Australian Prudential Regulation Authority

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Dear Trustee

Valuation of unlisted assets: Industry alert

APRA wrote to trustees on 16 April 2009 setting out some good practices on general principles to be used for unlisted asset valuations. The guidance was provided in response to the volatile market conditions during the global financial crisis, which demonstrated significant valuation difficulties for unlisted investments.

Given the ongoing work on finalising the accounts for the year ended 30 June 2010, it is timely to remind trustees of their obligations in regard to valuation practices, and to raise trustees' awareness of risks arising from unlisted investments that are more complex or less transparent relative to listed assets. In what follows, fund exposure to a collection of assets (often through down-stream vehicles) is referred to as 'investments', while the underlying individual exposures themselves that constitute such investments are referred to as 'assets'.

Considerations

In summary, trustees should ensure that:

- There is a strong governance framework for valuations which includes:
  - oversight by the trustee Board and relevant committees(s);
  - clear segregation of duties;
  - soundly developed and documented policies and procedures, and
  - robust implementation.
- The valuation process should take into account the risks posed by:
  - the valuation methodology;
  - the underlying assumptions; and
  - the use of modelling.
- Trustees understand, and where necessary query, the underlying bases for valuation, even when valuations are furnished by experts.

Consideration should also be given to equity issues between members when determining the suitability of an unlisted investment and its ongoing place in the portfolio of either a particular fund or an investment option within that fund. Given the ability of members to move between investment options as well as funds, volatile markets that might experience greater switching require valuations to be much more robust and suitably validated than during stable times. For members in pension phase, year-end valuations affect the balances on which maximum and minimum draw-downs allowed under tax rules are computed, necessitating appropriate liquidity controls.

The practice that some trustees have adopted of using certain investment options (such as the default option or in a hybrid fund, the defined benefit segment) as the *de facto* liquidity providers to the other options could, even if not constrained by the available liquidity in such options, lead to significant inequities and trustees need to appropriately focus on their obligations to manage the situation in members' best interests (as highlighted in APRA's Insight magazine Issue 1, 2010: '*Liquidity Management in Superannuation*').

Complex investment structures

If trustees are giving consideration to entering into, or increasing exposure to, unlisted investments as part of their ongoing investment strategy review, they should be mindful of the inherent valuation risks associated with investments that have multiple management layers, complex investment structures and/or underlying assets that are opaque in nature. APRA expects trustees to have commensurately greater scrutiny of these types of investments, drilling down to the underlying assets, in the due diligence process.

Not only are trustees responsible for developing an appropriate investment strategy, they are also responsible for the valuation of all investments of the fund. It is critical that trustees have sufficient understanding of the nature and underlying drivers of the valuation of any unlisted investments.

Accordingly, trustees should consider as part of their due diligence process:

- the extent to which the layers of investments downstream can be monitored by the trustee;
- the transparency, independence and robustness of the valuation process;
- the reduced transparency of holdings and the valuation bases used for offshore investments;
- implications of downstream managers employing 'confidentiality' as a reason for not revealing the actual underlying assets of downstream investments;
- the adequacy of the trustee's resources to evaluate and manage such investments;
- the adequacy of the trustee's understanding of the nature and characteristics of the downstream investments; and
- the capacity of trustees to drill down to the level of constituent assets, documented triggers for such drill down to occur and evidence of such occurrence.

Operational due diligence

In some instances, due to the limited access to information on the underlying assets of an unlisted investment, it might be necessary to rely on the valuation provided by the manager. This would obviously reflect the manager's valuation principles and processes and the trustee should be comfortable with these. The price the trustee is quoted from the manager is not an independent price although trustees may consider this the most relevant information in the absence of a more robust pricing process. This serves to emphasise the importance of operational due diligence and of the trustee being comfortable with the manager's valuation principles and processes, including a plan to deal with the valuation where it is considered unsuitable.

Given the reliance on the monitoring and controls of the manager, trustees should assess in their operational due diligence of managers:

- the quality of the manager' risk management framework;
- the adequacy of resources and infrastructure of the manager;
- the standards of conduct and investment discipline applied by the manager;

- the adequacy of (or controls to mitigate the lack of) segregation of duties within the manager's operations;
- the relationships and/or capabilities of the manager to regularly source details of underlying assets; and
- the level of disclosure provided by the manager.

Audit reports for downstream investments

Where external audit reports of downstream investments are used to provide assurance around valuations, trustees should be mindful of the type of opinion / report that has been issued. Trustees should pay close attention to:

- the scope of the audit;
- the basis of the opinion;
- the exceptions within a qualified opinion report and their significance to fund members;
- any other regular reviews conducted outside of the audit process;
- any possible impediments to the auditor's independence and how they were addressed; and
- any risk of 'forum shopping' to smooth reported outcomes.

Furthermore, the use of audited values does not by itself lessen trustees' responsibilities for the accuracy of investment valuations that are used to determine members' entitlements. In any event, given choice of investments / funds and portability, annual audited values are of limited utility in determining member entitlements during the financial year.

APRA expects trustees, their valuation experts and auditors to exercise increased vigilance to protect member interests, and would be looking to see corroborating evidence during its prudential reviews.

In the event you wish to discuss this letter, please contact your responsible APRA supervisor.

Yours faithfully

S.G. Venkatramani
General Manager
Specialised Institutions Division