CONSOLIDATION OF SMALL DEFINED BENEFIT SCHEMES

REPORT INITIATED BY THE WORKPLACE SAVINGS COMMITTEE OF THE FINANCIAL SERVICES COUNCIL OF NEW ZEALAND INCORPORATED (FSC) AND FUNDED BY THE FSC

AUGUST 2023

Financial Services Council NZ

CONTENTS

DISCLAIMER

This is an independent report prepared by Chapman Tripp (Mike Woodbury). The report was commissioned by the FSC and funded from the Workplace Savings New Zealand reserve held in the FSC's accumulated funds.

Though socialised with the Workplace Savings Committee and other selected workplace savings industry participants, the report's findings and recommendations are those of Chapman Tripp,

OVERVIEW
PURPOSE AND SCOPE OF REPORT

BACKGROUND

Despite many being exceedingly small and most now having been closed to new members for at least a generation, there remain around 50 registered defined benefit (**DB**) or *"hybrid"* DB/cash accumulation workplace savings schemes on the Register of Managed Investment Schemes in New Zealand (**Scheme Register**).

Many sponsors of those legacy DB schemes and sections would wind them up if practicable, but currently there are no reliably workable alternatives to leaving them in operation.

The principal wind-up impediment is trust deed provisions requiring the purchase (in that event) of replacement lifetime annuities for pensioners and in some cases employee members. This requirement, which cannot be modified without unanimous beneficiary consents, operates in practical terms to prohibit wind-ups because:

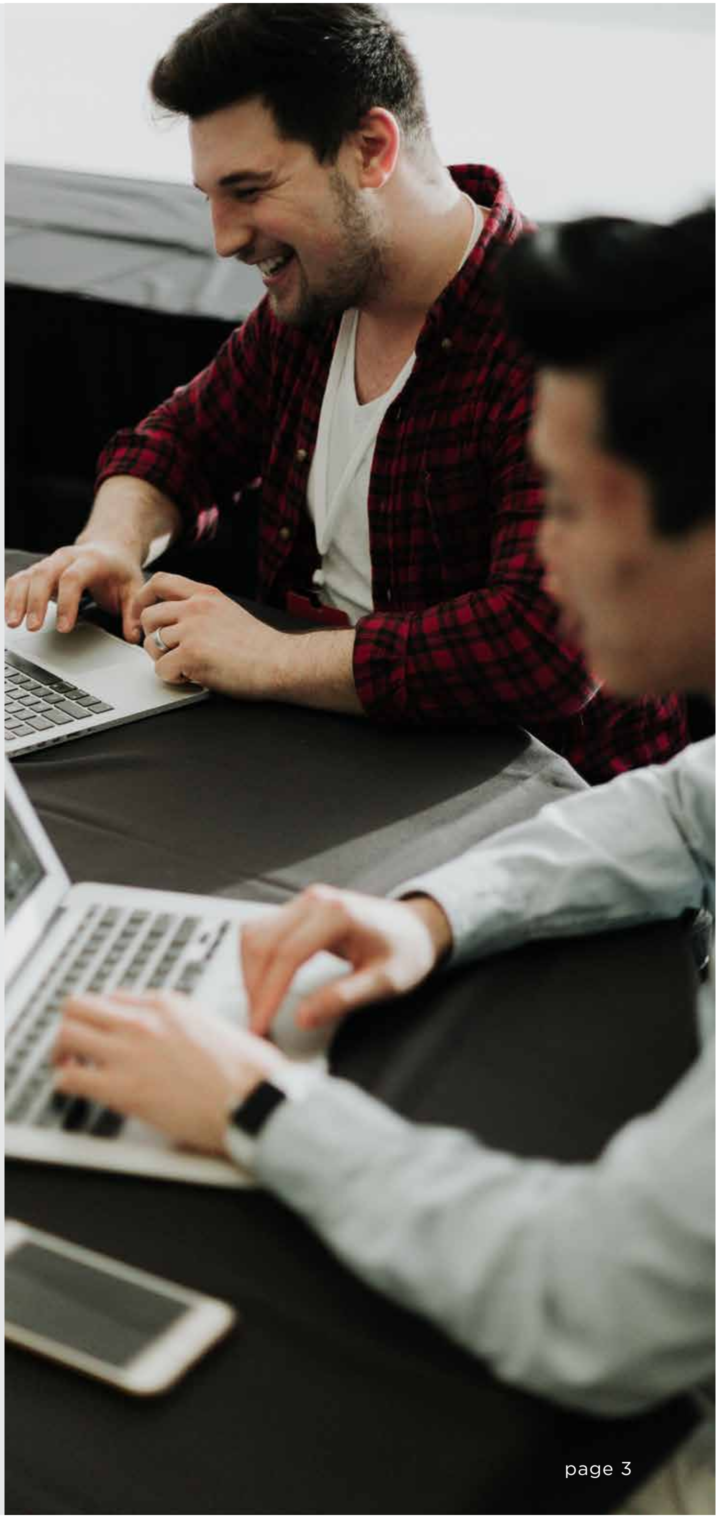
- there are no longer any New Zealand offerors of the required form of lifetime annuity (for reasons including the need for significant insurance reserves invested in fixed interest products and the difficult tax treatment of lifetime annuities under the Income Tax Act 2007); and
- even if annuities were again to become available, it is anticipated that the cost would be highly inhibitive (considerably exceeding the carrying value of the relevant pension liabilities).

Putting this simply, a significant number of small DB schemes and sections are in effect *"stranded"*, and operate at a disproportionately high cost in terms of trusteeship, service provision and legislative compliance, because with exceptions (for example some trust deeds do contemplate or allow lump sum wind-up payments):

- the annuities purchase obligation triggered on a wind-up; and
- the absence of a functioning annuities market in New Zealand;

combine to prohibit wind-ups as matters stand.

A very few sponsors have succeeded with wind-ups after effecting individual consents-based transfers of small pensioner groups into accounts-based "life benefit plans" within defined contribution (**DC**) master trusts which then generate allocated pensions. However, this solution has minimal utility as the Financial Markets Authority (**FMA**) will not consent to non-consensual bulk transfers from DB schemes to DC schemes due to the two scheme types being conceptually too different in kind.



REPORT COMMISSIONED

In November 2022 the Workplace Savings Committee of FSC (**Committee**) requested the FSC to commission via the Committee (using a portion of the residual funds maintained under the FSC/Workplace Savings New Zealand Merger Agreement dated 11 March 2019) a report on creating and giving effect to a regulatory reform-based solution whereby small DB schemes and sections could amalgamate into one or more customised multi-employer schemes that are themselves re-purposed restricted workplace savings schemes.

The reason for re-purposing an existing restricted scheme (several potential candidates have been already discussed in confidence[1]) would be so that the amalgamated schemes can then continue to benefit from the same very valuable (and now legislatively grandfathered[2]) governance-related and other compliance concessions which currently apply to them as restricted workplace savings schemes.

In response, the FSC agreed to commission and fund a report from Chapman Tripp addressing (at a high level and by way of initial research and provisional recommendations):

- the "*stranded DB schemes*" problem and the consolidation opportunity;
- the benefits of a workable solution, including for hybrid schemes with small DB sections (disproportionately complicating scheme administration and impeding future state optionality[3]);
- any key learnings from DB scheme consolidation initiatives in the United Kingdom and Australia;
- the legislative impediments to DB scheme consolidation (and how those might be addressed); and
- policy-led recommendations for facilitating scheme consolidation.

A "*STAGE 1*" INITIATIVE

This report focusses squarely on the potential cost reduction and administrative simplification benefits of a workable DB schemes consolidation solution and on addressing the current legislative impediments. It is in that sense very much a "*stage 1*" initiative intended for reference as a starting point.

The FSC anticipates that if the provisional recommendations in the report meet with wider FSC workplace savings scheme member support and a demonstrated sponsor appetite for consolidation, then the report will be followed by:

- a "*stage 2*" comprising FSC engagement with policy makers and regulators on behalf of relevant schemes to elicit technical support for (and make submissions on) the requisite policy changes and regulatory initiatives; and
- an eventual "*stage 3*" – following the passage of any required enabling legislation – in which:
  - › at least one existing scheme is re-purposed as a "*host*" scheme; and
  - › the commercial proponents of the consolidation initiative obtain the required (scheme-specific) enabling exemptions and effect inward transfers.

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1 The chosen scheme would optimally no longer have either members or assets, thus enabling it to be repurposed "off the shelf" (with a replacement governing document and trustee) by the relevant service provider. However, that is not considered essential (and a complication is that section 195 of the Financial Markets Conduct Act 2013 (**FMCA**) contemplates the FMA directing the wind-up of a scheme with no members, after giving its trustee 20 working days' notice).

2 The transitional provisions in Schedule 4 to the FMCA, which enabled pre-existing workplace savings schemes to be designated as restricted schemes under the Financial Markets Conduct (Restricted Schemes) Order 2016, were repealed effective 1 December 2016.

3 For a smaller hybrid scheme, as well as simplifying ongoing administration, a workable DB scheme transfer solution would remove the key impediment to a full wind-up or master trust transition (where the scheme's trust deed requires the purchase of annuities in order to wind up the DB section).

EXECUTIVE SUMMARY

SMALL DB SCHEMES AND SECTIONS – KEY STATISTICS

As at the latest available year-ends for which financial statements and annual reports were publicly available as at 8 August 2023 (see Appendix 1), the complement of DB schemes for which a workable consolidation solution will or might have some appeal was approximately:

- 22 schemes with assets below $20 million (collectively with $151 million in assets, 591 pensioners[4] and 73 employee members);
- another 8 schemes with assets below $100 million (collectively with $373 million in assets, 835 pensioners and 257 employee members).

Additionally, our review of the Disclose Register indicates that as at the latest available year-ends for which financial statements and annual reports were publicly available as at 8 August 2023 there were 10 hybrid schemes with small DB sections which had collectively around 380 pensioners and 35 employee members.

Of those 40 DB schemes and sections, 19 (and counting) already consisted solely of pensioners (and those 19 schemes and sections collectively had assets of around $115 million and 566 pensioners).

SMALL DB SCHEMES – COSTS

Publicly available statistics reviewed in detail as at 8 August 2023 indicate that currently:

- the average DB scheme with assets below $20 million incurs annual non-investment (i.e. administrative) costs of around $128,000;
- the average pensioner-only scheme incurs annual administrative costs of around $124,000; and
- DB schemes with assets of between $20 million and $100 million have average annual administrative costs of around $215,000 (but with a very wide range).

BENEFITS (AND POTENTIAL DOWNSIDES) OF CONSOLIDATION

The benefits of consolidation include significant cost and time efficiency gains from pooling governance, service provision and assets. United Kingdom research:

- confirms this empirically (indicating that a DB master trust transition can, on average, reduce a scheme's costs by as much as a third); and
- indicates that consolidation also helps drive more effective and efficient investment strategies and improved governance.

A key potential downside though is the need for the consolidation vehicle to acquire (and retain) sufficient scale to take advantage of the key cost saving benefits – and thus the risk of that scale not being reached or retained.

DB MASTER TRUSTS IN THE UK AND AUSTRALIA

DB master trusts are now a significant feature of the United Kingdom pension landscape and most:

- maintain a separate, ring-fenced section for each employer participant (funded separately from the other sections); and
- offer individual employer participants a choice of investment strategy (typically meaning a choice of asset sector benchmark allocations and ranges) from a standard whole-of-scheme suite of chosen underlying funds.

The UK recently put in place an informal self-certifications-based accreditation regime for DB master trust providers to provide clear information on key features and (given their precedent value) recent self-certificates are summarised in Appendix 2 to this report.

In Australia (where the prevalent DB schemes consolidation model is the inclusion of DB plans within otherwise accounts-based master trusts):

- the legislation expressly allows the requirement to obtain an actuarial report on a DB scheme to be met by obtaining a report on each employer's plan; and
- Australian Prudential Regulation Authority (**APRA**) guidance addresses the setting of shortfall limits that trigger reporting and restoration plan requirements if funding levels are unsatisfactory.

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4 Here and elsewhere, the term *pensioner* denotes a former employee (or where applicable the spouse or other dependant of a former employee) who is either currently receiving or awaiting the deferred receipt of a pension from the relevant scheme.

PROPOSED CONSOLIDATION MODEL

Our proposed consolidation model is best characterised (and indeed is described in the United Kingdom[5]) as "*ring-fenced consolidation*":

- a single trustee board governing the whole consolidated scheme; and
- shared administration as well as actuarial, legal, audit and investment management providers; but
- the separation (or ring-fencing) of the assets and liabilities of each participating employer's own plan[6].

This approach is recognised as having the potential to deliver better investment performance through reduced costs, and savings on back-office costs, though the economies of scale gained through consolidation are somewhat offset by the need for ring-fencing into individual sections. In particular:

- there may be limited scope for a material reduction in actuarial valuation costs given the need for each section to be assessed individually; and
- investment strategy must similarly be assessed in the context of (and decided after consultation with the sponsor of) each segregated plan[7].

Up-front analysis may thus be needed in order to confirm reliably that the potential cost savings will outweigh the projected transition costs, though we would expect that in most cases significant savings would accrue over time.

ENSURING REQUIRED TAX TREATMENT

To be taxed as a retirement scheme (rather than as a life insurance product) the DB master trust must be an exempt superannuation scheme in terms of section EY 11 of the Income Tax Act 2007.

Under section EY 11 as currently worded, the master trust would not qualify (by reason of operating for two or more non-associated employers).

We recommend seeking from the Inland Revenue policy team a **remedial amendment to section EY 11 of the Income Tax Act 2007** to enable the FMA to approve the master trust as an exempt superannuation scheme (and this report includes some suggested amendment wording).

We do not anticipate such an amendment being at all objectionable to Inland Revenue – the master trust would be an amalgam of smaller schemes each of which was already an exempt superannuation scheme, so the intent of section EY 11 would be in no way undermined.

A range of additional tax matters would also need to be covered off in respect of both transitioning into the master trust and its go-forward operations[8], and we intend discussing those matters with Inland Revenue alongside our pending consultation with it regarding section EY 11.

Those matters would include, without limitation:

- whether the master trust would be a single taxpayer, despite having segregated employer plans each with their own assets and liabilities (the single taxpayer approach would seem consistent with the master trust being one legal entity);
- whether the employer plans' specific tax positions would need to be aggregated, or whether – as is of course more desirable – each would have its own segregated tax position (with no '*offsets*' between plans);
- addressing potential transition issues around carrying forward tax losses and expenses;
- ensuring continued resident withholding tax exempt status;
- the treatment of any benefit fund portfolio investment entities;
- dealing with balance date changes;
- applying prescribed investor rates to investments; and
- the deductibility of transition costs (we understand these would likely be non-deductible absent specific tax relief, which would in our view be firmly merited).

5 See the Department of Work and Pensions (**DWP**) Green Paper ***Security and Sustainability in Defined Benefit Pension Schemes*** (at paragraphs 355 to 366 under *Consolidation Models*).

6 The central characteristic of a DB scheme is that contributions are not allocated to individual members on a defined basis. This does not inhibit a scheme comprising a series of employer-specific plans with accounting segregation.

7 The range of differing investment strategies summarised in **Table 3** of **Appendix 1** (even for DB schemes with assets below $20 million) demonstrates the need for sponsor investment choice.

8 Some analogous issues were addressed in sub-clause (4) of the now repealed ***clause 28*** of Schedule 4 to the FMCA, which prescribed a transitional amalgamations facility.

OBTAINING THE REQUIRED FMCA EXEMPTIONS[9]

For the reasons set out in the body of this report, the trustee of the master trust would need to seek from the FMA (logically in an omnibus exemption notice) exemptions:

- from complying with the new member admission constraints applying to restricted schemes under the FMCA (conditional on limiting new admissions to the members of other restricted DB schemes or sections);
- enabling it to on-board pensioners from other DB schemes;
- enabling it (by analogy with the Australian legislative solution) to satisfy its obligation to obtain whole-of-scheme actuarial reports by obtaining actuarial reports for each respective employer plan; and
- enabling it to satisfy certain of its related (and other) annual reporting obligations by reporting to the relevant members at a plan-specific (not whole-of-scheme) level.

We would also recommend seeking an exemption from the triennial actuarial review requirement for a pensioner-only plan within the master trust and replacing it with a requirement for a (simpler) annual vested benefits review.

OTHER POTENTIAL ISSUES

Possible need for more muscular funding obligations

In order to approve the bulk transfer of all members from the relevant DB scheme or section to the master trust, the FMA would need to be satisfied that the relevant terms and conditions of the master trust were no less favourable to members than those of the existing scheme.

This would necessitate an across-the-board mirroring of all benefit provisions and also ensuring that the sponsor contribution obligations applying under the employer's participation deed were at least as protective as those applying pre-transfer.

In practice there might in some cases be a need to put in place more muscular deficit funding obligations than those which applied under the transferor scheme's trust deed, so that:

- the transfer communications could reference deficit funding protections that are enhanced and not simply replicated (particularly where the current trust deed imposes relatively weak employer contribution obligations); and
- the master trust board was more comfortable accepting the sponsor to participation.

Reliably concluding a view on whether there will be a need for stronger deficit funding protections, and then agreeing on the requisite details, would be an important transitional issue for each DB scheme or section.

CONSOLIDATION SIMPLER IF A PENSIONERS-ONLY SOLUTION

If the DB master trust solution was offered solely to schemes and sections comprising only pensioners, the master trust would not need Product Disclosure Statements or other Offer Register entries.

Together with other factors such as ease of administration[10], this commends (and we therefore recommend) consolidation being offered solely to pensioner-only schemes and sections, at least initially.

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9 In our view (for the reasons set out in this report) the trustee of the master trust would be permitted as of right to invoke, respectively:

(i) the ***Financial Markets Conduct (Financial Statements for Schemes Consisting Only of Separate Funds) Exemption Notice 2022***, enabling it to produce annual audited financial statements covering only each respective employer plan;

(ii) the ***Financial Markets Conduct (Multiple-participant Schemes—Participation Agreements) Exemption Notice 2022***, under which the deed of participation governing each respective employer plan need not be registered on the Scheme Register as a governing document;

(iii) the ***Financial Markets Conduct (Restricted Schemes—Custodian Assurance Engagement) Exemption Notice 2020*** (**Custodial Audits Exemption**) in the same way as any other restricted scheme.

The master trust trustee would also be permitted to invoke the ***Financial Markets Conduct (Restricted Schemes – Disclosure and Reporting) Exemption Notice 2022*** (prescribing exemption relief in relation to quarterly reporting and a DB scheme's annual confirmation information).

10 The inclusion of employee member contributions and benefits provisions for very small groups would also materially complicate the drafting of the master trust deed and the relevant participation agreements.

RETENTION OF HUMAN RIGHTS ACT EXEMPTIONS

The trustees of some DB schemes and sections rely on valuable exemptions from age, disability, marital status, family status and sex discrimination that are set out in the Human Rights Act 1993 and the Human Rights Amendment Act 1994.

The most significant exemption (in practice) allows the provision of surviving spouse pensions without providing similar benefits in respect of single or widowed pensioners.

The exemptions are expressed in the Human Rights legislation as being available only in respect of long-standing schemes and their pre-1996 (or in a few cases pre-April 1980) members.

There is therefore an issue as to whether the exemptions could reliably be treated as having been carried across to a replacement master trust scheme. If they could not be, then:

- we doubt it would be realistic to seek to amend the Human Rights legislation to address such a small-scale issue; and
- the resulting need for benefit design changes would make some transitions too costly (for example by triggering a need to ensure surviving spouse pension provisions were matched by corresponding benefits for single pensioners).

Though there are arguments each way, we think the better view (if, as we recommend, the master trust comprises only transferred pensioners) is that:

- it would remain the case that the transferred pensioners' pension entitlements were benefits provided by the exempted transferor schemes, in the sense contemplated by the relevant Human Rights Act exemption provisions; and
- as such, there would be no breach of the Human Rights legislation triggered by the consolidation itself.

The basis for this view is that the pension entitlements:

- would have been earned entirely while the pensioners were contributory members of the transferor schemes; and
- would continue being paid within the master trust on terms that were entirely pre-ordained by the benefit provisions in the transferor schemes' trust deeds.

FINAL KEY OBSERVATIONS

Timing

Given the need for legislative reform as well as exemption relief and regulatory consents, enabling this initiative would appear to be at least a two-year project.

Commercial attractiveness

Additionally, though it seems clear that a workable consolidation solution would offer material cost and time saving benefits for employer participants (and of course some member benefits), its attractiveness to the potential commercial proponents would need careful testing given that the initiative would by its nature:

- adversely impact some administration managers' and other service providers' current business models; and
- reduce the number of available licensed independent trusteeship and other governance roles available for professional trustees and directors in the sector.

That said (and despite those self-evident commercial disincentives) all service providers consulted when preparing this report expressed their in-principle support for the initiative and acknowledged that consolidation (if workable) would be both merited and sensible.

Attractiveness to employers

We have referred above to several issues that might give some employers pause for thought before embracing the master trust solution. Others might include:

- concern about losing a degree of control over investment strategy and/or becoming 'wedded' to one provider and its service proposition; or
- an institutional preference for keeping the relevant scheme "*in the tent*" (so to speak):
  - › in order to retain ultimate control over its governance and management; and/or
  - › reflecting an ongoing parentalistic desire to look after current and past employees directly via '*in house*' trustees.

However, this initiative is very much employer-prompted in a practical sense – we understand most employer sponsors of smaller DB schemes would very much like to wind them up if and when practicable.

A sensible next step – and thus our final recommendation – would be for the FSC (through the Committee) to conduct a survey of small DB schemes and sections to test sponsors' appetite for a workable scheme consolidation solution along the above lines, given both:

- the work involved in reliably enabling such a solution; and
- the practical necessity for "*pledged*" participation pre-commercialisation, as any consolidation vehicle would of course need assured critical mass from its inception.

Before conducting that survey we would recommend that work be conducted both to quantify the anticipated costs (if any) of the legal work involved in liaising with Inland Revenue and FMA to elicit the necessary legislative changes and exemption relief, and how those would need to be met.

01 SMALL DB SCHEMES AND SECTIONS – KEY STATISTICS

The following statistics are based on those that were available on the Scheme Register (based on the assets and membership data in schemes' latest available financial statements and annual reports) as at 8 August 2023.

The statistics exclude DB schemes or sections which:

- are clergy-based registered charities and thus have non-replicable investment income tax exemptions; or
- remain open to new joiners; or
- have assets:
  - › greater than $100 million in the case of a DB scheme; or
  - › greater than $50 million in the case of a DB section within a hybrid scheme (i.e. a scheme with DB and DC sections).

We do acknowledge that the above size limits are arbitrary cut-offs, and that in any case (due to continued member attrition) numerous larger DB schemes or sections will also dip below the relevant size threshold either in the near term or in due course.

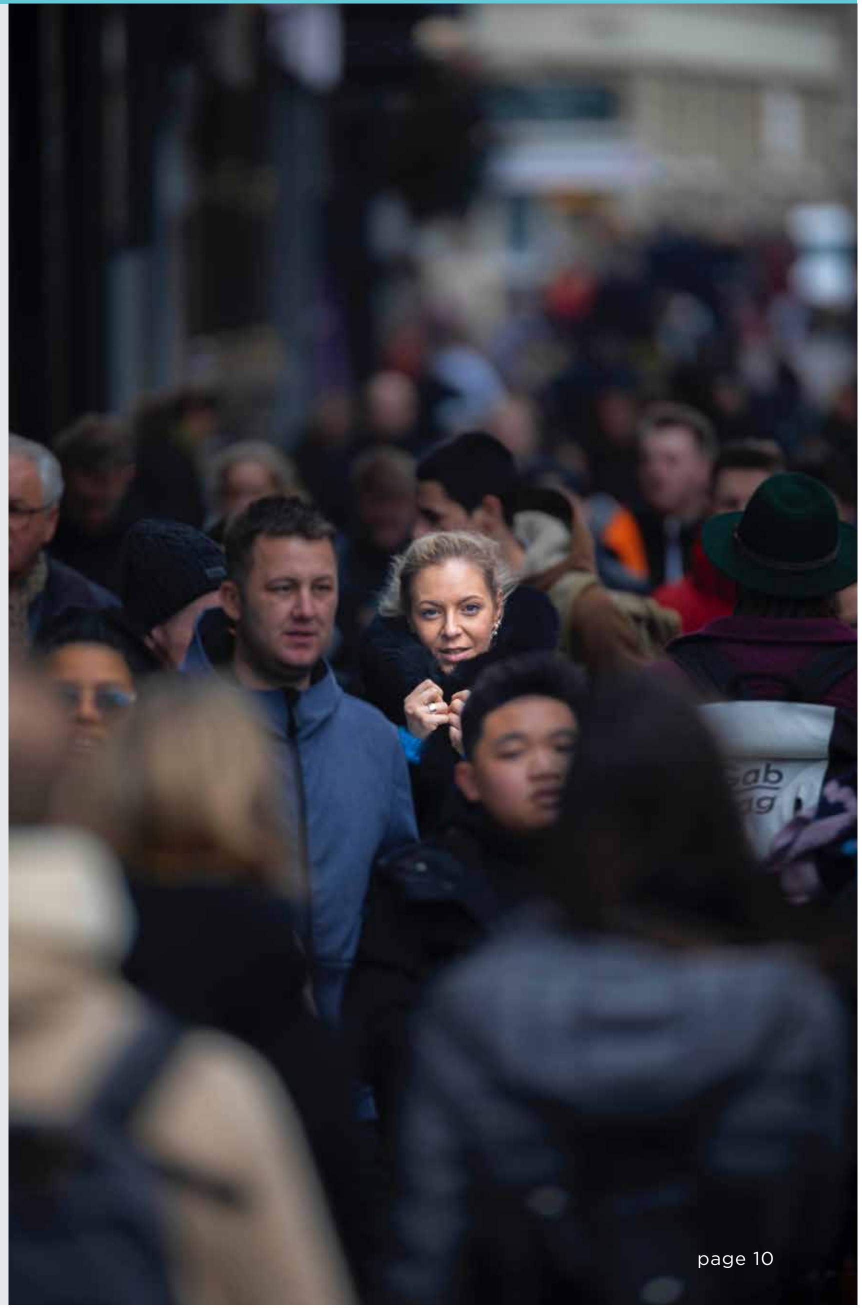
We elaborate selectively below (we have not included a hybrid schemes summary).

KEY POINTS

Net of the preceding exclusions, as at 8 August 2023 there were:

- **22 DB schemes with assets below $20 million** (which collectively had $151.2 million in assets, 591 pensioners and 73 employee members)
- **another 8 DB schemes with assets below $100 million** (and collectively $372.9 million in assets, 835 pensioners and 257 employee members)
- **10 hybrid schemes with assets below $50 million and/or a very small DB section** (a number of these schemes' DB liabilities in some cases cannot reliably be isolated, but indicatively they had around 380 pensioners and 35 employee members).

Of those 40 DB schemes and sections, **19 consisted solely of pensioners** (and they collectively had assets of around $115 million and 566 pensioners).



DB SCHEMES WITH ASSETS BELOW $20 MILLION

Table 1 in Appendix 1 shows that as at 8 August 2023 (based on the financial statements and annual reports most recently made available):

- 22 DB schemes on the Scheme Register had assets below $20 million; and
- those schemes (ranging in size from $19.7 million to $210,000) collectively had:
  - $151.2 million in assets;
  - 591 pensioners (current or deferred); and
  - 73 employee members.

DB SCHEMES WITH ASSETS BETWEEN $20 MILLION AND $100 MILLION

Table 2 in Appendix 1 shows that as at 8 August 2023 (based on the financial statements and annual reports most recently made available):

- 8 DB schemes on the Scheme Register had assets of between $20 million and $100 million; and
- those schemes (ranging in size from $77.8 million to $29.9 million) collectively had:
  - $372.9 million in assets;
  - 835 pensioners (current or deferred); and
  - 257 employee members.

PENSIONER-ONLY DB SCHEMES AND SECTIONS

A number of the DB schemes shown in Tables 1 and 2 (as well as certain DB sections within hybrid schemes) comprised pensioners only (i.e. they were simply managing and paying pensions). In this category there were:

- 14 DB schemes with (collectively) 457 pensioners and assets of $101 million; and
- 5 DB sections with (collectively) 99 pensioners and assets of $14 million (an indicative estimate).

Each such DB scheme is grey shaded in Tables 1 and 2.

Various other DB schemes and sections had trivially few remaining employee members (indicating that they too will very likely become pensioner-only schemes or sections in the relatively near term).

02 SMALL DB SCHEMES – COSTS

KEY POINTS

Indicatively (based on statistics available as at 8 August 2023):

- the average DB scheme with assets **below $20 million** incurs annual non-investment (i.e. administrative) costs of around **$128,000**
- the average **pensioner-only** scheme incurs annual administrative costs of around **$124,000**
- DB schemes with assets **between $20 million and $100 million** have average total administrative costs of around **$215,000**.

A stand-alone DB or hybrid scheme must bear the following non-investment costs, unless (or except to the extent that) those costs are paid for separately by the sponsoring employer:

- administration fees and expenses;
- actuarial fees;
- auditor remuneration;
- Licensed Independent Trustee (and in some cases other trustee) remuneration;
- legal fees;
- FMA levies;
- dispute resolution scheme fees;
- trustee liability insurance premiums; and
- a range of other costs as applicable, including investment consulting and tax advisory fees and FSC subscription costs.

We examined the latest available financial statements on the Scheme Register as at 8 August 2023 (for the DB schemes listed in Tables 1 and 2 in Appendix 1) to estimate, indicatively, the typical level of non-investment costs currently being incurred annually:

- by the schemes themselves; and/or
- where expenses paid by the sponsor are disclosed in notes to the financial statements, by their sponsors.

We excluded:

- group life insurance premiums, which are a benefit (not an administration) cost; and
- schemes where sponsors pay administration costs but the total amount of those costs is not disclosed in the notes to the financial statements.

We have not reproduced the resulting tables (given the sensitivities) but our analysis indicates that during the most recently reported-on financial years as at 8 August 2023:

- the average total non-investment costs incurred by DB schemes with assets of below $20 million was around $128,000 per scheme; and
- the average total non-investment costs incurred by pensioner-only schemes was around $124,000 per scheme.

DB schemes with assets of between $20 million and $100 million had average total non-investment costs of $215,000 per scheme, though these were a small and diverse sample group so this average should be treated with caution – these schemes' costs ranged from $80,000 (for a scheme comprising one of several within an employer group that were jointly administered) to $352,000.

All managerial time costs incurred by trustee board members (and incurred in relation to sponsors providing additional in-house support functions where relevant) are of course additional to each of the above figures.

An additional extra cost factor for DB schemes with 20 or fewer members is that they cannot be taxed as "widely held superannuation funds[11]" (which, under clause 6(c) of Part A of Schedule 1 to the Income Tax Act 2007, are taxed on their taxable income at 28%). Accordingly, those sub-20-member schemes:

- are currently taxed on their taxable income at 33% (under clause 3 of Part A of Schedule 1 to that Act); and
- will begin being taxed on their taxable income at 39% on and from 1 April 2024 under amendments currently proposed for the Act in the Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters) Bill[12].

11 These are defined in section YA 1 of the Income Tax Act 2007 as (relevantly) retirement schemes within the meaning of section 6(1) of the Financial Markets Conduct Act 2013 that have 20 or more members.

12 The FSC has submitted that these schemes should pay income tax at 28% (being the same rate as a widely held superannuation fund) as it is unfair for them to be taxed at a higher rate simply because, without any other change to their nature or design characteristics, they have now become exceedingly small due solely to having been in legacy mode for a number of years.

03 BENEFITS (AND POTENTIAL DOWNSIDES) OF CONSOLIDATION

KEY POINTS

The benefits of consolidation include significant cost and time efficiency gains from pooling governance, service provision and assets (and United Kingdom research confirms this empirically, as well as indicating that consolidation helps drive more effective and efficient investment strategies and improved governance).

A key potential downside though is the need for the consolidation vehicle to acquire (and retain) sufficient scale to take advantage of the key cost saving benefits – and consequently the risk of the requisite scale not being reached or retained.

GENERAL OBSERVATIONS

Consolidation seeks to achieve one or more of the following aims:

- creating efficiencies of scale;
- improving governance – saving costs and raising standards;
- enabling access to additional options through scale – e.g. a larger pool of assets may provide better and more cost-efficient investment options for sponsors; and
- transferring responsibility for managing the payment of benefits.

The key benefits of consolidation include:

- significant cost and time efficiency gains from pooling governance, service provision (e.g. administration management, actuarial and audit services) and assets;
- the transferred scheme no longer requiring its own trustee board (with attendant added cost, including both licensed independent trustee fees and management time);
- being relieved from governance and managerial responsibility and hence legislative and fiduciary non-compliance risks – those responsibilities and risks pass to the trustee of the master trust; and
- an anticipated greater assurance of high-quality, sustainable governance (addressing for example trustee succession planning concerns).

The DB master trust option has been described by proponents in the United Kingdom[13] as bringing with it the following benefits:

- existing scheme rules are adopted, so member benefits remain unchanged;
- when it comes to valuation, assumption setting and investment strategy discussions, employers can have as much or as little involvement as they choose;
- market research has shown that a DB master trust can, on average, reduce a scheme's costs by as much as a third;
- a DB master trust provides economies of scale by pooling governance, legal, actuarial, administration and investment functions, saving the scheme and the employer time, money, and the worry of increased regulatory pressures on the scheme governance; and
- the economies of scale will or may include:
  - › access to investment expertise and attractive investment opportunities at competitive prices out of reach for most smaller schemes;
  - › removal of current and future governance concerns;
  - › creation of scale to invest in the most up to date administration services;
  - › significantly reduced costs; and
  - › significant sponsor time cost savings.

In New Zealand, the master trust scheme itself would of course be essentially a legacy vehicle from its inception, with an initial period of net growth due to on-boarding new employers then followed (in due course) by becoming inexorably smaller and eventually sub-scale. By that stage the remaining employer plans would incur relatively high administration costs as a percentage of net assets. However, their sponsors:

- would already have benefited from long-term administration cost savings; and
- could likely expect even their ongoing higher costs to remain lower than the "*continuing stand-alone scheme*" counterfactual.

13 For example TPT Retirement Solutions in its 5 May 2021 web article ***How does a DB master trust fit into the consolidation space?***

There are some generally acknowledged potential downsides to consolidation though, and these include:

- potential loss of a degree of control over investment strategy;
- being '*wedded*' to one provider and its service proposition, and unable to choose administration and fund managers (and other service providers) directly on a '*best of breed*' basis – though with a consolidating service provider market and given the very small size of most schemes to which the master trust solution would appeal, we suggest that such loss-of-choice concerns would in most cases be materially outweighed by the attraction of lower administration cost; and
- the critical need for the master trust itself to acquire (and retain) sufficient scale in order to take advantage of the key cost saving benefits – and consequently the risk of the requisite scale not being reached or retained[14].

UNITED KINGDOM – OFFICIALS' COMMENTARY

In the United Kingdom, DB scheme consolidation initiatives have gathered pace in recent years and as such the UK provides much useful and informative commentary in this context.

The DWP noted in its February 2017 Green Paper ***Security and Sustainability in Defined Benefit Pension Schemes***[15] that:

- most DB schemes are small, and the data suggests that small schemes have higher administrative costs because they are unable to achieve the economies of scale available to larger schemes and are less able to negotiate low-cost investment management services;
- in general, smaller schemes also tend to have less effective governance and trusteeship; and
- as such, there is a strong case supporting greater voluntary consolidation.

The Green Paper also noted research cited in the 2016 discussion paper *21st Century Trusteeship and Governance* from The Pensions Regulator (**TPR**), which found that when working with advisors some trustees, particularly in small schemes, commonly accepted advice without any detailed consideration and failed to regularly review the quality and value for money of the service they received.

The Green Paper referenced TPR's *Trustee Landscape Quantitative Research 2015*, which noted that:

- of small schemes with external advisers and service providers 86% reported the trustee board rarely or never disagreeing with their advisers (with 50% reporting '*rarely*' and 36% '*never*'); and
- the trustee boards of smaller schemes were less engaged in investment decisions.

The DWP commented accordingly[16] that:

This evidence and analysis is well recognised and has led many stakeholders to argue that small schemes should be encouraged to merge or aggregate into one or more consolidation vehicles. Such a move would not only reduce running costs and be likely to improve governance but would also reduce the considerable administrative burden on small employers of managing their own pension scheme.

Correspondingly the Pensions and Lifetime Savings Association (**PLSA**)[17], a key lead industry body in the UK for pension schemes, commented in its 2017 *DB Taskforce Second Report – The Case for Consolidation*[18] that greater sharing of services or consolidation of the way schemes manage their assets or governance structures would:

14 Another (less significant) potential downside is that the levies payable by Class 5 schemes under Schedule 2 to the ***Financial Markets Authority (Levies) Regulations 2012*** increase in a non-linear manner, particularly at the three lowest size tiers. The master trust might therefore incur a higher annual levy than those that were payable by the previous schemes in aggregate.

15 See the DWP publication ***Security and Sustainability in Defined Benefit Pension Schemes*** (February 2017).

16 At paragraph 350 of the Green Paper.

17 ***https://www.plsa.co.uk/About-us***

18 ***https://www.plsa.co.uk/portals/0/Documents/0622-The-Case-for-Consolidation.pdf***

- have a clear positive impact on the efficiency of DB schemes and help address the stark discrepancies in administrative costs between small and large schemes for broadly equivalent services; and
- mitigate the significant leakage of costs in fees to intermediaries and weak bargaining position of a large proportion of DB schemes[19].

The DWP's 2017 Green Paper did acknowledge that there are likely also to be practical challenges to the successful implementation of a consolidation initiative, including:

- a potential need to improve the quality of scheme records before passing over the management of a smaller DB scheme (which may trigger significant cost);
- trustees and advisors being dis-incentivised to consider consolidation, as it might put their own positions at risk; and
- sponsors possibly being unwilling to share sensitive information about their business and commercial strategy (which often must be shared with scheme trustees when they consider the strength of the employer covenant) any wider than currently[20].

Consolidation was again specifically highlighted in the DWP's 2018 White Paper *Protecting Defined Benefit Pension Schemes*[21], which noted (relevantly) that:

- consolidation could help schemes benefit not only from reduced scheme running costs per member, but also more effective and efficient investment strategies and improved governance;
- evidence suggested that on average small and medium-sized schemes were more likely to fail to meet the governance standards expected by TPR than larger schemes; and
- a lack of opportunities to benefit from economies of scale meant small schemes tended to have higher administrative costs per member and were less likely to benefit from quality investment opportunities, for which advice comes at a premium.

The White Paper also observed that the trustees of larger schemes were more likely to be better engaged with their schemes, meet more frequently, work together with sponsors in an open and transparent manner and implement an approach which integrates the management of employer covenant, investment and funding risks – concluding that:

larger schemes are, on average, better governed than their smaller counterparts … [and] we have some evidence that better governance leads to higher investment returns or lower costs.

19 See also the PLSA's ***DB Taskforce Third Report – Opportunities for Change*** (September 2017).

20 A master trust 'governance charter' (or similar) with explicit confidentiality undertakings would mitigate this concern.

21 See the DWP publication Copy available Protecting Defined Benefit Schemes (March 2018). See also its publication Consolidation of Defined Benefit Pension Schemes (December 2018) and PLSA paper Consolidation of Defined Benefit Pension Schemes (February 2019). See also the comments about sub-scale schemes in the PLSA's DB Taskforce Interim Report (October 2016) and Charles Sutcliffe's paper Merging Schemes: An Economic Analysis of Defined Benefit Pension Scheme Merge Criteria (ISMA Centre, University of Reading, 12 May 2005).

04 DB MASTER TRUSTS IN THE UK

KEY POINTS

DB master trusts are now a significant feature of the United Kingdom pensions landscape and it appears most:

- maintain a separate, ring-fenced section for each employer participant (funded separately from the other sections); and
- offer individual employer participants a choice of investment strategy from a standard whole-of-scheme suite of chosen underlying funds.

The UK recently put in place an informal self-certifications-based accreditation regime for DB master trust providers to provide clear information on key features. Recent self-certificates (given their precedent value) are summarised in Appendix 2 to this report.

BACKGROUND

The United Kingdom legislation imposes strict funding and employer debt obligations on the sponsors of DB schemes and (partly as a consequence) DB pension scheme numbers in the UK are in steep decline.

The UK government and TPR have been encouraging consolidation among the thousands of small to medium-sized schemes operating in the UK, with a particular focus on schemes (including DB schemes) with less than £10 million in assets.

CONSOLIDATIONS BY TYPE

As explained in summary form in the Aon paper *Defined benefit consolidation: what are the opportunities?*[22], There are several recognised types of DB scheme consolidations in the UK:

- **insurance buy-out** (i.e. the purchase of annuities) followed by a scheme wind-up – not an option in New Zealand in the absence of a functioning annuities market;
- **insurance buy-in** (i.e. the purchase of annuities covering pension entitlements, with those annuities held as a scheme asset) – again, this is not an option in New Zealand;
- **commercial consolidations** – arrangements offering sponsors and trustees a full risk transfer without the need to purchase annuities – in essence:
  - › a "*commercial consolidator*" (operating a "*consolidator pension scheme*") takes on the responsibility for meeting future benefit payments after receiving:
    - » commercial investor funding (held in a risk capital buffer that can be accessed if needed); and
    - » assets from schemes and cash from sponsors; and
  - › the consolidator can extract profits for investors and:
    - » operates within the pensions regulatory framework, which carries lower reserving requirements and allows more flexibility in asset strategy when compared with the insurance regime; but
    - » must meet stronger funding requirements than regular DB schemes; and
- **moving to a DB** master trust with a single trustee board, on the basis that:
  - › the sponsor's section has its own ring-fenced assets and liabilities; and
  - › the sponsor retains financial responsibility for funding that section.

22 Copy available *here*.

DB MASTER TRUSTS GENERALLY

Relevantly here, DB master trusts are now a significant feature of the United Kingdom pensions landscape, with support from TPR (which, as noted earlier, has observed that people saving for their retirement are better served by big schemes than by small ones because larger schemes can benefit from significant economies of scale).

Most DB master trusts in the UK maintain a separate, ring-fenced section for each employer participant, with each such section funded separately from the other sections.

The consolidation vehicles utilised typically offer individual sponsors a choice of investment strategy from a standard whole-of-scheme suite of chosen underlying funds (delivering the benefits of scale in terms of investment options and fees but maintaining an element of choice for each sponsor).

SELF-CERTIFICATION REGIME

The UK recently put in place an informal and self-certifications-based "*accreditation*" regime for DB master trust providers so as to give members, trustees and sponsors the confidence that those vehicles will meet certain standards.

This relatively light-handed self-certification regime was a joint initiative between the DWP and the PLSA.

The voluntary regime went live on 27 October 2021 and the resulting self-certificates are based on a standardised ***DB Master Trust Self-Certificate*** template designed to enable DB master trusts to provide clear information on their key features (structure, governance, operations and the process for joining and leaving) for schemes considering consolidation.

The PLSA hosts the DB Master Trust Self-Certificates as on-line resource[23], and currently lists the DB master trusts that have completed self-certificates. Recent self-certificates are summarised in **Appendix 2** to this report as they will likely have some precedent value in this context.

23 https://www.plsa.co.uk/Policy-and-Research/Topics/DB-Master-Trust-Self-Certificates

05 DB MASTER TRUSTS IN AUSTRALIA

KEY POINTS

In Australia the prevalent DB schemes consolidation model appears to be the inclusion of DB plans within otherwise accounts-based master trusts.

The Australian superannuation legislation expressly allows the requirement to obtain an actuarial report on a DB scheme to be met by obtaining a report on each employer's sub-fund.

APRA guidance addresses the setting of shortfall limits that trigger action if funding levels are unsatisfactory, and the resulting reporting and restoration plan requirements.

DB SCHEMES IN AUSTRALIA

There has been a very strong trend towards DB scheme consolidation in Australia, which was a key contributor to the total number of corporate DB schemes there falling from 4,188 in 1997 to just 30 in 2016.

The few remaining stand-alone DB schemes are mainly for public sector (government) and corporate employees and most are now closed to new members[24].

DB PLANS WITHIN MASTER TRUSTS

A number of Australian master trusts such as the Mercer Super Trust[25] incorporate DB plans as well as accumulation-style superannuation plans for participating employers. In those DB plans (most of them closed to new joiners) employers contribute on members' behalf to the employer-specific 'DB pool' which services all members within the relevant plan.

In the Mercer Super Trust, the core governance requirements for the DB plans hosted within the Corporate Superannuation Division (formerly the DB Division) include the following[26]:

- the contribution and benefit rules governing each such DB plan are set out in the schedule to the participation agreement governing that plan;
- the Trustee must appoint an actuary to each DB plan (and may replace it with another actuary at any time);
- the Trustee must ensure that an actuarial valuation for each DB plan is conducted when required by the Australian superannuation legislation;
- the employer participant must receive a copy of each such report;
- the Trustee must obtain all actuarial certificates required by the Australian superannuation legislation in relation to each DB plan and provide a copy to each relevant employer;
- employer exits are permitted by way of bulk transfers of members and assets to replacement schemes;
- generally speaking each employer must contribute to its plan at the rate determined by the Trustee, after consulting the employer, on the advice of the actuary to the plan;
- the Trustee is permitted to make benefit adjustments (determined after obtaining the advice of the plan's actuary) in the case of any failure by the employer to contribute as required or agreed; and
- the employer may direct the Trustee to augment a DB member's benefit entitlement, but only if it pays any additional contributions which the plan's actuary advises are necessary to ensure the stability of the plan.

SEGREGATION OF PLANS – LEGISLATION

This segregation between plans reflects the fact that the Superannuation Industry (Supervision) Act 1993 (**SIS Act**) and the Superannuation Industry (Supervision) Regulations 1994 (**SIS Regulations**):

- provide for defined benefit sub-funds[27] within regulated superannuation funds, which must themselves have[28]:
  - › separately identifiable assets and separately identifiable beneficiaries; and

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24 Remaining large corporate DB funds include TelstraSuper, Qantas Super, Australia Post Super Scheme and Westpac Group Plan (Defined Benefit). Other large DB funds include Commonwealth Superannuation Scheme, Military Superannuation and Benefits Scheme, Public Sector Superannuation Scheme, UniSuper (DB section), Gold State Super and West State Super (source: *https://www.superguide.com.au/comparing-super-funds/defined-benefit-super-funds*).

25 *https://www.mercersuper.com.au/superannuation/defined-benefits/*

26 See the *Consolidated Designated Rules* for the Corporate Superannuation Division of the Mercer Super Trust.

27 SIS Regulations, regulation 1.03.

28 SIS Act section 69A (see also SIS Regulations, regulation 9.04B).

› rules whereby the interest of each beneficiary of the sub-fund is determined by reference only to the conditions governing the sub-fund;

- allow for the requirement to make the most recent actuarial report for a defined benefit fund publicly available to "*be met by the requirement being satisfied in relation to each defined benefit sub fund in the defined benefit fund*"[29];
- treat each sub-fund within a regulated superannuation fund as a regulated superannuation fund for the purpose of certain minimum defined benefit fund size constraints and other defined benefit pension payment restrictions[30]; and
- allow regulated superannuation funds to provide *defined benefit pensions* as defined[31] and for a sub fund within a regulated superannuation fund to be treated for key purposes as a regulated superannuation fund if (again) it satisfies the following conditions:

  › it has separately identifiable assets and separately identifiable beneficiaries; and

  › the interest of each beneficiary of the sub fund is determined by reference only to the conditions governing that sub fund.

RELEVANT APRA GUIDANCE

APRA's Prudential Practice Guide ***SPG 160 – Defined Benefit Matters*** (November 2013)[32] contains APRA's view of prudent practice in relation to Prudential Standard ***SPS 160 – Defined Benefit Matters*** (**SPS 160**), setting out APRA's requirements in relation to:

- actuarial investigation, reporting, monitoring and, where necessary, restoration of the financial position of a defined benefit fund "*or sub-fund*"; and
- conforming to the objective of meeting fund liabilities as they fall due and ensuring that asset values are sufficient to cover vested benefits.

Reflecting the relevant provisions in the SIS Regulations, the APRA Practice Guide prescribes that "*where the term 'defined benefit fund' is used in SPG 160, it should be read as 'defined benefit fund or defined benefit sub-fund' unless stated otherwise*".

The key points in SPS 160 include the following:

- an annual investigation will replace the regular cycle of triennial investigations when a defined benefit fund or sub-fund commences paying defined benefit pensions, and while those pensions continue (though a fund or sub-fund with more than 4 members may approach APRA for relief from the annual investigation requirement);
- a trustee board may set a shortfall limit that triggers action if the funding level falls below a satisfactory financial position (i.e. if the vested benefits ratio falls below 100%);
- actuarial advice must be taken (and interim actuarial valuations obtained) where, during the period between regular investigations, it appears the defined benefit fund or sub-fund is or may be in an unsatisfactory financial position and also is or may be in breach of its shortfall limit; and
- reporting obligations arise if an actuary or auditor forms the opinion that the financial position of a fund or sub-fund may be (or may be about to become) unsatisfactory.

The Practice Guide also covers:

- when a restoration plan is required in order to address an unsatisfactory financial position;
- the minimum requirements (including, typically, a 3-year maximum duration for restoring a satisfactory position); and
- the requirements for the monitoring of and adjustments to restoration plans.

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29 SIS Regulations, regulation 2.38(2)(d) and (4).
30 SIS Regulations, regulations 9.04G and 9,04I.
31 SIS Regulations, regulation 9.04E.
32 https://www.apra.gov.au/sites/default/files/prudential-practice-guide-spg-160-defined-benefit-matters_0.pdf

06 WOULD A MASTER TRUST WITH SEGREGATED EMPLOYER PLANS STILL BE A DB SCHEME?

KEY POINTS

The central characteristic of a DB scheme is that contributions are not allocated to individual members on a defined basis. This does not inhibit a scheme comprising a series of employer-specific sections with accounting segregation.

Section 6(1) of the FMCA defines a defined benefit scheme as "*a scheme that operates on the principle of unallocated funding*". It also states that this "*includes a scheme under which contributions are not allocated on a defined basis to individual members.*"

Correspondingly, section 129(1)(e) (relating to a superannuation scheme) and section 130(1)(e) (relating to a workplace savings scheme) both distinguish between:

- a defined benefit scheme; and
- a scheme "*under which contributions are allocated to scheme participants on an individual basis*" and the benefits provided are fully funded as they accrue.

There is no other directly relevant prescription in the FMCA, and the only relevant prescription in the Financial Markets Conduct Regulations 2014 (**FMCR**) is in:

- regulation 56(2A), under which the duty to make a fund update publicly available applies to a DB scheme "*if, and only if, contributions are allocated on a defined basis to any member*" – this contemplates either:
  - › a hybrid scheme with a DC section; or
  - › a DB scheme with employee members who have notional "*accounts*" within the scheme by reason of having either:
    - » made voluntary additional contributions; or
    - » not yet qualified for a salary and pensionable service-based retirement benefit (and instead remaining entitled for the time being only to a contributions-based leaving service benefit); and
- regulation 82(5), in which the *scheme participant's accumulation* definition distinguishes between:
  - › in the case of a DB scheme, "*the amount of the benefit that the scheme participant is entitled to receive on ceasing to be a member of the scheme*"; and
  - › in any other case, the net value[33] of the total of the scheme participant's contributions and any other vested contributions in respect of the participant.

The combined effect of these provisions is to prescribe that the central characteristic of a DB scheme is that contributions (and hence scheme assets) are not allocated to individual members on a defined basis.

On our analysis the provisions therefore do not inhibit a scheme comprising a series of employer-specific sections with accounting segregation, which operate in each case for the members sponsored by a particular entity. This is because no members will have any contributions allocated to them on an individual basis and thus the scheme cannot be characterised as a DC scheme.

33 Net value is defined in regulation 82(5) as "the value once any appropriate debits and credits have been made to account for things like fees, permitted withdrawals, and positive and negative returns".

07 WOULD THE DB MASTER TRUST RETAIN ITS CURRENT TAX TREATMENT?

KEY POINTS

- To be taxed as a retirement scheme (rather than as a life insurance product) the DB master trust must be an **exempt superannuation scheme** in terms of section EY 11 of the Income Tax Act 2007.
- Under section EY 11 as currently worded, the master trust **would not qualify** (by reason of operating for two or more non-associated employers).
- We recommend seeking from the Inland Revenue policy team a remedial **amendment to section EY 11** to enable the FMA to approve the master trust as an exempt superannuation scheme (and we have drafted some suggested amendment wording).
- We do not anticipate any objection to such an amendment – as the master trust would be an amalgam of smaller schemes each of which was already an exempt superannuation scheme, the intent of section EY 11 would be in no way undermined.

A key pre-condition for making the DB master trust solution workable in practice will be ensuring that the scheme used as the master trust continues qualifying (and remains approved by the FMA) as an "*exempt superannuation scheme*" in terms of section EY 11 of the Income Tax Act 2007 and can therefore be taxed in the same way as currently.

The funding of defined benefits to the members and beneficiaries of a DB scheme is in substance the provision of life insurance. As such, DB schemes and sections are taxed as life insurance products under section EY 11(1) unless (pursuant to section EY 11(2)) they meet all of the requirements of subsections EY 11(3) to (9).

All existing DB schemes and sections are currently assessed as meeting the requirements of section EY 11(3) to (9) and as such are taxed under the more favourable retirement schemes legislation rather than as life insurance products. Relevantly here, the core exemption requirements are that (our bolding):

- the scheme was:
  established by an employer, or a group of employers ***who are associated****, to provide benefits only to persons who are employees of, or related by employment to, such an employer, or to another* ***associated employer*** *who agrees after the [scheme's] establishment to make contributions to it (subsection (5)(a))*; and
- each beneficiary of the scheme is either:
  - a natural person that is an employee of or related by employment[34] (see below) to an employer of the kind referred to above (subsection (6)(a)); or
  - an employer of members of the scheme, to the extent of the employer's contingent interest in any scheme surplus (subsection (6)(c)).

It follows that under section EY 11 as currently worded, a DB master trust (due to operating for two or more non-associated employers) could not qualify as an exempt superannuation scheme for income tax purposes as it would fail the "*associated employers*" requirement.

Our provisionally recommended solution is:

- amending subsection EY 11(5) so as to insert a new paragraph (aa) worded materially as follows (thereby adding a new category of exempt employer scheme):
  a restricted scheme (within the meaning of section 6(1) of the Financial Markets Conduct Act 2013) approved by the FMA for the purposes of this subsection (5) due to providing benefits solely to persons who (in the absence of a transfer effected pursuant to section 179 of the Financial Markets Conduct Act 2013) would otherwise be members or beneficiaries of a fund which meets the requirements of paragraph (a); and
- adding to subsection (6)(a) the words "*(or is a person referred to in subsection (5)(aa))*".

34 The "related by employment" concept explicitly extends (pursuant to subsection (14)) to an ex-employee pensioner and to a relative or dependent of that pensioner (such as a spouse, nominated beneficiary or child pensioner).

Those amendments would:

- leave intact the current prohibition on exploiting the life insurance tax exemption by providing life insurance benefits to members of the wider public rather than as part of an employer-based scheme; but
- enable the FMA (which itself supports this solution in principle) to approve the DB master trust as an exempt superannuation scheme due to it being in effect the FMA-approved successor fund for a pre-existing suite of employer-based schemes which were themselves exempted.

We will initiate early engagement with Inland Revenue in this regard.

We anticipate the remediation of this issue being readily practicable, including because the Inland Revenue policy team (which engaged actively on last year's remediation of a punitive over-taxation issue impacting all pensions-based DB schemes[35]) in effect has a continuous rolling programme of initiating or acceding to changes that can reasonably be categorised as remedial in nature.

For completeness, we consider it most unlikely that Inland Revenue would be amenable (in the alternative) to issuing a binding ruling so as to provide the requisite relief. Inland Revenue will typically only rule on what the tax legislation actually prescribes, and in our view interpreting section EY 11 to cover the proposed DB master trust would strain it beyond its currently intended scope.

35 This was the welcome reversal (retroactive to 1 April 2021) of the imposition under section RD 67 of the Income Tax Act 2007 of a compulsory 39% – not 33% – employer's superannuation contribution tax (**ESCT**) rate on all contributions made to a DB scheme for the benefit of past employees (i.e. pensioners).

08 WOULD THE DB MASTER TRUST HAVE CONTINUED RESTRICTED SCHEME STATUS AVAILABLE TO IT?

KEY POINTS

As the master trust would admit members from a wide range of schemes with unrelated sponsors and from diverse industries, its trust deed as amended would not reliably comply with the constraints on new member admissions prescribed for a restricted scheme pursuant to section 131(1)(b)(i) of the FMCA.

To enable the master trust to operate as envisaged, the commercial proponent of any DB master trust solution would therefore need to seek from the FMA an Exemption Notice exempting the trustee from compliance with those constraints (subject to conditions having the effect of limiting new member admissions to members of other restricted DB schemes or sections).

The scheme chosen to be repurposed as the master trust vehicle will already have been designated as a restricted workplace savings scheme pursuant to the ***Financial Markets Conduct (Restricted Schemes) Order 2016*** and will need to retain its restricted status despite:

- its trust deed being replaced with a deed contemplating the admission of non-associated employer participants; and
- the consequent admissions to membership of non-associated groups of members.

Under section 131(1)(c) of the FMCA, one of the ongoing registration requirements for a restricted scheme is that the conditions of entry of members, or the way in which those conditions have been applied on entry, must not have been changed without the FMA's consent since the date of the scheme's registration under the FMCA in a way that expands, or is likely to expand, the classes of people who may become scheme participants.

The amendments allowing the admission to participation in the master trust of non-associated employer participants would accordingly require FMA consent under that provision (as well as pursuant to sections 139(1)(a) and (2) of the FMCA, in terms of which any amendments to the trust deed for a restricted scheme require FMA consent in any event).

That consent should be readily forthcoming provided that the trust deed amendments limit new membership admissions to members of:

- other restricted DB schemes; or
- the DB sections within other restricted schemes;

given the consolidation-driven purpose of the amendments and the fact that those DB members comprise a collectively small legacy group.

Another condition of being and remaining a restricted scheme is that pursuant to section 131(1)(b)(i) of the FMCA a scheme must admit as members (both in its conditions of entry and in the way in which those conditions are applied on entry) only one or more of the classes of persons referred to in subsection (2), being persons who:

- are employed by a particular employer or by a related body corporate of that employer;
- belong to a particular profession, calling, trade, occupation, or industry:
- belong to "*a particular association, society, or other entity with a definable community of interest*"; or
- are immediate family members of, or wholly or partially financially dependent on, a person in 1 or more of the above classes of persons (with *immediate family member* defined in subsection (3) as a spouse, civil union or de facto partner, parent, child, stepparent or stepchild).

Given that the master trust would admit members from a wide range of schemes with unrelated sponsors and from diverse industries, its new membership restrictions would not reliably comply with any of the provisions of section 131(2).

The provision coming closest to enabling the admission of members from other restricted DB schemes (or from the DB sections within them) is subsection (2)(d) – the transferring members could arguably be said to have a "*definable community of interest*" by reason of all belonging to stranded legacy schemes or sections.

However, unlike (for example) the practising adherents of a particular religion, those members would not all belong to any particular *"association, society or entity"* which reflects that community of interest.

Accordingly, to enable the master trust solution to operate as envisaged, the commercial proponent of a DB master trust solution would need to seek from the FMA an Exemption Notice exempting the trustee of the master trust from compliance with section 131(1)(b)(i) of the FMCA.

As to the exemption conditions, in our view those recommended in **section 10** of this report would suffice to ensure that the facility to admit new members to the master trust remains suitably restricted.

For completeness, although (as ever) remedial *legislative* amendments would of course be optimal from the perspective of ensuring both certainty and permanence:

- there is no relevant regulation-making power in section 544 of the FMCA; and
- a special purpose exemption is on our analysis the more *"natural"* solution anyway, as:
  - › it would be scheme-specific;
  - › the master trust would simply be an amalgam of smaller schemes each of which was already restricted (meaning the intended scope of section 131 would thus be in no way undermined); and
  - › those scope limitations should in our view pre-empt any concern that the exemption might be seen as quasi-legislation or policymaking.

09 WHAT WOULD BE NEEDED IN ORDER TO COMPLY WITH THE FMA TRANSFER APPROVAL REQUIREMENTS?

KEY POINTS

In order to approve the bulk transfer of all members from a DB scheme or section to the master trust, the FMA would need to be satisfied that the relevant terms and conditions of the master trust were no less favourable to members than those of the existing scheme.

This would necessitate not only an across-the-board mirroring of all benefit provisions but also ensuring that the sponsor contribution obligations applying under the employer's participation deed were at least as protective as those applying pre-transfer.

In practice there might in a few cases be a need (for example where the existing trust deed lacks appropriate prescription) to put in place more muscular deficit funding obligations than those applying under the transferor scheme's trust deed, so that:

- transfer communications can reference deficit funding protections that are enhanced and not merely replicated; and
- the master trust board is more comfortable accepting the sponsor to participation.

DOCUMENTARY AND PROCESS REQUIREMENTS

The following paragraphs summarise the documentary and process requirements (and the core pre-conditions) that would apply when seeking FMA approval under section 181 of the FMCA to transfer members from an existing DB scheme or section into the master trust.

Section 181 would require that a notice is given to every member in the relevant existing scheme or section that:

- the master trust's trustee has applied for FMA consent to transfer those members into the master trust without their written consents; and
- each notice recipient can make a submission to the FMA about the proposed transfer.

The notice recipients must in practical terms be given sufficient comparative information (by not less than 1 month before the proposed transfer date) to inform a possible submission and to make their own judgements on the transfer proposal.

Established market practice is for the communication to those being transferred to comprise a brief (suitably descriptive) covering letter, a tabular schemes comparison and anticipated questions and answers. The schemes comparison and/or the questions and answers must address any materially relevant risks.

Transfer notice materials are customarily referred to the FMA in draft for comment before being finalised and issued, so that any FMA feedback (by way of requested edits or additions) is addressed before the materials are then finalised and sent.

Following the end of the notice period, the new scheme's trustee must issue a certificate to the practical effect that all the transferring members have received transfer notices and the requirements of section 181 are otherwise met.

"NO LESS FAVOURABLE" REQUIREMENT

The FMA can only approve a proposed transfer if it is satisfied that:

- the terms and conditions of the new scheme are no less favourable to the proposed transferees than those of the existing scheme; and
- the transfer is otherwise reasonable in all the circumstances (including having regard to the value of the assets to be transferred).

The design elements that would need comparing (customarily in tabular form) in the transfer communication pack would typically include:

- governance and management (trusteeship, custody of assets, administration management and secretarial, auditor and actuary details);
- sponsor contribution obligations;
- investment policy and investment management;
- pension amount, frequency and related terms and conditions (e.g. as to spouse or survivor's pension entitlements);
- pension increase requirement or facility (where relevant);
- pension commutation (i.e. cash-out) optionality, again where relevant; and
- wind-up – when this is permitted and how assets must be applied in that event.

The core requirement tested in each case though is whether the sponsor contributions and benefits provisions that would apply to the transferred members under the new trust deed (and the relevant participation deed) are the same as or more protective than those applying immediately pre-transfer.

This necessitates those sponsor contributions and benefits provisions being at least mirrored.

Other less material points of difference such as:

- the loss of any facility for pensioner representation on the trust board (where that is a design feature of the current scheme); or
- the loss of potential protection from creditors in the event of bankruptcy[36];

are not assessed in practice as inhibiting the FMA's ability to consent to a transfer under section 181 of the FMCA.

This is because the "no less favourable" requirement is tested holistically and with an implied materiality threshold, and the FMA focusses its comparison on benefit entitlements and benefit security. Exact equivalence in all respects is not required, and trivial or peripheral points of difference (as opposed to those relating to 'significant rights') are generally disregarded.

A NEED FOR MORE MUSCULAR SHORTFALL FUNDING OBLIGATIONS?

For the life benefit plans established in the recent past within DC master trusts for small employee and pensioner groups (which typically generate accounts-based allocated pensions) the FMA has in practical terms required funding protections more muscular than those prescribed in the relevant DB scheme trust deeds, including requirements:

- for annual (not triennial) actuarial examinations of the plan's financial position; and
- that if the actuary reports a funding ratio (i.e. total plan balances as a proportion of total accrued benefit entitlements) below 95% then the employer must increase its contributions to a level projected to restore the funding ratio to 100% within (say) 3 years from the actuarial review date.

The core reason for the inclusion of those provisions has been to ensure that each such plan (and by extension the master trust of which it forms part) satisfactorily complies with the requirement in section 130(1)(e)(ii) of the FMCA to the effect that the trust deed for a DC scheme must require members' benefits to be "*fully funded as they accrue*".

That continuous full funding requirement does not apply in respect of a DB scheme, and in addition we note that:

- most such DC master trust arrangements were entered into pursuant to the now-repealed Superannuation Schemes Act 1989, under which participation deeds were lodged with and actively reviewed by the FMA; and
- in some cases it was the DC master trust providers themselves who demanded strengthened employer obligations.

Given that it would operate in the defined benefits environment, by contrast, in our assessment the DB master trust could (as a matter of law) provide for continued flexibility in terms of remediating financing shortfalls. In summary terms this would mean that:

- sponsors need not relinquish having a degree of control over the pace of funding (some sponsors and trustees have funding objectives that for example allow a scheme's funding position to dip below 100% without triggering immediate deficit remediation obligations); and
- in the event of a shortfall against an agreed funding objective (or the emergence of a deficit) in our view sponsor companies would be permitted to retain the flexibility built into paragraph 6.7.5 of the NZ Society of Actuaries professional standard PS40, which provides

36 This point of difference arises where:
(i) a member joined the existing scheme before 1 April 1990; and
(ii) there is a "bankruptcy forfeiture" provision in that scheme's trust deed (added before 1 April 1990) under which the member's entitlements are protected from creditors.
The benefit of that provision cannot be carried forward into the new scheme and the standard law applies post-transfer – if a transferred member is made bankrupt then their benefit entitlement passes to and vests in the Official Assignee in Bankruptcy and thus may not be protected from creditors.

that in the event of an actuarial deficit, the actuary determines the additional contributions necessary to clear the deficit within a time period acceptable to the FMA – in this regard the FMA has publicly acknowledged on a number of occasions that:

  - an acceptable period could be considered to be 3 to 5 years; but
  - the period could be longer if it is agreed that the circumstances justify it[37]; and

- though point-in-time full funding would of course be optimal (including for presentational reasons), in our view it would not be legally necessary for DB schemes or sections to be prohibited from migrating members and assets into a DB master trust unless actuarially fully funded as at the transfer date.

We do anticipate that in a few cases there may be a practical need to put in place more muscular shortfall funding requirements for the relevant plan, so that:

- transfer communications can advise beneficiaries and the FMA that deficit funding protections will be enhanced within the master trust and not simply replicated; and
- the master trust board is more comfortable accepting the sponsor to participation.

These might include circumstances where the existing trust deed is considered either to lack the necessary prescription or to inadequately reflect the strength of the sponsor's funding covenant[38].

Reliably concluding a view on whether there will be a need for stronger deficit funding protections, and then agreeing on the requisite details, would be an important transitional issue for each DB scheme or section.

37 That said, it might be reasonable for the master trustee to take a different (stricter) approach towards sponsors who offer a weaker covenant, requiring shorter deficit remediation periods.

38 As a practical example, some trust deeds provide simply that the sponsor company sets the contribution rate (sometimes after considering the advice of the actuary and in agreement with the trustees).

10 WOULD THERE BE A NEED FOR EXEMPTION RELIEF TO ALLOW PENSIONER TRANSFERS?

KEY POINTS

- The trustee of the master trust would require a special-purpose exemption notice to enable it to on-board pensioner members from other DB schemes.
- There are precedents for an enabling exemption to that effect and it would accord with several of the stated purposes of the FMCA.

The FMA granted exemptions in 2018 to the ***AMP***, ***Mercer*** and ***SuperLife*** master trusts to enable them to receive bulk transfers of non-employee members (in practical terms retired members with retained balances, and in a few cases pensioners) from stand-alone workplace savings schemes.

To enable it to on-board pensioner members by way of transfers from other schemes pursuant to section 180 or 181 of the FMCA, the trustee of the master trust scheme would require a functionally equivalent special purpose exemption under section 556 of the FMCA (which would logically be included within the Exemption Notice referred to in section 8 of this report).

This is because section 130(1)(d)(i) of the FMCA prescribes that the only individuals who can join a workplace savings scheme are "*eligible individuals*" as defined in section 130(2), meaning (in relation to a sponsor entity):

- an employee or director of that entity; or
- an individual who provides personal services (other than as an employee) principally to that entity.

Given this '*eligible individuals*' constraint, without an enabling exemption pensioners could not transfer into the master trust.

The exemption would serve each of the following stated purposes of the FMCA (set out in sections 3 and 4):

3(b) [to] promote and facilitate the development of [efficient] financial markets:

4(b) to ensure that appropriate governance arrangements apply to financial products [that] allow for effective monitoring and reduce governance risks:

4(c) to avoid unnecessary compliance costs:

4(d) to promote innovation and flexibility in the financial markets.

The exemption would also be no broader than was reasonably necessary to address the matters giving rise to it, as it would be restricted to elective and FMA-approved pensioner transfers from other workplace savings schemes that occur under (and therefore meet the conditions prescribed in) section 180 or section 181 of the FMCA.

In order to facilitate successive pensioner transfers from different schemes over time, the Exemption Notice should:

- exempt the trustee of the master trust from section 130(1)(d) of the FMCA to the extent that it requires admissions to membership of a workplace savings scheme to be restricted to "*eligible individuals*" as defined in section 130(2); and
- consistently with the Exemption Notices already issued to other master trust providers in this context, be subject to the conditions that the trustee must:
  - › admit as members only:
    - » members of other restricted workplace savings schemes who are or were employed or otherwise engaged by an entity that is a participating employer in the master trust (or by a related person or predecessor of that entity);
    - » persons who are immediate family members of, or wholly or partly financially dependent on, persons in the preceding category (or persons who would fall within the preceding category had they not died) and as a result are or were entitled to become members or beneficiaries of the relevant restricted workplace savings scheme; and
    - » persons otherwise eligible to become members of, or to receive a benefit from, another restricted workplace savings scheme as a result of any other relationship with a person who falls within the first of the above categories (or would fall within that category had they not died); and
  - › reflect those restrictions in its trust deed.

11 WOULD THE FMCA OFFER REQUIREMENTS APPLY TO PENSIONER-ONLY TRANSFERS?

KEY POINTS

If (or to the extent that) the DB master trust solution was offered solely to schemes and sections comprising only **pensioners**, the master trust **would not need Product Disclosure Statements** or other Offer Register entries.

Pensioners are the passive recipients of continuing, deferred or contingent pensions and cannot contribute to the relevant scheme. As such, the offer-related disclosure requirements in Part 3 of the FMCA and Part 3 of the FMCR do not apply to a pensioner-only bulk transfer proposal – it is not an offer of financial products for issue in terms of section 39 of the FMCA, and accordingly Part 3 of the FMCA does not apply.

This is because in summary terms:

- though the membership interests issued to transferred pensioners are financial products[39] issued to them[40] when each transfer takes effect:
  - › section 6(1) of the FMCA defines an *offer* to include (relevantly) "*inviting applications for the issue of financial products*"; and
  - › the trustee of the master trust would not be "*inviting applications*" from pensioners for the issue of membership interests to them – applications would be neither invited nor forthcoming and instead each pensioner would simply receive a notice advising them (relevantly) that:
    - » the trustee has applied for FMA consent to transfer them into the master trust without their written consent; and
    - » they may make a submission to FMA about the transfer if they so wish; and
- section 6(1) of the FMCA defines an *application* (in relation to financial products) to include an "*offer to acquire*" the products and defines *acquire* to include "*obtain by … subscribing*" (which conveys obtaining a financial product in return for a contribution of some sort[41]).

Consequently, pensioner-only transfer proposals pursuant to section 181 of the FMCA would not be "*offers*" as contemplated by section 39 of the FMCR – they would involve neither "*invitations*" nor "*applications*" (and in any case no "obtaining by subscription") so the offer-related disclosure requirements in Part 3 of the FMCA would not apply.

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39 In terms of sections 7(1)(c), 8(3)(a) and 9(1)(b) of the FMCA.

40 Pursuant to section 11(2)(a).

41 Although "subscribing" is not defined in the FMCA itself, *subscribe* was defined in section 2(1) of the Securities Act 1978 to include "purchase and contribute to, whether by way of cash or otherwise" (with subscription and subscriber having corresponding meanings).

Paragraph (a) of the *acquire* definition also includes "obtain by … taking an assignment or transfer of", but that is not a relevant concept here because:

- "taking an assignment of" a financial product refers to taking a legal transfer of an ownership or security interest from another product holder, which is not what happens in the context of an FMA-approved transfer; and
- "taking a transfer of" a financial product alludes to the transfer of transferable financial products under subpart 9 of Part 5 of the FMCA, which does not apply to a retirement scheme and in any case deals with transferring the holding, not the issuance, of the product.

Following an FMA-approved transfer a pensioner is simply issued a replacement membership interest (rather than taking a transfer or assignment of an existing product from another holder).

12 WOULD THE TRUSTEE BE REQUIRED TO PRODUCE WHOLE-OF-SCHEME FINANCIAL STATEMENTS?

KEY POINTS

The trustee of the master trust could invoke an existing Exemption Notice enabling it to produce annual audited financial statements covering only each respective employer-specific section (and not also the scheme as a whole).

To enable the trustee to invoke the Exemption Notice the trust deed would need to include prescriptions to the practical effect that:

- each employer section's assets must be held solely for the benefit of the relevant members; and
- tax must be calculated and paid separately for each separate section.

The trustee of a DB scheme comprising a series of employer-specific sections (each funded on an unallocated basis as described above) could in our assessment invoke the ***Financial Markets Conduct (Financial Statements for Schemes Consisting Only of Separate Funds) Exemption Notice 2022*** (**Segregated Funds Exemption Notice**) so as to relieve it from having whole-of-scheme financial statements, on the basis that all liabilities and assets are ring-fenced in individual employer-specific funds and there are no cross-liabilities.

The managers of schemes of that nature are exempt from the requirement to complete whole-of-scheme financial statements (as they are not relevant to members and may be unhelpful or misleading) and instead are required only to complete financial statements for each of the individual funds.

The basis for invoking the Segregated Funds Exemption Notice would be that (in summary terms):

- each employer-specific pool of assets is a *separate fund* as defined in section 461A(2) of the FMCA;
- the scheme is therefore one to which section 461A(3) applies (because the trustee's liabilities are limited to one or more separate funds); and
- the scheme consists of one or more separate funds and all scheme assets are attributable to a separate fund.

The scheme's trust deed would need[42] to prescribe that:

- for each separate fund, except in relation to the payment of tax:
  - the assets of the fund must be held solely for the benefit of the members sponsored by the relevant employer; and
  - the liabilities of the trustee in respect of that fund must be met from the assets of that fund only (and not from the assets of any other separate fund or other scheme assets); and
- in relation to the payment of tax, that:
  - tax must be calculated and paid separately for each separate fund; or
  - if that is not the case, adjustments must be made between the separate funds to put each of them into the position it would have been in if tax were calculated and paid separately for each separate fund.

42 Pursuant to clauses 6(d) and (e) of the Segregated Funds Exemption Notice.

13 DOES THE FMCA ALLOW SECTION-SPECIFIC ACTUARIAL AND ANNUAL REPORTING?

KEY POINTS

The trustee of the master trust should seek exemptions enabling it:

- by analogy with the Australian legislative solution, to satisfy its obligation to obtain actuarial reports by obtaining actuarial reports for each respective employer plan; and
- to satisfy certain of its related (and other) annual reporting obligations by reporting to the relevant members at a plan-specific (not whole-of-scheme) level.

We also recommend:

- seeking an exemption from the triennial actuarial review requirement for a pensioner-only plan within the master trust; and
- replacing it with a requirement for a simpler annual vested benefits review.

ACTUARIAL REVIEWS

One of the practical requirements for giving effect to the DB master trust solution will in our view be ensuring that the trustee:

- need only obtain actuarial reports (and then summarise those to members) for each respective plan; and
- need not also (or instead) obtain and summarise whole-of-scheme actuarial reports.

In other words, within a master trust scheme which has accounting segregation between employer plans, it will be important to ensure that for each plan the trustee need only:

- obtain and share with the FMA, the employer and (on request[43]) plan members; and
- summarise in or alongside the annual reports given to plan members[44];

the actuarial reports that are specific to that plan.

The legislative issues arising in this regard are that:

- section 169(2) of the FMCA requires the manager of a DB scheme to ensure that an actuary examines at not more than 3 yearly intervals the financial position of "*the scheme*"; and
- clause 80(2) of Schedule 4 to the FMCR requires that a DB scheme's annual report:
  - › states whether the rates or amounts of contributions paid have been in accordance with the recommendations contained in the most recent report of an actuary required under section 169 of the FMCA; and
  - › summarises "*that report*".

Regarding the section 169(2) issue:

- it might credibly be asserted that the practical effect of obtaining a full suite of plan-specific actuarial reports is that because (collectively) those reports cover the entire scheme, by logical extension the trustee has obtained an actuarial examination of the financial position of "*the scheme*";
- at best though, this argument would in our view be tenable only if each such report was prepared as at the same review date and the reports all used the same core methodology; and
- as such (and for certainty's sake in any case) we recommend that the Exemption Notice referred to in sections 8 and 10 of this report should also include an exemption to the practical effect that (by analogy with the Australian legislative solution) the DB master trust trustee can satisfy its section 169(2) obligations by obtaining actuarial reports for each respective plan.

The practical necessity for employer plan-specific actuarial reports would likely make this one area where there are minimal (if any) cost savings for employer participants. There might perhaps be modest cost savings if broadly the same report template was rolled out across all employer plans, but there would remain a need for customised assumptions and methodologies given the range of differing investment strategies and liability profiles.

43 Pursuant to regulation 53A of the FMCR.

44 Pursuant to clause 80(2) of Schedule 4 to the FMCR.

Given this[45], we would recommend:

- seeking an exemption from the triennial actuarial review requirement for a pensioner-only plan within the master trust; and
- replacing it with a requirement for a simpler annual vested benefits review (these in practical terms already produce the same result for a pensioner-only scheme in the triennial review year)[46].

ANNUAL REPORTS

The essence of the annual reporting issue arising under clause 80(4) of Schedule 4 to the FMCR is that:

- from the perspective of the members of the relevant plan, only the employer's conformity with (and the details of) that plan's actuarial report would matter; and
- it would not be sensible or appropriate either to share those details with the members of non-associated plans or to report on and summarise each such actuarial review in the master trust annual report.

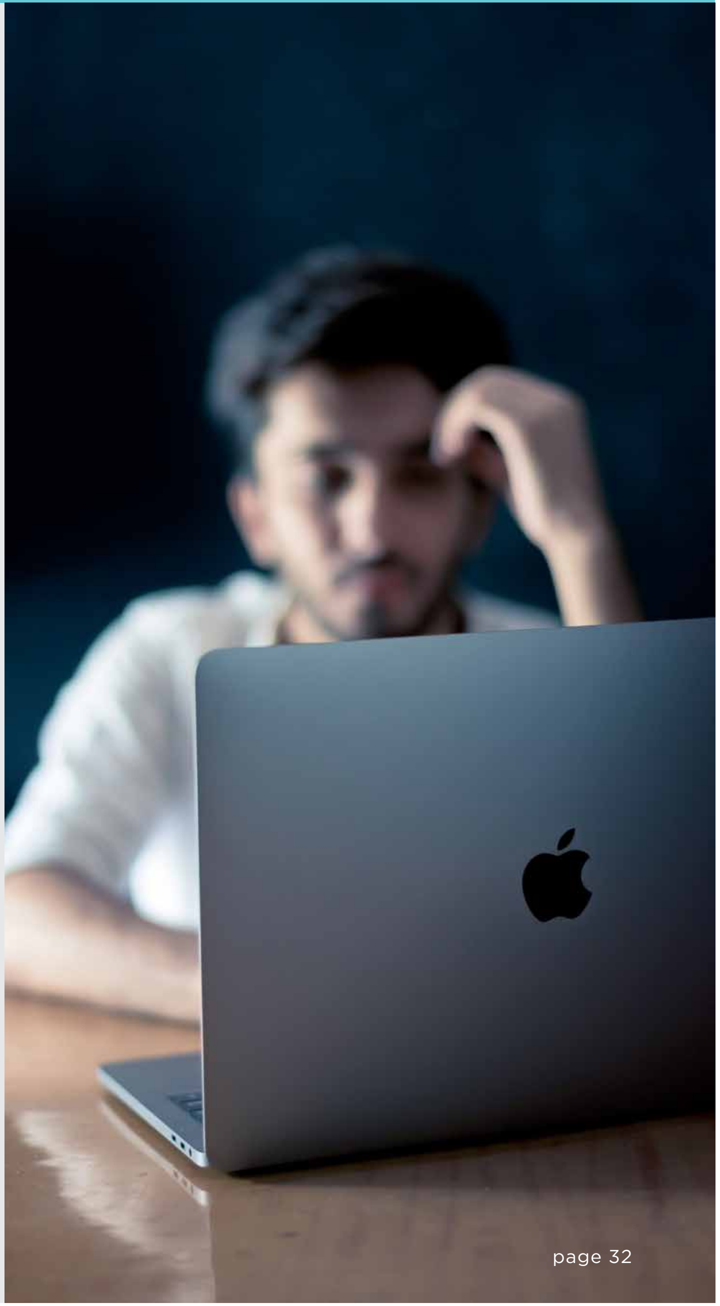
More generally though, there are other aspects of the annual reporting requirements prescribed in Schedule 4 to the FMCR, being:

- the information about scheme participants and contributions required under clause 78;
- the information about material governing document or SIPO changes required under clause 79(1)(a) and (c); and
- much of the "*other information*" required under clause 80;

which would not be meaningful (or appropriate) unless rendered plan-specific, with two obvious examples being SIPO changes[47] and confirmation of the funding position as at the balance date[48].

We have discussed this aspect with an administration manager, who concurs that accordingly the relevant Exemption Notice should include an exemption to the effect that the DB master trust trustee can satisfy those particular Schedule 4 requirements by reporting to the relevant members at a plan-specific (not whole-of-scheme) level.

The administration manager comments that customising an otherwise whole-of-scheme annual report in those specific respects should be straightforward and trigger only modest extra cost.



45 We note also that sponsor company valuations (required under NZ IAS 19) would persist, effective at each sponsor company's balance date. This may necessitate the master trust administration manager being able to provide data to external actuarial advisers and field questions from sponsor companies' auditors.

46 Annual reviews can also be characterised as a more robust minimum frequency of funding assessments in order to spot potential underfunding.

47 In this regard the only "material" SIPO changes would in our view be those significantly impacting either:
(i) the master trust as a whole (e.g. a change to an underlying sector specialist fund manager); or
(ii) the plan specifically (e.g. a change to the SIPO schedule prescribing the plan-specific asset allocation).

48 Clause 80(6)(b) requires disclosure of whether the market value of the scheme property at the balance date equalled or exceeded the total value of benefits that would have been payable had all members ceased to be members at that date and had provision been made for the continued payment of all benefits being paid as at that date.

14 WOULD THE MULTIPLE-PARTICIPANT SCHEMES EXEMPTION NOTICE BE AVAILABLE?

KEY POINTS

Each employer agreeing to participate in the master trust would enter into a deed of participation with the trustee prescribing the contribution and benefit provisions specific to the relevant members.

That participation deed would comprise part of the trust deed governing the master trust but (pursuant to the Financial Markets Conduct (Multiple-participant Schemes—Participation Agreements) Exemption Notice 2022) it would not be registrable on the Scheme Register.

As is established market practice for multi-employer workplace savings schemes, the trust deed for the master trust would contemplate that in order to be admitted to participation in the master trust each employer participant must enter into a deed of participation between it and the master trust's trustee.

Each deed of participation would comprise part of the *governing document* of the master trust, as that term is defined in ***section 6(1)*** of the FMCA.

This is because that deed of participation would:

- prescribe for the employer (in respect of the relevant members) certain section-specific contribution and benefit provisions comprising the core design features of that employer's own "*plan*" within the master trust; and
- thus be described in the trust deed for the master trust as forming part of (and hence as amending) the trust deed itself.

The master trust deed must include that prescription as a matter of legal necessity (i.e. it must prescribe that each participation deed forms part of the trust deed) because pursuant to ***section 135***(1)(c) and (e) of the FMCA any customised terms or conditions regarding either:

- the contributions payable to a scheme (or the manner of calculating them); or
- the rules applying to the determination and payment of member benefits;

must be provided for adequately in the governing document itself.

By reason of comprising part of the "*1 or more trust deeds that constitutes the scheme*" (the operative words of the *governing document* definition in section 6(1)) each deed of participation would be presumptively registrable on the Scheme Register pursuant to ***section 141(1)*** of the FMCA as "*an amendment to … the governing document*" for the master trust.

However, the ***Financial Markets Conduct (Multiple-participant Schemes—Participation Agreements) Exemption Notice 2022*** (**Participation Agreements Exemption Notice**) exempts a "*multiple-participant scheme*" from section 141(1) to the extent that it requires the scheme manager (in this context the trustee) to register copies of individual participation agreements (or amendments to those) on the Scheme Register. The master trust:

- would be a "*multiple-participant scheme*" by reason of having non-associated employer participants[49] each of whom participates under a customised participation deed; and
- would accordingly be permitted to invoke the Participation Agreements Exemption Notice, subject to meeting the prescribed exemption conditions.

In summary terms those exemption conditions are that the trustee of the master trust:

- must ensure that a copy of a participation deed is made available, on request and free of charge, to any member to whom it relates as soon as practicable after that member requests a copy; and
- must, within 4 months after the balance date of the master trust, provide the FMA with a list of:
  - the sponsors that participated in the master trust during the financial year ended on that date; and
  - the dates of the participation deeds that were entered into during the financial year.

49 ***Clause 8B(5)*** of Schedule 4 to the FMCR defines a "*multiple-participant scheme*" as "*a retirement scheme in which there are at least 2 participants that are not related bodies corporate*" and a participant as "*a person that, by virtue of the person's participation in the scheme, entitles investors to be admitted as members of the scheme*".

15 COULD THE MASTER TRUST INVOKE THE CUSTODIAL AUDITS EXEMPTION?

KEY POINTS

The trustee of the master trust would be permitted to invoke the Financial Markets Conduct (Restricted Schemes – Custodian Assurance Engagement) Exemption Notice 2020 in the same manner as the trustee of any other restricted scheme.

The trustee of the master trust would be permitted to invoke the ***Financial Markets Conduct (Restricted Schemes – Custodian Assurance Engagement) Exemption Notice 2020*** (*Custodial Audits Exemption*) in the same way as any other restricted scheme provided that:

- all scheme property is held directly by the trustee company (or, if the trustees are individuals, by a corporate nominee whose only directors are trustees);
- all scheme administration with respect to holding scheme property (along with all keeping of scheme property records) is contracted to an external administration manager; and
- no more than 5% of scheme property (by value) consists of investments other than direct investments in *standard assets* as defined in the Exemption Notice.

In other words the Custodial Audits Exemption would remain available to the relevant scheme in the same way as currently, despite it being repurposed as a master trust.

As to whether there would or might be "*transition year*" compliance issues for the master trust to navigate given the on-boarding of members from numerous other schemes during a *relevant year* (as defined in the Custodial Audits Exemption), as we see it no wider issues should arise for the master trust itself, provided that throughout the relevant year:

- it has had the same (external) administration manager; and
- it has met the various exemption conditions.

This is despite the fact that the master trust may have received transfers from transferor schemes which:

- were unable to invoke the Custodial Audits Exemption (due for example to not having fully outsourced their administration and/or having had significant allocations to non-standard assets); or
- failed to comply with one or more Custodial Audits Exemption conditions;

as compliance with the custodial audit requirement (and thus the exemption conditions) would be tested solely by reference to the operation during the relevant period of the master trust itself, and not the pre-transfer operation of any scheme from which new members have transferred during the period.

If post-transfer a transferor scheme no longer had either members or assets then it should be possible for its trustee(s) to elicit practical confirmation from the FMA that (as there would be no utility in requiring otherwise) that scheme need not obtain any final custodial assurance engagement.

16 WHAT ABOUT LOSS OF HUMAN RIGHTS ACT EXEMPTIONS?

KEY POINTS

The trustees of some DB schemes and sections rely on exemptions from age, disability, marital status, family status and sex discrimination that are set out in the Human Rights legislation.

The most significant exemption allows surviving spouse pensions without providing similar benefits in respect of single or widowed pensioners.

There is an issue as to whether the exemptions could reliably be treated as having been carried across to a replacement master trust. We think the better view (if the master trust comprises only transferred pensioners) is that there would be no breach of the Human Rights legislation triggered by the consolidation itself, because the pension entitlements would have been earned entirely while the pensioners were contributory members of the transferor schemes.

Many DB schemes and sections rely on one or more of the following exemptions from age, disability, marital status, family status and sex discrimination that are set out in the Human Rights Act 1993 (HRA) and the Human Rights Amendment Act 1994 (HR Amendment Act):

- under section 70(1) of the HRA, none of the prohibitions (in the context of employment or the provision of goods and services) relating to different treatment on the ground of age or disability applies to:
  any condition in, or requirement of, a superannuation scheme[50] in existence at the commencement of this Act[51] in relation to a person who was a member of the scheme at the commencement of this Act or who becomes a member of the scheme before 1 January 1996;
- under section 2 of the HR Amendment Act, nothing in the HRA prevents the provisions of a superannuation scheme or its trustee(s) from providing, on the death of a member, a benefit for either:
  - › the member's spouse; or
  - › the member's civil union or de facto partner;

  without providing a similar, corresponding or equivalent benefit on the death of other members, but only if the member joined the scheme before 1 January 1996 or:
  - › immediately before joining, was a member of another superannuation scheme that provided surviving spouse or partner benefits; and
  - › became a member of their current scheme: ***as a result of a requirement, or the exercise of a right, to leave that other scheme by reason of any merger, takeover, or restructuring of, or reorganisation of the business of, that person's employer***;
- under section 3 of the HR Amendment Act, nothing in the HRA relating to different treatment on the ground of sex or marital status applies to a person who joined a superannuation scheme before 1 April 1980 (unless amendments were made to that scheme so as to address the sex and marital status discrimination restrictions in the Human Rights Commission Act 1977 and those amendments applied to that person).

Under section 70(4) of the HRA, schemes may otherwise have provisions:

- providing or requiring different member contributions; or
- providing member benefits that differ in nature or amount;

50 Section 2(1) of the HRA defines a *superannuation scheme* in functional terms, as follows (such that it includes a workplace savings scheme): *"any superannuation scheme, fund, or plan, or any provident fund, set up to confer, on its members or other persons, retirement or other benefits, such as accident, disability, sickness, or death benefits"*.

51 The HRA came into force on 1 February 1994 (see section 1(2)).

by reason of disability or age only if the different treatment is based on:

- actuarial or statistical data upon which it is reasonable to rely; or
- where no such data is available in respect of persons with a disability, reputable medical or actuarial advice or opinion on which it is reasonable to rely;

and in each case the different treatment is reasonable having regard to the particular circumstances.

Additionally, the High Court ruling in ***Coburn v. Human Rights Commission*** [1994] 3 NZLR 323 confirms that surviving spouse pension provisions that are not matched by corresponding benefits for single or widowed pensioners are unlawful except as permitted under the savings provision in section 2 of the HR Amendment Act.

It was for the purpose of preserving their trustees' entitlements to the key savings provisions regarding age and marital status discrimination that a number of DB schemes and sections that had not already become legacy schemes or sections were closed to new joiners effective 1 January 1996.

For DB schemes and sections whose trustees currently rely on one or more of the above savings provisions, there is an issue as to whether it would be possible to carry over to the master trust the benefit of the above savings provisions.

If doing so was not possible then, given the consequent need to make expensive benefit design changes (such as extending the provision of survivor's pension benefits to pensioners who do not qualify due to not having qualifying spouses) in some cases this might make the transition exercise prohibitively costly for sponsors or frustrate it outright.

In the absence of any exemption facility within the HRA, to accommodate the relevant schemes within the master trust framework the HRA would in that case require a further amendment to the practical effect that if a transferred member is one in respect of whom a particular HRA or HR Amendment Act savings provision applied immediately before they were transferred to the master trust[52] then that savings provision continues applying in respect of the member.

There are real world limits, however, on the extent to which the proponents of the DB master trust solution might realistically expect to be able to obtain primary legislative amendments so as to render that solution workable for particular schemes.

Though there are arguments each way, we think the better view (if, as we recommend, the master trust comprises only transferred pensioners) is that:

- it would remain the case that the transferred pensioners' pension entitlements were benefits provided by the exempted transferor schemes, in the sense contemplated by the relevant Human Rights Act exemption provisions; and
- as such, there would be no breach of the Human Rights legislation triggered by the consolidation itself.

The basis for this view is that the pension entitlements:

- would have been earned entirely while the pensioners were contributory members of the transferor schemes; and
- would continue being paid within the master trust on terms that were entirely pre-ordained by the benefit provisions in the transferor schemes' trust deeds.

52 The master trust could be defined as a scheme approved by the FMA as an *exempt superannuation scheme* for the purposes of section EY 11(5)(aa) of the Income Tax Act 2007 (see above).

APPENDIX

APPENDIX 1
SMALL DB SCHEMES AND SECTIONS STATISTICS

Table 1: DB schemes with assets below $20 million

NAME	ASSETS	PENSIONERS	EMPLOYEE MEMBERS
3M New Zealand Limited Superannuation Scheme	$13,717,312	30	14
AMP (New Zealand) Staff Superannuation Plan (Section 1)	$13,772,000	90	-
AMP (New Zealand) Staff Superannuation Plan (Section 2)	$530,000	2	-
Aon Group Pension Plan	$7,900,271	13	-
ASB Bank Limited Provident Savings Fund	$237,793	2	-
Automobile Association (Canterbury) Incorporated Staff Superannuation Plan	$2,117,159	13	2
Bank of New Zealand Officers' Provident Association	$19,693,763	52	-
BIL NZ Group Pension Plan	$210,000	26	-
Bostik NZ DB Superannuation Fund	$1,944,148	3	4
Carter Holt Harvey Retirement Plan	$8,622,250	80	-
Commercial Union and RIG Pension Scheme	$9,099,884	50 (1 deferred)	1
Colgate-Palmolive Super Plan	$4,121,121	7	9
DXC (New Zealand) Staff Superannuation Fund	$5,365,765	26	-
Ford Motor Company of New Zealand Limited Pension Fund	$13,685,482	32 (1 deferred)	15
Glaxo New Zealand Pension Plan	$1,889,082	9	-
Goodman Fielder (N.Z.) Retirement Plan	$3,835,971	45	-
IBM New Zealand Limited Pension Scheme	$10,427,295	20	1
Johnson & Johnson (NZ) Limited Staff Pension Plan	$10,416,769	4	11
Marsh & McLennan New Zealand Superannuation Scheme	$2,792,065	7	7
Orica New Zealand Limited Retirement Plan	$14,467,875	59 (1 deferred)	14
Smith & Nephew Limited Superannuation Scheme	$2,741,300	7	-
Unisys New Zealand Employees' Retirement Income Fund	$3,617,671	14	-
Totals (22 schemes)	**$151.2M**	**591**	**73**

Table 2: DB schemes with assets between $20 million and $100 million

NAME	ASSETS	PENSIONERS	EMPLOYEE MEMBERS
AMP (NMLA) New Zealand Superannuation Scheme	$77,796,362	183	16
BP New Zealand Retirement Plan	$54,926,038	116 (2 deferred)	126
Church of Jesus Christ of Latter-Day Saints Deseret Benefit Plan for New Zealand	$51,173,303	120 (1 deferred)	64
Guardian Assurance Superannuation Plan	$29,893,724	41 (3 deferred)	-
Heinz-Wattie Limited Pension Plan	$48,791,053	92 (4 deferred)	2
Nestle New Zealand Pension Fund	$30,162,100	70 (2 deferred)	25
New Zealand Refining Company Pension Fund	$43,983,056	94*	8*
Vero and Asteron New Zealand Staff Pension Scheme	$36,303,310	119 (8 deferred)	16
Totals (8 schemes)	**$372.9M**	**835**	**257**

*as at 30 June 2022

Table 3: current benchmark income/growth splits – schemes with assets below $20 million

NAME	INCOME ASSETS	GROWTH ASSETS
3M New Zealand Limited Superannuation Scheme	45%	55%
AMP (New Zealand) Staff Superannuation Plan (Section 1)	53.5%	46.5%
AMP (New Zealand) Staff Superannuation Plan (Section 2)	53.5%	46.5%
Aon Group Pension Plan	45%	55%
ASB Bank Limited Provident Savings Fund	100%	-
Automobile Association (Canterbury) Incorporated Staff Superannuation Plan	50%	50%
Bank of New Zealand Officers' Provident Association	100%	-
BIL NZ Group Pension Plan	100%	-
Bostik NZ DB Superannuation Fund	70%	30%
Carter Holt Harvey Retirement Plan	75%	25%
Commercial Union and RIG Pension Scheme	40%	60%
Colgate-Palmolive Super Plan	40%	60%
DXC (New Zealand) Staff Superannuation Fund	40%	60%
Ford Motor Company of New Zealand Limited Pension Fund	60%	40%
Glaxo New Zealand Pension Plan[53]	30%	55%
Goodman Fielder (N.Z.) Retirement Plan	77%	23%
IBM New Zealand Limited Pension Scheme	80%	20%
Johnson & Johnson (NZ) Limited Staff Pension Plan[54]	30%	55%
Marsh & McLennan New Zealand Superannuation Scheme	40%	60%
Orica New Zealand Limited Retirement Plan	50%	50%
Smith & Nephew Limited Superannuation Scheme[55]	30%	55%
Unisys New Zealand Employees' Retirement Income Fund	40%	60%

53 Scheme has 15% allocation to alternative assets, not classed as either income or growth.
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APPENDIX 2
DB MASTER TRUST SELF-CERTIFICATION SUMMARIES (UK)

1) ABRDN PENSIONS MASTER TRUST[56]

Sectionalised, with all employer covenants preserved on transferring in and benefit structure based on transferring scheme – additionally:

- corporate professional trustee with two directors
- power to appoint and remove trustees sits with abrdn Founder Co Limited (wholly owned entity within abrdn group with no other operational responsibilities)
- each section of the scheme governed by its own appendix to master trust's Trust Deed, which incorporates incoming scheme's rules almost unaltered (except for certain constitutional powers such as power to appoint trustees or create a new section of master trust)
- sections anticipated (but not required) to be invested in abrdn pooled funds – default position is incoming schemes will use those investment portfolios for investment purposes
- ESG factors integrated within investment process of all underlying component funds
- each incoming employer ultimately remains responsible for ongoing costs and charges of their section – default position is payment out of assets of that section, but option of employer meeting them directly
- schemes join via bulk transfer of assets and liabilities (and legal adherence to master trust is achieved via a simple Deed of Participation)
- each participant can exit master trust without consent of trustee or other participants (no exit fee) via bulk transfer of assets and liabilities to new vehicle
- link to employer not severed and member benefits unchanged – assets and liabilities remain segregated, enabling schemes to pool together to benefit from economies of scale, while avoiding cross-subsidies.

2) CITRUS PENSION PLAN[57]:

Sectionalised, with all employer covenants preserved on transferring in and benefit structure based on transferring scheme – additionally:

- governed by corporate trustee with 5 directors (maximum 12 – six nominated by employers through 'Employers' Forum', four nominated by members, plus an executive director and an independent Chairman
- Employers' Forum comprises representatives from each employer participant – provides opportunity to input into Plan's objectives and governance (annual Employers' Forum updates employers on strategic and governance issues, and proposes employer nominated directors)
- most key decisions are shared between trustee and employers – trustee sets investment strategy but in consultation with employers (and for Plan wide amendments consent of all employers is normally obtained through silent consent procedure)
- unilateral employer power to trigger winding up of a section by terminating liability to pay contributions (trustee can trigger wind-up only if employer fails to pay contributions due on expiry of reasonable notice or goes into liquidation)
- investment strategy set at section level, reflecting funding position and covenant and objectives of employer (manager proposes an asset allocation and hedging ratio)
- funding:
  - › each section is considered based on its own characteristics using an integrated risk management approach – trustee agrees assumptions with employer, using standard assumptions-setting framework as starting point (with employer preferences and long-term objectives considered where appropriate)
  - › trustee agrees initial funding and longer-term targets with employer as part of take-on process (trustee will consider adopting assumptions of transferring scheme or adapting to its preferred approach)
- scheme operates on share of cost model and has standard pricing structure covering all core services (administration, actuarial, investment, legal, covenant assessment, and scheme secretarial) with fixed fees where possible

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56 https://www.abrdn.com/en-gb/institutional/insights-thinking-aloud/article-page/is-a-db-master-trust-the-solution-for-you
57 https://www.citruspensions.co.uk/how-it-works/for-employers/

3) DELOITTE PENSIONS MASTER PLAN:

Sectionalised, with all employer covenants preserved on transferring in and benefit structure based on transferring scheme – additionally:

- each section has own Section Trustees, who can be identical to trustees of transferring scheme and are responsible for all decisions in relation to section (e.g. regarding benefits, funding and investment)
- also Master Plan Trustee who monitors each section's compliance with rules of master plan (bare trustee which legally owns assets and invests as instructed by Section Trustees)
- Section Trustees appointed in same way as trustees were appointed to transferring scheme
- Master Plan Trustee appointed by Deloitte Pensions Services Limited
- each section governed by its own Section Rules, which incorporate precise wording of transferring scheme rules
- Deloitte provides actuarial and pensions administration services and plan has single auditor (otherwise Section Trustees appoint advisers of own choice for section)
- Section Trustees decide investment strategy – can select from, but not restricted to, range of low-cost funds on plan's investment platform
- Section Trustees responsible for scheme funding and agreeing this with employer
- Section Trustees and employers responsible for ongoing costs and charges of section
- only income Deloitte receives is from provision of professional services to Sections, as set out in engagement terms agreed with Section Trustees and employers
- entry is via bulk transfer of assets and liabilities
- sections can exit master plan without restriction (decision of Section Trustees and employer) – no exit fee and exit via bulk transfer to another scheme.

4) MERCER DB MASTER TRUST[58]

Sectionalised, with all employer covenants preserved on transferring in and benefit structure based on transferring scheme – additionally:

- three corporate trustees, all appointed by Mercer as plan provider
- trustees also have power to appoint professional advisors and third-party service providers
- each scheme transfers into own segregated section of master trust
- investment strategy for each section set by trustees in consultation with employer
- core approach is to invest in diversified growth portfolio and a liability matching portfolio, with proportion of assets allocated to each depending on investment return required by funding strategy agreed between employer and trustees
- funding strategy for each section set by agreement between employer and trustees
- employers exit via bulk transferred to new provider.

5) STONEPORT PENSION SCHEME

Was sectionalised until 31 December 2022, when became "*non-sectionalised (or centralised)*", with all employer covenants preserved on transferring in/"*strengthened on becoming a centralised scheme*" and benefit structure based on transferring scheme – additionally:

- 3 individual independent trustees, selected by Stoneport
- employers each become member of Stoneport Pensions Alliance Limited (company limited by guarantee which acts as principal employer)
- trustees and principal employer share most key decisions, including power of amendment, wind-up power and exit of an employer after becoming a centralised scheme
- individual employers set contributions, subject to trustee approval
- Stoneport operates a separate Matching Fund, designed to mirror investment strategy of UK insurer providing bulk annuities, and Investment Fund, which aims to outperform Matching Fund by 2-5% per annum, and Trustees determine composition of each fund
- employers choose allocation of their notional asset account between Matching Fund and Investment Fund.
- schemes join via bulk transfer of assets and liabilities

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58 https://www.uk.mercer.com/what-we-do/wealth-and-investments/defined-benefits-pension-schemes/master-trust.html

- cost savings are delivered through Stoneport operating like one large single employer scheme (i.e. with just one actuarial valuation and one set of audited accounts)
- by pooling liabilities, "*Stoneport provides far greater certainty of outcomes, and in targeting a shared funding objective*".

6) TPT DB MASTER TRUST

Sectionalised, with all employer covenants preserved on transferring in and benefit structure based on transferring scheme – additionally:

- corporate trustee with 9 directors – three are nominated by employers, three nominated by members and three co-opted by nominated directors
- provider's investment team works collaboratively with employer to create, manage and monitor each section's investment strategy
- initial investment strategy is discussed before scheme joins, then reviewed at regular intervals and at least at every actuarial valuation
- bespoke funding and investment strategy is created in consultation with employer
- provider is not-for-profit organisation
- schemes join via bulk transfer and:
  - › simple deed of adherence is executed, adopting existing Trust Deed and Rules for incoming scheme
  - › provider liaises with current administrators to obtain member data and records
  - › existing scheme actuary certifies that members' benefits are not adversely impacted by transfer
  - › transfer agreement (provided by TPT) is signed by trustees of previous scheme, sponsor and TPT
- dedicated transition managers lead implementation process
- trustee has power to agree bulk transfer to another approved pension scheme or insurance vehicle, provided no changes to member benefits and no deterioration in employer covenant (no exit fee)
- single, all-inclusive charge fixed for first three years' participation.

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AUGUST 2023