



Newsletter

The Credit Crisis - its Impact on Family Law Practitioners

specialising in superannuation valuations for family law purposes since 2003

Abstract: - The share market has experienced unprecedented volatility in recent times. This introduces new challenges for the family law practitioner (FLP).

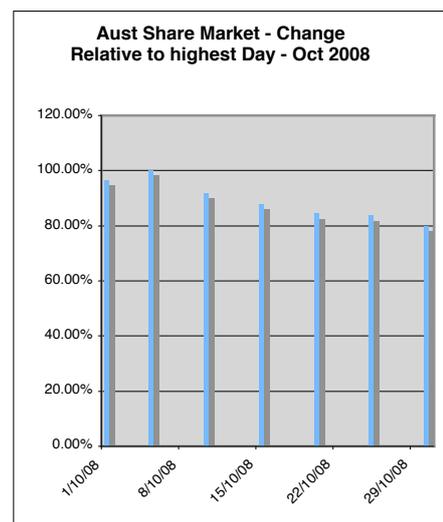
Negotiations precede agreements, which in turn precede the superannuation splits by the trustees. At the beginning of the process is the asset valuation. The time lag between the asset valuation and the execution of the superannuation split in ordinary times would result in a variation of asset prices that might not be material. Today, the increased volatility can result in winners and losers. Additional safeguards are needed. This newsletter addresses what the family law practitioner needs to take into consideration in volatile market conditions. Implementing the suggestions lowers the risk of a PI claim from a disgruntled client

The Credit Crisis

The credit crisis has produced both a collapse in the share price and increased volatility. Shares peaked in November 2006 and have now fallen by more than 40%. A return to the previous high would require about a 76% increase on the current level.

A noteworthy market movement in the past was 1%. Now, it is not uncommon for share markets to rise and fall by more than 5% over a few days. The volatility of the Australian share market in October 2008 is in the following chart.

Another measure of volatility is the exchange rate. The eighth largest movements in the aussie dollar since it was floated all occurred during Oct 2008.



The chart above shows that during Oct 2008, the difference between the highest value day and the lowest value day was 20% - and that



was just in one month! That means that an accumulation fund with 100% exposure to Australian shares valued at \$100,000 in early Oct would only be worth \$80,000 at the end of that month.

However, the cash returns in the same period have been positive and balance funds, with exposure to fixed interest and property had sustained less volatility.

What Should Practitioners' Do?

In volatile markets, practitioners need to:

- Be aware of the type of asset class that is in the superannuation fund,
- Be aware of the impact of the market volatility,
- Structure offers to account for volatility by including review clauses, and
- Account for market movements between valuation date and the superannuation splitting date.

The most common type of superannuation fund is an accumulation fund and that will be discussed first followed by defined benefit funds.

Accumulation Funds

The family law value (FLV) of these funds is simply the balance of the member's account. No valuation is necessary.

The impact of volatility is best illustrated by an example.

For simplicity, the following scenario assumes that only the husband has superannuation, that no contributions are made to that account, the asset class is all Australian shares and that the split is 50/50. The financial scenario is that the husband retains assets of \$50,000, the wife retains assets of \$200,000 and the husband's super fund, valued at \$400,000 is to be used to equalise the assets. This means that a split of \$125,000 in favour of the wife is required. If the

market falls 20% since the valuation, the super split of \$125,000 would be detrimental to the husband. The fall should be spread equally between parties as illustrated:

The Pool

Other assets	\$250,000
Super	\$400,000
Total	\$650,000
Equal share	\$325,000

	Wife	Husband
Other assets	\$200,000	\$50,000
Super	\$125,000	\$275,000
	\$325,000	\$325,000

Super falls by 20%	now	\$320,000
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Other assets	\$200,000	\$50,000
Super	\$85,000	\$235,000
	\$285,000	\$285,000

Fall in super	\$80,000
To husband	\$40,000
To wife	\$40,000

How then to protect the interest of the parties? The answer depends on whether the trustees will accept a formula for determining the base amount. Some trustees will and others refuse. If the trustees will accept a formula, the splitting order should contain the following formula:

The base amount equals: *Original base amount + (a - b) * s*, where

- a* = FLV closest to date of actual split
- b* = FLV used for negotiations
- s* = percentage split going to the non-member spouse

Note that the trustees would be given all figures except *a* – the current value. In the example used, the formula would give the following revised base amount in favour of the wife:



$$\begin{aligned} & \$125,000 + (\$320,000 - \$400,000) * 0.5 = \\ & \$85,000 \end{aligned}$$

Thus the formula accords with the outcome in the above table.

If the trustees will not implement a formula, then the best that can be done is to insert a revised base amount just prior to the orders being submitted to the court or the signing of a financial agreement.

An alternative to a clause that captures all market movements is to have a clause that is only operative if the market rises and fall beyond a specified percentage such as 5%.

What if contributions are being made?

If the objective of the agreement is to exclude all post separation contributions, then the formula needs to pick up the change in unit prices from date of valuation to date of the split. If unit prices are not available for the superannuation fund, then the agreement could use unit prices published by other funds such as a Q Super. The change in unit prices will reflect the change in market conditions. Importantly, the outcome would be the same as if it had been possible to split the super as at the date of separation.

If the member was invested in a balanced fund, the earnings should reflect the balanced fund returns. It is important that any adjustment is consistent with the type of fund. For example, if the member elected to place all his superannuation monies into Australian shares, any re-valuation should reflect changes in Australian shares and not any other asset class.

Percentage Splits?

Some FLP ask why a percentage split should not be used as the percentage would pick up any change in the FLV. However, a percentage split would also pick up all the post separation contributions. Furthermore, some trustees are reluctant to accept percentage splits because it may impact on all future payments. Percentage splits are best avoided when the superannuation is in the growth phase. They are appropriate when the super is in the payment phase.

Defined Benefit Funds

Whether market changes influences the FLV will depend on how the defined benefit is calculated.

If the super scheme is fully defined by virtue of salary and years of service (possibly linked to contribution rates), then market conditions will have no impact. A good example is the Public Service Scheme (PSS). Any decrease in member component is made good by an increase in the employer share, leaving the total unchanged.

Where the defined benefit has an accumulation component as an add-on or where the accumulation component is used to derive the defined benefit, market conditions can influence the FLV. A review clause similar to the accumulation scheme could be considered.

Non Separate Interest Defined Benefit Schemes

The above are DB schemes (eg Telstra Super and NSW Govt Schemes) do not create a separate interest for the non-member spouse when a superannuation split occurs. Rather, the split occurs when the member receives his or her monies – generally on retirement. To account





for the passage of time, the base amount is adjusted by AWOTE (a wage index) plus 2.5% - currently about 7% per annum is applied to the base amount. The adjusted base amount is deducted from the member's account at payment time.

So, when markets fall, the superannuation holder has a diminished balance whilst the non-member's balance grows at around 7%. This radically changes the outcome.

The solution is to only split superannuation from a non-separate interest DB scheme as a last resort. This should be the case in any event. However, in some cases, there is insufficient real assets and it is not possible to avoid splitting.

A more practical suggestion is to include a non-superannuation clause in the orders that claws back unintended gains to the non-member spouse. If the period to retirement is long term, AWOTE plus 2.5% is likely to approximate investment returns. This would not be the case in the short term. So if the member is retiring in the next few years, the non member spouse will pick up an unintended windfall gain at the expense of the member and a review clause is warranted. Alternatively, the parties could agree not to escalate the base amount.

Self Managed Superannuation Funds

The valuation issues are the same as for accumulation schemes. However, the structure of SMSFs, the control of contributions, the timing of the split, and the structure of the orders all point towards a percentage split where the assets are mainly shares.

Another impact of rapidly changing asset values in SMSF is that the statutory limits on in-house

assets could be breached. FLPs should always consider an indemnity to protect the departing party.

Summary

These turbulent times call for greater vigilance by FLP on superannuation asset values. As a matter of course, any agreement reached should include a clause that subjects the base amount to fine tuning in accordance with movements in the market. The FLPs check list should include an analysis of market movements relevant to the client between valuation date and the date of any likely split.

Communication with clients on this topic will be a positive for FLPs. The outcomes of any review might even be secondary – the most important aspect is that the issue was identified, quantified and the client advised. Sometimes, it is just not worth upsetting delicate negotiations for a few extra dollars. But that decision should not be made without the facts.

Feedback

Please [email](#) me any feedback or topics you would like covered in future newsletters.

Curriculum Vitae - click [here](#) to view my CV or to read my previous Newsletters.

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