).³⁷ The letter to the trustee said that:

<blockquote>

The Employer ... understood its obligation to fund the benefits of active members of the Plan and that it was required to fund those benefits. It was the Employer's view, however, that benefits were funded to the date that members left its service. No further funding was provided for the benefits of members who

³⁶ VBN v APRA [2006] AATA 710 at [81].

³⁷ VBN v APRA [2006] AATA 710 at [75]. The benefits were considered generous relative to the benefits for in-service employees which increased in line with salary increases. Based on long-term averages, investment returns are likely to be higher than salary increases.

had left the service. The Employer did not intend to provide any further funding for members who were not active members of the Plan.³⁸

This statement does not seem to be consistent with the trust deed. Under the trust deed, the employer had an obligation to fund benefits for all fund members – including deferred benefit members. Even if the AXA fund was closed down, the employer would have a continuing obligation to fund any deficits.

The employer did indeed threaten to close the AXA fund if necessary:

<blockquote>

The Plan Actuary has confirmed that the funding of the deferred pension benefit is imposing an unacceptable burden on the employer sponsor. This burden was not foreseen at the time the Plan Rules were amended to allow deferred benefits, and if this issue cannot be satisfactorily resolved then the employer sponsor may be forced to consider closing the Plan. This would be to the detriment of all members.³⁹

The plan actuary had previously suggested that the cost of the deferred benefits could be contained by altering the crediting rate policy. He proposed using two separate crediting rates each year. One rate, based on the AXA fund's investment earnings, would be used to determine the lump sum benefit available to members choosing the lump sum option. But another rate – a lower rate – would be used to determine the value of the pension option. This approach would “control the financial ramifications of the pension option.”⁴⁰

The employer supported this proposal. But under the trust deed, the employer did not have the power to make this decision – the trustee was responsible for determining the crediting rate.

The CEO did not believe that this was a satisfactory situation. According to evidence presented to the AAT, the CEO believed that the trustee should not make decisions about the crediting rate without considering the financial impact on the employer.

³⁸ *VBN v APRA* [2006] AATA 710 at [75].

³⁹ *VBN v APRA* [2006] AATA 710 at [76].

⁴⁰ *VBN v APRA* [2006] AATA 710 at [74]. It is interesting to note the similarities to the differential bonus policy adopted by the Equitable in the United Kingdom in the 1990s, in relation to their guaranteed-rate annuities. This policy also led to a protracted legal battle.

<blockquote>

Among the matters that the CEO had questioned was the identity of the person who decides the crediting rate. It was noted that “the trustee alone should not do this as it puts a financial obligation on the Employer”.</blockquote>

The CEO wanted the trustee to pay much more attention to the employer’s wishes. According to the evidence presented to the AAT, the CEO made his views known quite forcefully. He was “keen on urgent action and wanted to fix the interest rate issue as soon as possible”.⁴¹

The following memo reveals the CEO’s attitude to the trustee:

<blockquote>

Not sure the message has yet got through as the Trustees continue to meet and make decisions without discussing them in advance with the employer. One of ... [the Plan Executive’s] jobs is to make sure that [VBW] and I are made aware WELL IN ADVANCE of any financial issue coming before the Trustee so that we can consider our position and make sure the Trustee knows what it is before making any decisions. The current approach has GOT TO CHANGE. The trustees are still meeting and discussing/deciding on crediting rates, policy on choice of fund etc without a formal approach to get the employers [sic] view first.⁴²</blockquote>

In an email to one of the directors of the trustee, the CEO later expressed the view that: “We have to get the message over that the employer runs this fund, not the Trustees.”⁴³

According to the AAT:

<blockquote>

Clearly, this is not correct in law, just as his statement that it is for the Employer to decide whether to make additional contributions is not correct.⁴⁴</blockquote>

Consistently with SISA, and the general trust law, the trustee is responsible for running the fund. Furthermore, under the regulations, the fund rules must not permit the

⁴¹ *VBN v APRA* [2006] AATA 710 at [102]

⁴² *VBN v APRA* [2006] AATA 710 at [158], quoting a memo written in October 2002.

⁴³ *VBN v APRA* [2006] AATA 710 at [552].

⁴⁴ *VBN v APRA* [2006] AATA 710 at [552].

trustee to be subject to direction by any other person when the trustee exercises powers under the trust deed.⁴⁵

<DIV> THE TRUSTEE’S DILEMMA: THE 2001-2002 CREDITING RATE DECISION

As discussed above, the trustee and the employer made three decisions during 1997-1998:

1. the deferred benefit was introduced;
2. a policy of smoothing crediting rates was introduced; and
3. the employer took a three-year contribution holiday.

Each of these decisions seemed reasonable at the time: the fund had a large surplus and a supportive employer. However, these decisions, when combined with an adverse investment experience and a change in the employer’s attitude, created a difficult situation for the fund in 2002.

The decisions made by the trustee in relation to the crediting rate policy for the financial year ending 30 June 2002 are examined below.

Normally, the final crediting rate would be determined in arrears. That is, the trustee would wait until the end of the financial year (30 June 2002). At that time, the fund administrators would then calculate the actual rate of return earned by the fund over the past year. The trustee would consider that information and apply the crediting rate policy. The rate would normally be declared within a few weeks of the end of the financial year (say mid-August).

An interim rate would be applied to determine the benefits for any member who left during the year, ie before the crediting rate was declared. The interim rate would normally be a conservative estimate of the expected crediting rate and would be revised from time to time during the year in line with investment experience.

<subdiv>Review of the crediting rate policy 2001-2002

What factors should the trustee take into account in determining the crediting rate?

The trustee must always act in compliance with the trust deed. The trust deed for the AXA fund said that the deferred benefits “shall accrue with interest at a rate

⁴⁵ *VBN v APRA* [2006] AATA 710 at [19]. There are certain exceptions, as set out in *Superannuation Industry (Supervision) Regulations 1994* (Cth), reg 4.03, eg the employer-sponsor can instruct the trustees to terminate the fund.

determined from time to time by the Trustees after considering the advice of the Actuary".⁴⁶

The interpretation of this clause later became controversial. The trustee acted on the assumption that the crediting rate could be either positive or negative. The trustee did eventually declare a negative rate for 2001-2002. However, the AAT later asserted that the trustee was wrong: the term "accruing with interest" implies a non-negative crediting rate. Hence the trustee had breached its duty to comply with the terms of the trust deed when it set a negative rate.⁴⁷

Normally, the trustee would also consider established policy and member expectations before setting the crediting rate for the year.⁴⁸ Based on the information which had previously been provided to members, most members probably expected that the 2001-2002 crediting rate would be determined using the three-year average method, ie a continuation of the established policy.

Over the years, this policy had been explained to members many times. When the deferred benefits had been introduced in 1997, the members had been told that:

<blockquote>

The amount you decide to leave in the Plan will accumulate with interest from the date you leave service. The interest rate credited will be the Plan's crediting rate as determined by the Trustee. This rate is determined by smoothing the Plan's investment return to avoid major fluctuations from year to year. Details of the Trustee's Investment and Interest Crediting policies are set out in the Trustee's Report to Members each year.⁴⁹</blockquote>

In August 1998, the trustee sent out a newsletter describing the method of smoothing which had been adopted (ie a three-year average subject to a minimum rate). The method of smoothing was again described in annual reports to members in 1999, 2000 and 2001. The annual reports explained that the smoothing policy was designed to avoid

⁴⁶ *VBN v APRA* [2006] AATA 710 at [44].

⁴⁷ *VBN v APRA* [2006] AATA 710 at [354].

⁴⁸ *VBN v APRA* [2006] AATA 710 at [128].

⁴⁹ *VBN v APRA* [2006] AATA 710 at [27].

major fluctuations.⁵⁰ The smoothing policy was also described in newsletters to members in December 2001 and again in April 2002.⁵¹

Prior to the June 2002 decision, the trustee did not inform the members of concerns about the crediting rate, nor did it inform the members of its decision to review the crediting rate policy.⁵² Clearly, it was reasonable for the members to assume that the existing policy would be used to determine the crediting rate for 2001-2002.

However, during 2001-2002 circumstances had changed, and the trustee had to take account of the new situation before choosing a crediting rate.

<subdiv>The adverse selection problem

In late 2001, in the aftermath of the 9/11 terrorist attack, share markets crashed all around the world, including Australia. The AXA fund's investment return for the third quarter was -5.8%. The fund was in an unsatisfactory financial condition, and in October 2001 the plan actuary warned the trustee that this created the risk of adverse selection by the members:

<blockquote>

I note that the current crediting rate policy can result in a high degree of smoothing (the current circumstances being a prime example) and effectively assume sufficient reserves are available via the defined benefit section to allow this to occur. They also provide scope for some selection against the Plan by former employees who may choose (to a greater or lesser extent) when to withdraw their benefit from the Plan.⁵³</blockquote>

What did this mean?

The effect of adverse selection can be illustrated with an example. Suppose a fund has assets of \$90 million and liabilities of \$100 million (ie a VBI of 90%).

Now suppose that 30% of the benefits belong to deferred benefit members who are entitled to withdraw their full lump sum benefits at any time. Suppose that the deferred benefit members are aware that investment experience has been poor this year, and hence they know that the smoothed crediting rate will be low for the next few years.

⁵⁰ *VBN v APRA* [2006] AATA 710 at [78].

⁵¹ *VBN v APRA* [2006] AATA 710 at [84], [95].

⁵² AXA Australia Staff Superannuation Pty Ltd, *Undertaking Relating to AXA Australia Staff Superannuation Plan* (2005), s E(14) (undertaking), available at http://www.apra.gov.au/Media-Releases/05_32.cfm viewed 1 July 2010.

⁵³ *VBN v APRA* [2006] AATA 710 at [80].

They might decide to withdraw their benefits immediately, ie take \$30 million out of the fund.

This would leave the fund with assets of \$60 million and liabilities of \$70 million. The VBI will fall to just below 86%. This is detrimental to those members who remain in the fund: the security of their benefits has been eroded.

This was quite similar to the situation of the AXA fund. By the end of 2001, the AXA fund was in an unsatisfactory financial position, with an increasing proportion of deferred benefit members. Deferred benefit members could exit the fund at any time or convert to a pension, but current employees did not have that option.⁵⁴ Under the circumstances, adverse selection posed a threat to the financial stability of the fund.

<subdiv>The 2001-2002 crediting rate decision

In late 2001, after considering the plan actuary's warnings, the trustee directors asked the actuary to review the smoothing policy.⁵⁵

Over the next few months, the plan actuary and directors of the board considered the situation carefully. The board delegated most of the work to a subset of directors: the Investment Sub-Committee. The Investment Sub-Committee held several meetings over the next few months, working with the plan actuary to consider an alternative and formulate a new policy.

There were strong arguments in favour of a change in policy:

- The earned rate of interest for 2001-2002 was estimated to be about -5.8%. The normal smoothing policy would have produced a crediting rate of about +3.9%. So continuation of the smoothing policy would mean crediting rates almost 10% above fund earnings – hence substantially increasing the level of over-crediting. The crediting rate reserve would fall to about -14%.⁵⁶

⁵⁴ In Australia, choice of fund legislation did not become effective until 1 July 2005.

⁵⁵ *VBN v APRA* [2006] AATA 710 at [80], [82].

⁵⁶ *VBN v APRA* [2006] AATA 710 at [401].

- The AXA fund was in an unsatisfactory financial condition with a VBI of 86%.⁵⁷ Since the crediting rate would apply to liabilities of about \$100 million, the cost of an extra 10% over-crediting would be about \$10 million, pushing the VBI down to 83%.⁵⁸
- A continuation of the three-year averaging policy would inevitably lead to under-crediting in future years (as the investment losses in 2001-2002 would drag down the smoothed rates in 2002-2003 and 2003-2004). Knowing this, some members might select against the AXA fund by withdrawing their benefits or commuting to a pension. This would push the VBI even lower and would crystallise the losses in the fund. Ultimately, someone else would have to bear those losses (either the employer or other members).
- The employer was not willing to make extra contributions to fund further over-crediting. In fact, the employer was pressing hard for a reduction in the crediting rate and a recoupment of past over-crediting – and threatening to close the AXA fund if the interest rate problem was not “fixed”.

The AAT later pointed out that, under the circumstances, it would have been imprudent to increase the extent of over-crediting unless the shortfall could be made up from some other source. In practice, the employer was the only probable source. And the trustee had reasonable grounds to believe the employer would be unwilling to cover the shortfall.

After considering these issues, the plan actuary recommended the abandonment of the three-year average method, effective for 2001-2002, and a recoupment of past over-crediting.⁵⁹

The trustee followed his advice, and on 24 June 2002, just days before the end of the financial year, the board of directors of the trustee resolved that:

<blockquote>

The negative reserve be recouped over 2 years;

The current interest rate crediting procedures, methodology and process be discontinued effective for 2001/02 and subsequent years;

⁵⁷ Assets \$271.6 million and vested benefits \$317.2 million. *VBN v APRA* [2006] AATA 710 at [399].

⁵⁸ *VBN v APRA* [2006] AATA 710 at [403].

⁵⁹ *VBN v APRA* [2006] AATA 710 at [121], [123].

To develop and implement new current interest rate crediting procedures, methodology, processes for 2001/02 and subsequent years by the Trustee having regard to the advice of the Actuary, the earning rate for the year, and the level of the relevant Crediting Rate Reserve.⁶⁰

A disclosure issue

At this stage, the trustee had a difficult decision to make. What should the trustee tell the members about the new policy?

The trustee did have a legal obligation to provide information to members. Under reg 2.35 of the Regulations (as they applied at that time).⁶¹

<blockquote>

The Trustee of a Fund must give information to a member concerning any event in relation to the fund that the trustee reasonably believes the member would reasonably be expected to be informed of.

</blockquote>

And specifically under reg 2.36:

<blockquote>

(1) If the governing rules of a fund are changed, or because of any other act carried out or consented to by the trustee, a change occurs in relation to the fund and the change is of a kind stated in subregulation (2), the trustee must give information concerning the change to each member affected by the change.

(2) The kinds of changes are those that:

(a) have an adverse effect on a member's rights or claim to accrued benefits or the amount of those benefits; or

(b) have an adverse effect on the benefits to which a member may become entitled; or

(c) have an adverse effect for the member on the circumstances in which those benefits would become payable; or

(d) have an adverse effect for the member on the manner in which those benefits would be worked out; or

(e) have an adverse effect in the security of the member's benefits.</blockquote>

⁶⁰ *VBN v APRA* [2006] AATA 710 at [115]. Note there was a typographical error in the board minutes but the meaning is fairly clear.

⁶¹ *VBN v APRA* [2006] AATA 710 at [13]. Disclosure is now governed by the *Corporations Regulations 2001* (Cth): see *VBN v APRA* [2006] AATA 710 at fn 32.

That is, the trustees must provide information about any act carried out by them which might have an adverse effect for the member in respect of the way a benefit is to be calculated.

However, what would happen if the members realised that the new policy was likely to result in a negative crediting rate for 2001-2002? If the members were given advance warning of such changes, before the new crediting rate was declared, then they would have time to pull their money out of the AXA fund immediately (or else commute their lump sum to a pension). This would be beneficial to those members who left – they would lock in the benefits of past over-crediting and avoid the impact of the negative rates. But if they did so, there would be a negative impact on the financial position of the AXA fund and the remaining members.

The trustee recognised the need to inform the members of the change in policy. A newsletter was issued to members dated June 2002.⁶² The newsletter was carefully worded and the text was checked by a lawyer who confirmed that it complied with legislative requirements and was neither misleading nor deceptive.⁶³

However, in the subsequent review of the case, both APRA and the AAT criticised the trustee for poor communication of the policy changes. The June newsletter omitted key details of the new policy and created a misleading expectation among the members. Furthermore, the information provided to fund members by the plan administrators during this period was also misleading. APRA argued that the deficiencies in communication put the trustee in breach of its fiduciary obligations.⁶⁴

What did the newsletter say?

<blockquote>

In recent years the rate credited to accumulation benefits within the Defined Benefits Division has been determined based on the average earning rate over the previous three years (subject to some adjustments). This approach was aimed at reducing fluctuations in yearly returns passed on to members' accounts, while still reflecting the actual earnings over longer periods.

The trustee has reviewed this policy having particular regard to the investment earnings outlook for the current year and the year to year differences between earning rates and crediting rates which have

⁶² It appears that members did not receive the newsletter until early July 2002.

⁶³ *VBN v APRA* [2006] AATA 710 at [117].

⁶⁴ *VBN v APRA* [2006] AATA 710 at [360].

occurred and may arise in future from the three year average approach. The outcome of the review was a decision to change the crediting rate policy to allow the Trustee flexibility to determine the rate each year having regard to the current year's earning rate, past earning rates vs Credited rates, and other relevant considerations, rather than using a formula approach.

Consistent with the revised policy, the following interim crediting rates have been adopted for benefit calculations for members leaving the Plan (or deferred benefit members converting to a pension);

2% for members excluding category T.

The interim rate is a rate which applies to people who leave a fund before the annual crediting rate is determined. The interim rate is usually a conservative approximation to the rate which is finally declared. Many AXA fund members read the newsletter and noted that the interim rate was set at 2% and that this rate had been set "consistent with the revised policy". They took this to mean that the 2001-2002 crediting rate would be a positive rate.

Some of the members were concerned – anyone who read the newspapers knew that the investment returns for the year were very poor. Some of them contacted the AXA fund's administrators (the fund had a helpline for members). Based on evidence to the AAT, they were reassured by the information they received. One member was specifically informed that any change to the crediting rate policy would not be applied retrospectively.⁶⁵

This reassurance was misleading. On 13 August 2002, the board of directors of the trustee declared a rate of -5.8%, which was the rate of return earned by the AXA fund in 2001-2002. The trustee sent a letter out to members to inform them of this decision. The letter also explained that the trustee intended to recoup past over-crediting before 30 June 2004, ie by reducing the crediting rate for the next two years.

Many members were both surprised and angry. It was certainly not what they had expected, based on the information which they had been given previously:

- they were not going to receive 3.9%, which would have been the rate based on the smoothing policy which had been established over the last four years;
- they were not going to receive 2%, which would have been consistent with the interim rate advised in the June 2002 newsletter;

⁶⁵ *VBN v APRA* [2006] AATA 710 at [371]ff.

- instead, the value of their accounts was going to FALL by 5.8%; and
- the crediting rate over the next two years would also be reduced in order to recoup past over-crediting (which amounted to about 5%).

Many members complained to the trustee. They were particularly angry about the perceived retrospectivity of the decision. Some of them also consulted their lawyers.⁶⁶

The AXA fund had another poor year in 2002-2003. The earned rate was -0.1%. Under the previous crediting policy, the smoothed rate would have been set at 2%. However, in accordance with the new policy, the crediting rate was set at -0.1% for 2002-2003.

<DIV> APRA'S INTERVENTION AND THE AAT'S REVIEW

Prior to the introduction of SISA, fund members who suffered a loss had a general law right to take legal action against a trustee who was alleged to have failed to meet its fiduciary responsibilities. Such an action was costly and was, in practice, an ineffective avenue for most members.

SISA changed this situation. If it appears to the relevant regulator – most often APRA – that a contravention of the governing legislation (such as SISA) may have occurred or be occurring in relation to a superannuation entity, APRA may conduct an investigation and is given a range of powers for this purpose.⁶⁷ Depending on the results of the investigation, APRA has a range of alternatives for dealing with any contravention, such as applying to the Federal Court for an order disqualifying a trustee or other person,⁶⁸ or instituting civil proceedings for the recovery of damages or property,⁶⁹ or securing an enforceable undertaking in connection with the instant matter.⁷⁰

⁶⁶ Murray L, "AXA Executive under Investigation over Super Irregularities", *The Sydney Morning Herald* (4 June 2005).

⁶⁷ SISA, s 263ff.

⁶⁸ SISA, s 126Gff. Formerly, and at the time of the proceedings in *VBN v APRA*, APRA could itself make a disqualification order: s 120A (repealed).

⁶⁹ SISA, s 298.

⁷⁰ SISA, s 262A.

<subdiv>The enforceable undertaking

After the trustee announced the negative crediting rate, several of the superannuation fund members complained to APRA and the Australian Securities and Investments Commission (ASIC).⁷¹ The regulators investigated the matter, and became concerned about the prudential and disclosure aspects of the crediting rate decision. APRA discussed these concerns with the trustee.

The trustee did not agree with APRA's views: it denied that it had breached any statutory or general law requirements. However, in November 2003, it did agree to conduct an internal review of the 2001-2002 crediting rate decision. In the end, "the Trustee was able to review the decision with the benefit of hindsight and exercise its judgment afresh".⁷² On 11 November 2004, after considering all relevant matters, the trustee resolved to reverse its previous decision. As a result, the old smoothing policy would be used to determine the crediting rates for 2001-2002 and 2002-2003, and retrospective adjustments would be made to benefits:

- the crediting rate for 2001-2002 was retrospectively increased from -5.8% to 3.9%; and
- the crediting rate for 2002-2003 was retrospectively increased from -0.1% to 2.0%.⁷³

Therefore the overall effect was to increase the crediting rates by about 12% in total for the two-year period. This would mean that the members' benefits would increase by about \$10 million in total. Most of this sum – about \$9.2 million – would go to the 288 deferred benefit members.⁷⁴ The trustee sent out letters to all the affected members to inform them of the increase in their benefits.

In order to alleviate any ill effects on the financial position of the AXA fund, the employer agreed to take account of the increased liability when determining the funding arrangements for the year. In effect, the employer made an additional lump sum

⁷¹ APRA is responsible for prudential supervision of superannuation funds; ASIC is responsible for market conduct and disclosure relating to investments.

⁷² Letter to members explaining the reversal of the crediting rate decision, attached to the undertaking, n 52.

⁷³ Undertaking, n 52.

⁷⁴ APRA and ASIC, n 21.

contribution, so that the VBI of the AXA fund was back above 100% by the end of the financial year 2004-2005.⁷⁵

This agreement was recorded in an enforceable undertaking between the trustee and APRA.⁷⁶

<subdiv>The alleged breaches of covenants: Issues of partiality and disclosure

Although the trustee had denied any wrongdoing, APRA did not agree. APRA decided that the trustee had contravened the SISA. Specifically, the trustee, in the opinion of APRA, had breached three of the covenants deemed by s 52(1) to be in the governing rules (such as a trust deed) of the superannuation entity (where they are not expressly provided for): these covenants are stipulated in s 52(2). They impose on the trustee of a superannuation entity a range of obligations, including:

<blockquote>

(b) to exercise, in relation to all matters concerning the entity, the same degree of care, skill and diligence as an ordinary prudent person would exercise in dealing with the property of another for whom the person felt morally bound to provide;

(c) to ensure that the trustee's duties and powers are performed and exercised in the best interests of the beneficiaries;

...

(g) if there are any reserves of the entity – to formulate and give effect to a strategy for their prudential management, consistent with the entity's investment strategy and its capacity to discharge its liabilities (whether actual or contingent) as and when they fall due.</blockquote>

Pursuant to s 120(A) of the SISA, APRA had at the relevant time the power to disqualify directors of a trustee which has breached any of the covenants. Between June and October 2005, APRA disqualified several of the directors.⁷⁷ The disqualified directors then appealed to the AAT against these disqualification orders.

⁷⁵ AXA Australia Staff Superannuation Plan:Trustee Report as at 30 June 2005 (December 2005).

⁷⁶ Undertaking, n 52.

⁷⁷ Seven directors were disqualified. Only six of them were directors at the time the crediting rate decision was made. APRA's grounds of complaint included additional problems arising from the employer offer which was made in 2003. Two people who were directors at the time of the crediting rate decision were not disqualified: *VBN v APRA* [2006] AATA 710 at [57].

Factual issues raised by APRA, and reviewed by the AAT, included:

- the retrospective impact of the crediting rate decision, which was detrimental to those members who held accumulation benefits, especially deferred benefit members;
- the failure to consider alternatives, such as seeking financial assistance from the employer;
- failure to communicate to a class of member, namely the deferred benefit members, relevant information, thereby creating a misleading expectation among these members; and
- partial decision-making, which subordinated the interests of one class of members – the deferred benefit members – to the interests of the other members.

APRA presented testimony from a highly respected actuary who was acting as an expert witness. He stated that, in his opinion, it would have been better to change the crediting policy prospectively instead of retrospectively, ie:

<blockquote>

My recommendation to the Trustee in August 2002 would have been:

- Apply the old policy to determine the 2001/2002 crediting rate
- Confirm that the new policy would apply from 1 July 2002
- Approach the employer-sponsor to provide funding in relation to any members who exit the Plan or who exercise their option to commence payment of their deferred pension.⁷⁸

The expert witness agreed that the trustee, and in turn its directors, was faced with a difficult and complex situation at the end of 2001-2002. He agreed that the trustee had to weigh a number of different factors when making its decision. He agreed that the plan actuary has presented the trustee with reports which outlined most of the relevant considerations. He agreed that there was no one correct decision. In his opinion, the trustee had not placed enough weight on the duty to avoid misleading the members.⁷⁹

No doubt many actuaries would agree with this expert witness. But other actuaries – including the plan actuary – would disagree. The AAT noted that the trustee had sought

⁷⁸ *VBN v APRA* [2006] AATA 710 at [376].

⁷⁹ *VBN v APRA* [2006] AATA 710 at [407], [412].

and received actuarial advice and it had followed that advice – not blindly but after careful consideration.⁸⁰

<subdiv>Principles governing review of a trustee’s discretion

The AAT pointed out that the SISA does not require the trustee to make the best possible decision. The position of a trustee is a difficult one:

<blockquote>

There can be no doubt that the position of a Trustee is difficult. It must work its way through a web whose mesh is made of the obligations it owes under the SIS Act and Regulations and its Trust Deed and the corresponding privileges bestowed upon the Plan’s Members. The net is held, as it were, at one end by the Employer and at the other by the Plan’s Members. In exercising its discretions to find its way through the net, it cannot be directed by the Members and, for most purposes, it cannot be directed by the Employer. It might be thought that the Trustee is the only entity that can alter the net. That is not so. The Employer can alter it by changing the benefits that are offered under it provided it does not do so affect accrued benefits retrospectively. The Members, though, cannot alter or move the net at all.⁸¹ </blockquote>

Moreover, a tribunal (or court) reviewing a trustee’s decision on the merits ought to be cautious and not too readily impeach the trustee’s decision on the basis that the appellate tribunal would have made a different one. Where the decision is discretionary:

<blockquote>

it will rarely be the case that there will ever be only one decision that does not contravene the covenants. It is more likely that there will be a range. Although expressed in the context of an appellate court’s reviewing the discretionary decisions of an executor, the views of Kirby P in *Golosky v Golosky* suggest that we should be cautious in undertaking our task:

Unless appellate courts show restraint in disturbing the evaluative determinations of primary decision-makers they will inevitably invite appeals to a different evaluation which, objectively speaking, may be no better than the first. Second opinions in such cases would be bought at the cost of diminishing the finality of litigation in a troublesome area and, sometimes at least, with a burden of costs upon the estate which should not be encouraged.⁸² </blockquote>

The latitude afforded a trustee was expressed graphically in a passage from the majority judgment in a High Court decision:

⁸⁰ *VBN v APRA* [2006] AATA 710 at [426].

⁸¹ *VBN v APRA* [2006] AATA 710 at [385].

⁸² *VBN v APRA* [2006] AATA 710 at [329]; see also at [274]ff, citing *Cowan v Scargill* [1985] 1 Ch 270; *Edge v Pensions Ombudsman* [1998] Ch 512; *Golosky v Golosky* (unreported, NSW Court of Appeal, No CA 40012 of 1991, 5 October 1993).

<blockquote>

Where a trustee exercises a discretion, it may be impugned on a number of different bases such as that it was exercised in bad faith, arbitrarily, capriciously, wantonly, irresponsibly, mischievously or irrelevantly to any sensible expectation of the settlor, or without giving a real or genuine consideration to the exercise of the discretion. The exercise of discretion by trustees cannot of course be impugned upon the basis that their decision was unfair or unreasonable or unwise. Where a discretion is expressed to be absolute it may be that bad faith needs to be shown. The soundness of the exercise of a discretion can be examined where reasons have been given, but the test is not fairness or reasonableness.⁸³</blockquote>

The trustee's discretion then is not readily to be impeached unless it is shown to have been influenced by irrelevant or improper considerations.

<subdiv>**The crediting rate decision**

The trustee abandoned the smoothing rate policy for 2001-2002, and in so doing favoured one class of member – those who were not deferred benefit members – over the deferred benefit member class. This gave rise to an allegation of partiality. The trustee's decision to credit a negative crediting rate was also said to breach the trust deed. The trustee was alleged to have given inadequate information to the deferred member benefit in relation to the change of crediting policy. It was also accused of favouring one class of member over another.

<group>***The crediting of a negative crediting rate***

The AAT decided that the trustee's decision to credit a negative crediting rate breached the trust deed.⁸⁴ This breached a general law duty imposed upon the trustees, ie to comply with the trust deed. Construction of the instant trust deed (which included, relevantly, terms such as "accrue" and "interest") revealed that there could not be a negative crediting rate. It was technically unnecessary to determine whether this departure from the trust deed also amounted to breach of one or more of the s 52(2) covenants, given that APRA had not made an issue of this in relation to the directors.⁸⁵ Without a breach of the covenants, there was no basis for disqualifying the directors pursuant to s 120A, insofar as the decision concerning the negative crediting rate was concerned.

⁸³ *VBN v APRA* [2006] AATA 710 at [285], citing *Attorney-General (Cth) v Breckler* (1999) 197 CLR 83.

⁸⁴ *VBN v APRA* [2006] AATA 710 at [331]ff, [350].

⁸⁵ *VBN v APRA* [2006] AATA 710 at [354].

<group>Did the trustee fail to give relevant information to the members or some of them: The disclosure issue

The tribunal was much more critical of the trustee's communication of its decision to the members. The trustee had been aware of potential problems with the crediting rate for a long time. In December 2000, the plan actuary had warned that the increase in the number of deferred benefit members was creating a substantial cost and had suggested a reduction in the crediting rate. In July 2001, the employer had complained about the "unacceptable burden" caused by the deferred benefit members and had threatened to close the AXA fund unless the situation was resolved. In October 2001, the plan actuary raised more concerns about the problems caused by over-crediting and the potential for adverse selection. However, the trustee did not mention any of these matters to the members in any of the annual reports and newsletters which were issued to members during this period.

In fact, the members were not given any information about changes in the crediting rate policy until the June 2002 newsletter. And even then, the information provided in that newsletter had the effect of misleading several of the members.

The AAT determined that the trustee had deliberately withheld information from the deferred benefit members so that they could not select against the AXA fund.

<blockquote>

For many [members], and particularly for those who have been Members for a lengthy period of time ... they have very little effective control over a significant financial investment that they have been required to make and that, in some instances, they have made voluntarily. In most cases, they have no control over an investment that is often intended to provide a significant source of income to care for them in their retirement. Only Deferred Benefit Members have some control over their investment but their control is dependent upon their having knowledge of relevant material upon which to base their decision about a significant investment.

In this case, the findings that we have made lead us to conclude that the Deferred Benefit Members did not have the knowledge they required. Furthermore, the Trustee kept the knowledge from them and did so deliberately so that they could not select against the Plan ...

On the basis of the evidence, we consider that it was in the best interests of the Deferred Benefit Members to be told of the change in the crediting rate policy prospectively with regard to the year to come and not retrospectively about the year past at a time when they could not alter their positions and protect them. It was not in their best interests not to be told of the change.⁸⁶ </blockquote>

⁸⁶ *VBN v APRA* [2006] AATA 710 at [385], [386].

Nonetheless, the tribunal did not make a finding that the trustee was in breach of the covenants by dint of the inadequacy of disclosure; thus this was not a matter that could be relied upon to disqualify the directors under s 120A.⁸⁷

<group>The trustee favoured one class of members over another: The partiality issue

Although the trustee had not acted in the best interests of the deferred benefit members, the AAT decided that this did not necessarily mean that the trustee had breached SISA and the Regulations and/or failed to meet its fiduciary responsibilities.

<blockquote>

The fact that it is not in the best interests of one group of Members does not necessarily mean that the Trustee has not acted in the best interests of the Members as a whole ... Regard needs to be had to the outcome for all Members.⁸⁸</blockquote>

At the time the trustee made the crediting rate decision, there was clearly a conflict between the interests of the deferred benefit members and the other members. If the normal smoothing policy was continued, then the financial position of the AXA fund would deteriorate and the situation would be exacerbated if the deferred benefit members chose to select against the fund. This would create additional risks for the remaining members.

The trustee directors were well aware of this conflict of interests. One of them explained the dilemma which they faced:

<blockquote>

I was quite clear in my understanding of the implications of the decisions that we were making by this time, that there was that particular sub-set of people within the deferred benefit group ... who would clearly ... be more likely to be upset than others. I also recall going through the process of remembering that my obligation as a trustee was to look after the interests of all members and that that was one of the things that made this such a weighty decision, because it was by no means obvious how to look after everyone's – in fact it was impossible to look after everyone's interests equally, there had to be a balance between looking after members generally and one particular subset of a subset who were clearly not going to be happy with the direction we were going.⁸⁹</blockquote>

⁸⁷ VBN v APRA [2006] AATA 710 at [386].

⁸⁸ VBN v APRA [2006] AATA 710 at [387].

⁸⁹ VBN v APRA [2006] AATA 710 at [395].

The conflict could be resolved if the employer was willing to pay higher contributions to cover the shortfall – but the trustee did not expect that the employer would be willing to do so, and this belief was quite reasonable.

A prima facie obligation of a trustee is to act impartially as between members⁹⁰ where there are no countervailing considerations justifying partiality. The AAT recognised that on occasions trustees necessarily had to act partially as between beneficiaries or classes of beneficiary. The AAT noted a comment in an English decision that “trustees, when exercising a discretionary power to choose, must not of course take into account irrelevant or improper factors. But provided they avoid doing so, they are entitled to choose and to prefer some beneficiaries over others.”⁹¹ Further, trustees are not to have regard to the interests of one person or another but “to the interests of the estate as a whole, and ... to exercise their discretion in the way that will, in their opinion, tend to produce ultimately the largest amount of money for distribution” among the persons interested.⁹²

The trustee did not breach its general law duties or the relevant statutory covenants – s 52(b) (the duty to exercise due care and skill) and (c) (the duty to act in the best interests of the beneficiaries).⁹³ The AAT pointed out that:

<blockquote>

In the end, the Trustee was faced with a choice between Scylla and Charybdis. In avoiding one, it would founder in the second. In selecting a crediting rate and in abandoning the smoothing rate policy in respect of the 2001/02 year, we are satisfied that it steered the fairest course that it could among all of the Members. As we have already found, it was not in the best interests of the Deferred Benefit Members but it was the fairest decision because it placed the burden of the Plan’s earnings upon all. For those, like long-term Deferred Benefit Members, they remained in a more beneficial position than they would have been had the Trustee always credited the Plan’s earning rate. Members who had belonged to the Plan for a short period only suffered but their suffering reflected what had happened in the industry that year. It was not a case in which legal advice would have assisted the Trustee to make its decision. Actuarial principles were applicable. It sought and received actuarial advice. It followed that advice; not blindly but after considering it both in the Investment Sub-committee and at Board meetings.⁹⁴ </blockquote>

⁹⁰ *Cowan v Scargill* [1985] 1 Ch 270, cited in *VBN v APRA* [2006] AATA 710 at [274].

⁹¹ *VBN v APRA* [2006] AATA 710 at [275], citing Scott VC in *Edge v Pensions Ombudsman* [1998] Ch 512.

⁹² *VBN v APRA* [2006] AATA 710at [280], citing Wartrington J in *Re Charteris; Charteris v Biddulph* [1917] 2 Ch 379.

⁹³ *VBN v APRA* [2006] AATA 710at [387]ff, [426].

⁹⁴ *VBN v APRA* [2006] AATA 710 at [426].

<DIV> THE EMPLOYER OFFER AND THE CASH CREDITING RATE

<subdiv>The switch to cash crediting rates

As noted previously, the CEO of the employer was keen to reduce the cost of providing pension benefits to deferred benefit members. In mid-2002, a consultant suggested that the best approach would be to reduce the number of deferred benefit members by persuading them to take a lump sum and withdraw from the AXA fund.

After a considerable amount of discussion, the employer decided to offer members a choice between two alternatives:

- *lump sum option*: take their lump sum benefit, plus an enhancement of say 5% or 10%, and leave the fund; or
- *deferred benefit option*: remain in the fund as deferred benefit members, accumulating benefits with interest at the fund crediting rate.

Naturally, in order to make an informed decision, members would need to know the future crediting rate policy of the AXA fund. If the trustee intended to declare low crediting rates in the future, and/or recoup some of the past over-crediting, then the deferred benefit option would be relatively less attractive.

The employer wanted to encourage members to take the lump sum option and to minimise the costs of providing benefits for any deferred benefit members who remained in the AXA fund. As explained above – each extra dollar of interest credited could increase the cost of the pension benefit by about \$1.28. Therefore, the employer strongly encouraged the trustee to change the crediting rate policy for 2003-2004 and subsequent years (this would naturally make the deferred benefit option less attractive). Based on the evidence presented to the AAT, it appears that the employer threatened to close the AXA fund if the trustee did not agree to change the crediting rate policy.

In the end, the trustee agreed to do so.⁹⁵ In December 2002, the board of directors of the trustee resolved to adopt a cash-based crediting rate for the deferred benefit members. The main reasons for adopting this policy were:

<blockquote>

⁹⁵ According to the information provided to the members as part of the enforceable undertaking, the trustees took advice from Mercer Human Resources Consulting Pty Ltd before making this decision. The trustees then concluded that the cash crediting rate is a sound interest calculation method.

- The introduction of deferred benefits has resulted in substantial additional amount of actual and potential liabilities.
- There are considerable funding risks associated with the provision of pension benefits.
- The Employer's attitude to continued support of the Plan is contingent on a number of actions being taken to mitigate the risks associated with the pension liabilities.
- One of these actions is to change the crediting rate policy for deferred benefits to provide a more appropriate growth rate.
- The main purpose of the deferred benefit facility is to allow members to access a Plan pension from age 55. For members in service, growth in their retirement pension is directly linked to increases in salary.
- Membership of the deferred benefit category is voluntary not compulsory and members can leave and take a lump sum at any time (or a pension if over age 55).⁹⁶

The employer also wanted the trustee to agree to recoup past over-crediting (amounting to about \$2 million) – that would mean that the crediting rate for 2003-2004 would be even lower than the cash rate. However the trustee would not agree to this.⁹⁷

Clearly, the desire to reduce the cost of deferred benefits was the main reason for the change in the crediting rate policy. Naturally, the deferred benefit members were unlikely to be happy about this, and there was concern that this decision might lead to further complaints from members.⁹⁸ According to newspaper reports, the members were indeed unhappy about this, contemplating legal action.⁹⁹

The new cash crediting rate would not be based on the rate of return earned by the AXA fund – instead, it would be based on a suitable external rate.¹⁰⁰ The trustee would not necessarily invest the plan assets in cash. The trustee could invest in growth-type assets, which would be expected to have long-term rate of returns significantly above the cash rates. If actual returns exceeded the cash rates, then this would improve the financial condition of the AXA fund, and allow the employer to reduce future contribution rates.

⁹⁶ *VBN v APRA* [2006] AATA 710 at [175].

⁹⁷ *VBN v APRA* [2006] AATA 710 at [186].

⁹⁸ *VBN v APRA* [2006] AATA 710 at [184].

⁹⁹ Murray, n 66; Newman G, "Super Blooper: AXA Investments Under Fire", *The Australian* (7 June 2005).

¹⁰⁰ *VBN v APRA* [2006] AATA 710 at [197].

That is: “The Employer would be free to mismatch and to try to recover some of the cost of the annuity guarantee.”¹⁰¹

During this period, the employer began to take a stronger interest in the investment policy of the fund, eg the CEO told the trustee that:

<blockquote>

[the] employer regards this as a balance of cost scheme and therefore is of the view that no changes to investment policy should take place without the consent of the employer. In the short term there should be no change in policy notwithstanding the move to a cash crediting rate for deferred members.¹⁰²</blockquote>

<subdiv>Disclosure issues for the employer offer

After the trustee adopted the cash crediting policy, the employer made an offer to the deferred benefit members.¹⁰³ The trustee passed on this offer to members. Naturally, it was important for the members to be fully informed about their choices.

Consider a deferred benefit member above age 55 with an accumulation of \$L. Under the employer’s offer, the deferred member had a choice between taking:

- a lump sum of 110% of L; or
- a pension benefit.

The trustee knew that the actuarial value of the pension benefit was approximately 128%L on average. That is, the average cost to the employer of providing this pension benefit was estimated at 128%L. If the member wanted to buy an equivalent pension on the open market (eg from another insurer), then the cost would be even higher than 128%L (since the purchase price for open-market annuities includes loadings for commission and profit).

The actuarial value was set out in an early draft of the information to be provided to members, but it was later deleted. The trustee apparently decided that the actuarial value was not useful information for the members because it was only an average value.

¹⁰¹ *VBN v APRA* [2006] AATA 710 at [190].

¹⁰² *VBN v APRA* [2006] AATA 710 at [195].

¹⁰³ The employer offer was made in April 2003.

The value for any individual member might be either higher or lower, depending on the member's individual circumstances.

Instead, the trustee advised the members that:

<blockquote>

The actual value of the pension option for any individual member will depend on their ultimate life span, their marital status (and life span of their spouse) as well as future earning rates and CPI increases.

It is important that you carefully consider how valuable the pension option is, or may be, to you. You may wish to seek appropriate advice on this issue.¹⁰⁴</blockquote>

In 2003, 47 deferred benefit members accepted the employer offer, took the lump sum and left the AXA fund.

APRA later argued that the members should have been told that the average actuarial value of the pension was 128% of the lump sum. APRA argued that this information would have been useful to the members in making their decision about the employer offer. The trustee did not agree. However, after further discussions with APRA, the trustee signed an enforceable undertaking, agreeing to give the affected members the right to rejoin the fund. In the end, only one member took up this offer.

When APRA disqualified some of the trustee directors, the adequacy of the information provided to members was a major issue. APRA took the view that the information provided to members in April 2003 did not contemporaneously include all the information in the possession of the trustee, or available to it from its advisors, which a member needed in order to make an informed decision on the employer's offer.¹⁰⁵

APRA contended that the trustee had, in relation to the employer offer, breached the s 52(2)(c) covenant, which required the trustee to act in the interests of the beneficiaries.¹⁰⁶ This was rejected by the AAT. On the facts, there had been no breach of s 52(2)(c):¹⁰⁷ "It might or might not have drawn Members' attention to the value of their

¹⁰⁴ *VBN v APRA* [2006] AATA 710 at [168]

¹⁰⁵ Undertaking, n 52 at [J].

¹⁰⁶ *VBN v APRA* [2006] AATA 710 at [453].

¹⁰⁷ *VBN v APRA* [2006] AATA 710 at [484]ff.

pension options but we are satisfied that the Employer Offer as a whole did that quite adequately given the options that were available to a Member.”¹⁰⁸

APRA was also concerned about the trustee’s decision-making process. The task of managing the details of the employer offer had been delegated to a sub-committee. The sub-committee included directors who had been nominated by the employer, but did not include any directors who had been chosen by members.¹⁰⁹ APRA felt that the trustee should have been particularly careful about the employer offer because the trustee knew that the employer was making the offer in the hope of cutting costs (ie by reducing the total cost of benefits payable to members).

Further, the fact that the trustee knew that the employer wanted the defined benefit members to transfer to the accumulation category, in the anticipation that this would be less costly to the employer in the long run, did not mean that the trustee was to be taken to have exercised its power for an improper purpose.¹¹⁰

The trustee did not breach its obligation to act with due care, skill and diligence (s 52(2)(b) in relation to the employer offer). It delegated consideration of the employer offer to volunteer directors who were:

<blockquote>

best possessed of the skills to consider the issues. They were Employer representatives and there was no member representative among them. That does not, in our view, detract from them being able to be the Trustee’s delegates and from acting properly on the Trustee’s behalf and in its interests.¹¹¹</blockquote>

Inter alia, all of the directors knew that the offer document had undergone extensive review, legal and otherwise, and that the trustee’s final recommendation was that the members obtain their own financial advice. Hence the trustee fulfilled the s 52(2)(c) covenant.¹¹²

¹⁰⁸ *VBN v APRA* [2006] AATA 710 at [484].

¹⁰⁹ Under the SISA equal representation rules, half of the trustee directors must be employer representatives and half must be member representatives (with an optional additional independent).

¹¹⁰ *VBN v APRA* [2006] AATA 710 at [489].

¹¹¹ *VBN v APRA* [2006] AATA 710 at [516].

¹¹² *VBN v APRA* [2006] AATA 710.

APRA was also concerned it appeared that two of the trustee directors had a conflict of interest. They were AXA employees who held very senior positions, and they had both been closely involved in formulating the employer offer. In their role as employees, they were expected to act in the best interests of their employer, ie helping the employer cut costs, and this would be achieved if a high proportion of members accepted the offer. But in their role as trustee directors, they had a duty to provide impartial and unbiased information to the members. Did this create a conflict?

The AAT pointed out that the SISA automatically creates a potential for conflict. Under the equal representation rules, half the directors are appointed by the employer and half are chosen by the members. When passing the law, Parliament certainly would have been “aware that there was a potential for conflict for directors between their duties as directors of a trustee and the interests of those by whom they were nominated”.¹¹³

The AAT found that both of these men had managed the potential conflict properly: neither of them had withheld relevant information from the other directors and neither had attempted to improperly influence the other directors’ decision.¹¹⁴

Hence the AAT determined that neither of these men should be disqualified.

<DIV> IMPROVING RISK MANAGEMENT AND GOVERNANCE

In a defined benefit superannuation fund, there is always a potential for conflicts of interest, such as:

- conflicts between the interests of employers and members; and
- conflicts between different groups of members.

In *VBN v APRA*, these conflicts of interest created considerable difficulties for the members, the employer, the trustee, and the regulators. There were serious negative outcomes for all parties, including increased risk and uncertainty, negative publicity and damage to reputation, and considerable legal costs.

Management of these conflicts is a difficult task for the trustee. What can be learnt from *VBN v APRA*? Could such problems be avoided in the future?

¹¹³ *VBN v APRA* [2006] AATA 710 at [546].

¹¹⁴ *VBN v APRA* [2006] AATA 710 at [559]ff, [567].

<subdiv>Benefit design and trustee discretion: Employer perspective

It is often desirable to give trustees wide discretion over the management of a superannuation fund so that the trustee has flexibility to respond to changing circumstances. For example, trustees are usually given flexibility to determine the fund's investment policy so that they can cope with both external events (market conditions) and internal factors (changes in membership profile and liquidity needs).

However, in *VBN v APRA*, it was counterproductive to give trustee discretion over the crediting rate policy. Both the employer and the members faced additional risk and uncertainty as a result of the discretionary elements of the benefit design.

The employer clearly wanted to have control over the cost of fund benefits. This is a perfectly reasonable objective for any business. So, this article argues that the employer made a strategic error when it designed the deferred benefit option in 1997. By giving the trustee the discretion to set the crediting rate, the employer lost control of decisions which would affect its own superannuation costs.

The trustee did take account of the employer's funding costs when setting the crediting rate – but this was only one of the factors which influenced its decision. In the end (ie after the enforceable undertaking), the trustee made a decision which imposed significant additional costs on the employer.

The employer had the right to determine the benefit design. Under the AXA trust deed, the trustee's responsibility was limited to making sure that any benefit changes did not have an adverse impact on the other fund members. The employer could have specified the method of calculation of the crediting rate – ie equal to the fund earning rate, or equal to the cash rate, or equal to some external benchmark such as price or salary inflation (eg the consumer price index or average weekly earnings). A clearly defined method of calculation would have eliminated a potential source of conflict between the interests of members and the interests of the employer.

<subdiv>Benefit design and trustee discretion: Member perspective

Theoretically, when trustees are given discretion, this discretion must be exercised on behalf of the members as a whole. However, *VBN v APRA* demonstrates that the existence of this discretion may well be detrimental to some fund members.

It is clear that the employer's attitude to the AXA fund had a significant impact on the crediting rate decision. Initially, when the deferred benefit option was introduced in 1997, the employer was willing to fund generous benefits based on the actual fund earning

rates (smoothed over time). By 2003, the employer was no longer willing to provide such generous benefits, and the trustee was persuaded to adopt a cash crediting rate policy.

As an example, consider the impact of this change on an average deferred benefit member aged 45, with a lump sum of L , assuming that the long-term average cash rate is 3% per annum and the long-term average investment returns are 5% per annum, and assuming that the member chooses the pension option:

- Value of pension benefit under original policy = $L * 1.05^{10} * 1.28 = 2.08L$
- Value of pension benefit under revised policy = $L * 1.03^{10} * 1.28 = 1.72L$

The expected value of the member's pension benefit would fall by about 17.5% as a result of this change in policy.

Some would argue that this is acceptable – the original benefit was generous for some members and the employer had no legal obligation to provide such generous benefits.

But there is no doubt that the existence of the discretion created considerable uncertainty for AXA fund members (including those employees who might be eligible for deferred benefits upon retirement in the future). If the expected value of their benefits can be reduced so easily whenever the employer wishes to cut costs, then this makes it very difficult to plan for the future.

Since the superannuation system is now an integral part of Australia's retirement income system, this level of uncertainty in benefit entitlements seems undesirable.

<subdiv>Smoothing crediting rates

In the past, many defined benefit superannuation funds have adopted policies to smooth crediting rates. There are advantages for the members and for the employer: the fund can invest in more volatile assets – which would be expected to produce higher average returns over the long run – without causing too much volatility in members benefits.

However, sound management of a smoothing policy is not simple. A number of actuarial papers have described the problems which might arise from time to time.¹¹⁵

¹¹⁵ Humphreys J and Newman CA, *Crediting Rates for Superannuation Plans: Transactions of the Institute of Actuaries of Australia* (1993) Vol I, pp 180-228; Grenfell C, *Uses of SIS (Stochastic Investment Simulations), Transactions of the Institute of Actuaries of Australia* (1997) pp 385-576.

These studies have shown that there is a reasonably high probability that a three-year smoothing policy will lead to a negative crediting rate reserve. The probability would vary depending on the fund's asset mix, but the expert witness who provided evidence to the AAT suggested that the notional crediting rate reserve would fall below -10% approximately one year in 12.¹¹⁶ If investment returns are declining, then the reserve might remain negative for several years. Problems are even more likely to arise if the smoothing policy commences at a time when investment returns are high – as was true when the AXA fund first adopted its three-year average policy.¹¹⁷

Negative reserves are particularly likely to be a problem when members have the option to select against a fund, eg by withdrawing their lump sum benefits and/or converting the lump sums to a pension. Adverse selection may not be a problem if the negative reserve is small. But the larger the size of the negative reserve, the greater the incentive for members to select against the fund.

Since AXA fund's smoothing policy did not contain any rules for limiting the size or duration of any negative reserves, the smoothing policy put the solvency of the fund at risk.

After *VBN v APRA*, APRA issued new guidelines for the sound management of crediting rates and investment fluctuation reserves:

<blockquote>

Returns credited could exceed returns earned for an extended period of time, which, without proper management, could result in sustained negative Investment Fluctuation Reserve. APRA views this as imprudent, particularly given the likelihood, with portability, that during such times some members may choose to exit the fund to lock in the higher benefits (adversely affecting the situation of remaining members ...)

... It is imperative that trustees recognise the importance of bringing the situation back into balance and adequately document their decisions in relation to the duration of a negative reserve. It would also be sound practice for the trustee to set minimum and maximum limits on the size of the IFR, and where a negative IFR is permitted, the maximum duration of any negative IFR and the circumstances in which any negative returns would be borne immediately by members.¹¹⁸ </blockquote>

¹¹⁶ *VBN v APRA* [2006] AATA 710 at [400].

¹¹⁷ Humphreys and Newman, n 115.

¹¹⁸ APRA, *Prudential Practice Guide Draft SPG 235 – Use of Reserves in Superannuation Funds* (29 April 2009), available at <http://www.apra.gov.au> viewed 1 July 2010.

According to the evidence presented to the AAT, during 2000 and 2001 the trustee and the employer had obtained legal advice and actuarial advice about changing the crediting rate. The advisors recommended that the members should be informed about any change *in advance*.¹²⁰

The trustee did seek legal advice about the legality of retrospective changes to the policy – but it appears that the trustee only obtained this advice AFTER the decision was made when the members started to complain. The retrospective decision was announced to members in August 2002. In September 2002, the AXA fund’s legal advisor provided advice on the following issues:

- whether the trustee provided misleading information under the *Trade Practices Act 1974* (Cth);
- whether there has been any contravention of reg 13.16 of the Regulations (which forbids any reduction in accrued benefits);
- the (perceived) retrospectivity of the change to the policy; and
- members’ concerns about the timing of their decisions to withdraw funds.

The legal costs incurred by all parties were quite high relative to the disputed amount. APRA incurred legal expenses of about \$2 million.¹²¹ The legal costs incurred by AXA probably exceeded \$20 million.¹²²

Compare this to the cost of the additional benefits provided under the enforceable undertaking: when the crediting rate decision was reversed, the additional benefits cost about \$10 million.

AXA ended up paying for both the additional benefits AND significant legal costs. The APRA investigation and the AAT hearing would have taken up quite a lot of time and attention from senior people at AXA. It took more than two years to resolve the matter. Seven of the trustee directors were disqualified for several months in 2005-2006, which

¹²⁰ *VBN v APRA* [2006] AATA 710 at [74], [76], [81].

¹²¹ Information provided to the Australian Parliament: see Senate Standing Committee on Economics, *Supplementary Budget Estimates* (2 November 2006) pp E48-E49 (Answers to questions on notice relating to the Treasury portfolio).

¹²² Johnston E, “Axa Chief Hits Back at APRA”, *The Australian Financial Review* (18 January 2008); Greenblat E, “APRA Humbled in Victory over Regulator”, *The Australian Financial Review* (20 April 2007); Moncrief M, “AXA Chief Skips the Trumpeting”, *The Sydney Morning Herald* (20 April 2007).

would have affected their ability to accept certain work responsibilities. Since *VBN v APRA* was reported in the newspapers, it is likely that the company suffered some reputational damage as well. For example, the headlines included:

- “Insurance Chief Forced to Step Down”;¹²³
- “AXA Chief Stands Aside as Regulator probes Staff Super Fund”;¹²⁴
- “AXA Chief Expects to be Cleared of Wrongdoing over Super Fund”; and¹²⁵
- “AXA Executive under Investigation Over Super Irregularities”.¹²⁶

With the benefit of hindsight, it seems likely that AXA would have been better off to continue with the smoothing policy for one more year and to make a change in the crediting rate policy prospectively (ie effective for the 2002-2003 financial year).

<DIV>CONCLUSION

VBN v APRA demonstrates both the strengths and the weaknesses of Australia’s prudential legislation.

When certain members of the AXA fund were disadvantaged by the actions of the trustee, APRA was able to intervene on their behalf to obtain a better outcome. This was done by the use of the SISA method of enforceable undertakings.

Furthermore, APRA has taken steps to prevent a recurrence of such problems, by issuing guidance notes on the use of smoothing reserves and on the management of conflicts of interest.

However, *VBN v APRA* revealed some flaws in the disqualification process. After the AAT announced its decision in this matter, the regulator was subjected to a considerable amount of criticism in the press.¹²⁷ There were complaints that APRA had

¹²³ *Northern Territory News* (19 September 2005).

¹²⁴ By Richard Gluyas, *The Australian* (17 September 2005).

¹²⁵ By Tim Boreham, *The Australian* (6 June 2005).

¹²⁶ By Murray, n 66.

¹²⁷ Bartholomeusz S, “Overlook the Spin: APRA got it Wrong”, *The Sydney Morning Herald* (24 August 2006); Gluyas R, “Costello Limits APRA Right to Ban Directors”, *The Australian* (17 April 2007).

been too harsh in judging the actions of the trustee and overzealous in issuing disqualification orders.

The decision in *VBN v APRA* confirms that trustees including superannuation trustees (and in turn directors of a corporate trustee who can be held to account for the trustee's breach of the s 120A covenants) enjoy a considerable measure of legal protection against the imposition of legal liability where they act in good faith. As noted above, the law requires courts and tribunals to exercise a high degree of caution in reviewing trustee decisions on the merits. It is not sufficient to impeach a trustee's discretionary decision that the appellate tribunal would have made a different decision. At general law, unless the trustee has acted arbitrarily, wantonly and irresponsibly, or has had regard to materially irrelevant matters that are hostile to the expectations of the settlor, or has not given genuine consideration to the exercise of the discretion, the decision will prima facie be safe. The fact that a trustee's decision is shown merely to be unfair or unreasonable will not per se provide a basis for impeaching it.¹²⁸ The covenants do not materially alter these principles.¹²⁹ The s 52A(2)(b) due care and skill covenant is replicated in equity.¹³⁰ It is clear, however, that the degree of care and skill required by a professional trustee such as a superannuation trustee will be assessed against the standards of care and skill observed by reasonable trustees in that class.¹³¹

Subsequently, the government held a review of regulation which considered, inter alia, APRA's powers.¹³² AXA made a submission to this review, expressing serious concerns about APRA's powers of disqualification. This review ultimately led to an amendment to SISA: disqualifications are now determined by the court, not by APRA nor the AAT.¹³³

¹²⁸ See *Attorney-General (Cth) v Breckler* (1999) 197 CLR 83.

¹²⁹ See the discussion of this issue in *VBN v APRA* [2006] AATA 710 at [268]ff.

¹³⁰ The seminal decision on this issue is *Re Speight* (1883) 22 Ch D 727 at 739-740, where Jessel MR said that a "trustee ought to conduct the business of the trust in the same manner that an ordinary prudent man of business would conduct his own, and beyond that there is no liability or obligation on the trustee".

¹³¹ See *Bartlett v Barclays Trust Co (No 1)* [1980] 1 Ch 515.

¹³² The Treasury released a consultation paper on *Streamlining Prudential Regulation: Response to "Rethinking Regulation"* on 4 December 2006. Various parties made submissions to the review. These are available at <http://www.treasury.gov.au/contentitem.asp?Navid=037&ContentID=1199> viewed 1 July 2010.

¹³³ *Financial Services Legislation Amendment (Review of Prudential Decisions) Act 2008* (Cth).