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APRA

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Dear Trustee

VALUATION OF UNLISTED ASSETS – GENERAL PRINCIPLES FOR TRUSTEES

In the current market conditions, APRA considers it appropriate to clarify its expectations of Trustees in relation to practices undertaken in the valuation of unlisted assets held by the superannuation fund(s) under their trusteeship. By nature, unlisted investments are more complex than listed investments. While AAS 25 *Financial Reporting by Superannuation Plans (AAS25)* requires market value for year end accounts, equity and consistency dictate such use throughout on all on / off movements given ongoing contributions and investment earnings as well as portability and fund choice. In unlisted assets, there is no ready bench mark for market value, hence the need for additional guidance.

APRA's main objective in this letter is to provide Trustees with an understanding of what it considers to be prudent practice when setting valuation policies and processes for unlisted assets, thereby assisting them to better meet fiduciary obligations in this area. This is in addition to the need to comply with the relevant professional standards.

Valuations of 'appraisal based' assets can have a critical impact on members, given their relative illiquidity and infrequency of valuation. Valuation risk must be addressed explicitly in the Trustee's Risk Management Plan. APRA expects Trustee Boards intending to invest in unlisted assets to collectively possess sufficient understanding of the basic drivers of valuations, and be aware of the complexities surrounding the valuation of unlisted investments.

The attachment to this letter sets out the valuation principles according to the following sections:

- Framework
- Governance; Process
- External Advice
- Member considerations
- Examples of unacceptable valuation practices
- Other Guidance.

APRA supervisors will have regard, amongst other matters, to the manner in which Trustees adopt prudent practices in their ongoing risk assessment and supervisory stance.

Yours sincerely

Ramani Venkatramani
General Manager
Specialised Institutions Division

ATTACHMENT

Valuation of Unlisted Assets - General Principles for Trustees

Framework

The Trustee needs to consider the valuation issues that are posed by the various types of investment structure through which Trustees may gain access to private markets. These include direct investments into unlisted assets (such as private equity); pooled vehicles; 'fund of fund' vehicles and investments made through life policies.

Similarly, valuation issues specific to different asset classes need to be considered by Trustees. Most notable examples include direct property; infrastructure assets; private equity and hedge funds.

Governance

One of the most critical aspects for the Trustee to implement and monitor with regard to valuations of unlisted assets is the governance of the process. The key components include a robust, well documented policy framework which is approved by the Board and communicated to all parties responsible for its application. The policies should be reviewed by the Trustee on a regular basis. In addition, it is considered good practice to have in place a nominated body dedicated to the oversight of the valuation process. This could take the form of a Valuation Committee, or similar group within the Trustee's governance structure.

On the operational side, there should be adequate segregation of duties between staff involved in the asset management process and those staff involved in the approval process for adoption of the valuation. Where, due to the complexities involved, reliance is placed on valuations provided by the Investment Manager, Trustees need to be able to demonstrate how they are effectively mitigating the potential conflict of interest that arises.

Process

The following aspects of the valuations process for unlisted assets should be considered by Trustees (this should not be taken as an exhaustive list):

- Select the optimal valuation **source,** in terms of transparency and appropriateness.
- The valuation **methodology** should be appropriate for the investment; robust and applied consistently from one period to the next.
- **Frequency of revaluation:** Superannuation Circular IID.1 states that the periodic valuation for assets that are not regularly traded should be obtained independently and updated regularly, particularly in times of market volatility. Further, APRA expects Trustees to apply the latest available valuation for the calculation of performance. There should be a clear basis for determining the frequency of valuation, and a clear policy indicating circumstances that would necessitate an immediate revaluation in between periodic valuations.
- Monitoring the process around any use of **indexation** as a proxy for asset value movements (for the period between formal valuations of the asset).
- Exposure to **model risk**, where valuation models are used. This includes having robust processes in place for the construction and maintenance of models developed in-house, and the independent validation of those models including the identification and mitigation of model bias.

- Determination of the events and circumstances upon which the **assumptions** underlying the valuation would need to change, which may result in a revaluation of the unlisted asset.

When adopting a particular valuation (whether or not internally sourced), the Trustee needs to demonstrate what considerations have been made, including consistency with previous valuation exercises.

External advice

APRA notes that many Trustees engage external parties to provide input into the valuation process. Aspects to consider by the Trustee in relation to its external valuers include reputation; resourcing; qualifications; areas of specialisation; experience and methodology/process undertaken.

As with all examples of reliance on external advice, APRA expects Trustees to make appropriate enquiries into the results of the advice. This would include, for example, querying the basis for valuations that appear to depart from economic fundamentals. While APRA does not expect Trustees to substitute their own technical judgement for that of appropriate experts, APRA does expect Trustees to ask questions to ensure they understand the basis for valuations and if not satisfied, initiate further appropriate action.

Member considerations

Given that asset valuations form a significant input into the calculation of unit prices and crediting rates, the robustness and timeliness of the valuations can potentially have a material impact on equity amongst members, via mispricing of transactions and potential arbitrage opportunities. For further discussion on unit pricing issues, please refer to the *Unit Pricing: Guide to Good Practice* released by APRA and ASIC (last updated August 2008).

The Trustee should disclose the valuation approaches/methodologies used and other pertinent issues surrounding exposure to unlisted assets.

Examples of unacceptable valuation practices

To assist in illustrating the principles set out in this letter, set out below are some examples of unacceptable valuation practices observed by APRA in its supervisory activities. This list should not be considered exhaustive.

- Lack of independence in the valuation process. This is usually manifested in reliance on investment manager valuations, without appropriate validation being performed.
- Appointing investment managers without consideration of their valuation policies and processes, and continuing lack of awareness of these on the part of the Trustee.
- Reliance on internal models without any verification of inputs or assumptions, and with no validation of valuation results.
- Obtaining a number of external valuations and selecting the most favourable one to adopt ("valuation shopping").
- Smoothing returns by recognising increments/decrements over time, and not when identified.

Other guidance

For additional guidance, Trustees may wish to refer to published guidelines from various sources. Some are listed below. In all cases, Trustees should determine the relevance and appropriateness of such guidelines in the context of their own funds and legal obligations.

- IFSA (“Investment and Financial Services Association”) guidelines
- AVCAL (“Australian Private Equity & Venture Capital Association Limited”) guidelines
- IVSC (“International Valuation Standards Council”) guidelines
- RICS (“Royal Institution of Chartered Surveyors”) guidance notes