INFORMATION PAPER

Findings from APRA’s superannuation thematic reviews

October 2021

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Executive summary

APRA is the prudential regulator for superannuation RSE licensees, authorised deposit-taking institutions and insurers. APRA's purpose is to ensure Australians' financial interests are protected and the financial system is stable, competitive and efficient. In addition to protecting the financial interests of Australians today, APRA is preparing to regulate the superannuation sector in a world where the shape and structure of the financial system is rapidly evolving.

APRA continues to drive change to improve the lives of Australians in their retirement – and expects RSE licensees to be taking the same forward-looking focus to deliver quality member outcomes to Australians now and into the future.

The purpose of this Information Paper is to share with RSE licensees a number of risks and vulnerabilities that RSE licensees must have front of mind to drive better practices across the industry that lead to continuing improvements in outcomes.

These risks and vulnerabilities are informed by the findings of three thematic reviews into core areas of RSE licensee business operations critical to delivering outcomes to members:

- strategic and business planning, and assessing performance against strategy, via a benchmarking review of implementation of *Prudential Standard SPS 515 Strategic Planning and Member Outcomes*;
- RSE licensee expenditure decision-making; and
- unlisted asset valuation practices, which are central to delivering investment outcomes in the best financial interests of beneficiaries.

APRA is engaging with RSE licensees to understand how RSE licensees are facing into the future of the superannuation industry. In this light, APRA expects each RSE licensee to assess itself against the findings discussed in this Information Paper, with a view to identify any sub-standard practices and improve relevant processes and procedures.

The examples examined in the review on RSE licensee expenditure decision-making were tested against the best interests duty, which applied at that time. Since 1 July 2021, all decisions on expenditure must demonstrably be made in the best financial interests of members. APRA is engaging with RSE licensees about expenditure of the kinds identified in this report in the context of this heightened expectation and will determine any action that may be necessitated by the requirements of the best financial interests duty.

Key observations

The value of strong governance and strategic planning was a common theme across all reviews, consistent with APRA's view that these elements are critical to improving outcomes for members. Where robust frameworks, clear accountability and holistic approaches to planning existed, practices were of a better standard across the board, regardless of the area of the RSE licensee's business being reviewed.

The key observations from APRA's reviews are outlined below.

SPS 515 benchmarking

Practices that RSE licensees need to strengthen as part of their next BPR and business planning cycle, include:

- Better connection between BPR findings and updates to business plans
- Greater clarity on how strategic objectives support desired member outcomes
- More robust analysis of the drivers of business performance
- Consideration of entire business operations, not just individual RSEs, for RSE licensees of multiple RSEs
- Stress testing of financial projections
- Robust and appropriate member cohort analysis

RSE licensee expenditure

- Many RSE licensees failed to rigorously measure and assess anticipated benefits to fund members of expenditure on marketing campaigns and related activities
- Prevalence of qualitative assessment over quantitative measures including a general absence of appropriate metrics and deep analysis
- Instances of RSE licensees being unable to demonstrate how additional benefits associated with sponsorships, that were provided to directors, executives and staff of the fund resulted in any improved outcomes for members

Unlisted asset valuation

- Most RSE licensees demonstrated a proactive approach to revaluing unlisted assets in response to the heightened market volatility in early 2020
- Revaluation frameworks need to be improved
- Limited board engagement
- Examples of an over-reliance on external parties
- Entities with pre-established valuation committees typically had more robust valuation frameworks

Glossary

BPR	Business performance review
RSE licensee	Registrable superannuation entity licensee
SPS 515	*Prudential Standard SPS 515 Strategic Planning and Member Outcomes*
SPS 530	*Prudential Standard SPS 530 Investment Governance*
YFYS reforms	Reforms reflected in the Treasury Laws Amendment (Your Future, Your Super) Act 2021

Chapter 1 - Introduction

Given the importance of superannuation to the financial future of Australians and the Australian economy, it is critical that the financial system is optimised to deliver the best financial outcomes for members. Australians place their trust in RSE licensees to ensure their superannuation fund delivers value from every business plan enacted, dollar spent or investment made.

Presiding over more than $2.2 trillion of members' money, RSE licensees are expected to safeguard and grow retirement savings. With the ever-increasing size and importance of the superannuation system, RSE licensees can expect ever-increasing scrutiny.

On 30 July 2021, APRA wrote to all RSE licensees regarding the implementation of the Your Future, Your Super (YFYS) reforms. These reforms are a powerful signal to the superannuation industry. RSE licensees must ensure they are acting in the best financial interests of members and meet performance benchmarks. Failing to do so will result in significant consequences.

In this context, APRA is focused on holding RSE licensees to account for identifying and rectifying sub-standard practices and improving standards and performance.

To that end, APRA has recently undertaken three thematic reviews:

- implementation of *Prudential Standard SPS 515 Strategic Planning and Member Outcomes* (SPS 515);
- RSE licensee expenditure;
- unlisted asset valuation practices.

Whilst the detailed findings from each thematic review provide specific insights in each of these areas, APRA continues to observe a number of common and recurring themes in RSE licensee practices.

The underlying themes were that strong governance and robust strategic planning are critical to improving outcomes for members and avoiding potential misconduct. Where robust pre-existing frameworks, clear lines of accountability and holistic planning existed, practices were of a better standard across the board.

It is vital that funds are well-governed and intensely focused on the best financial interests of members.

1.1 APRA's recent superannuation thematic reviews

SPS 515 implementation benchmarking

SPS 515 is central to APRA's overarching strategic goal of improving outcomes for superannuation members, and APRA's expectation that RSE licensees should manage their operations like the significant (in most cases multi-billion dollar) financial services businesses they are.

Between March and June 2021, to gauge how RSE licensees are meeting the requirements of SPS 515, APRA conducted a benchmarking exercise across 24 RSE licensees. This focused particularly on business plans and business performance reviews (BPRs). The RSE licensees reviewed represented a cross section of industry.

APRA reviewed business plans and BPR documentation to understand RSE licensee practice and assess how well RSE licensees have embraced, and embedded, the intent of SPS 515. The review also identified opportunities for improvement.

The key observations from this review, including areas of better practice, are set out in Chapter 2.

RSE licensee expenditure thematic review

In late 2020, APRA commenced a review to understand how RSE licensees approached decision-making in relation to expenditures and importantly how they assessed and analysed the benefits for members, if any, that resulted. This now also provides a baseline understanding of the extent to which RSE licensees would need to change their practices to meet the heightened expectations of the best financial interests duty.

The thematic review, undertaken between November 2020 and October 2021, focused on expenditure by a subset of RSE licensees on advertising, sponsorships and promotions (collectively referred to as marketing expenditure in this paper). The 12 RSE licensees reviewed represented a cross section of the industry.

This review analysed how RSE licensees made decisions regarding marketing expenditure of approximately $87 million from 2018 to 2020. Specifically, APRA considered whether certain expenditure was in the best interests of beneficiaries (the relevant fiduciary duty at the time), and assessed whether RSE licensees had applied appropriate governance and oversight to their expenditure decisions.

The key observations from this review, including APRA's expectations for future prudent practices, are set out in Chapter 3.

The review also identified RSE licensees where decisions regarding marketing expenditure may not be consistent with the sole purpose test and the duty to act in the best interests of beneficiaries (refer to Chapter 3 for examples that fall into this category). APRA will continue to investigate these matters and, where appropriate, undertake enforcement action.

Unlisted assets valuation thematic review

The heightened market volatility in early 2020 as a result of COVID-19 highlighted the importance of RSE licensees taking a prudent approach to valuing unlisted assets. Between September 2020 to March 2021, APRA conducted a thematic review of unlisted asset valuation practices present throughout 2020. The review sought to assess industry practices and identify any key areas for improvement, focused on:

- enhancing APRA's understanding of the range of practices across the industry;
- identifying RSE licensees that may require supervisory attention in relation to valuation governance; and
- providing insights for enhanced requirements and guidance on unlisted asset valuation and member equity risk.

APRA issued a questionnaire and an information request to 31 RSE licensees, selected according to their level of exposure to unlisted assets and covering a range of competency in valuation governance. These RSE licensees reflected a spread of assessed valuation risk, from acceptable (minor weaknesses to be addressed) through to material. APRA supervisors are engaging with those RSE licensees that were assessed as having material valuation risk.

The key observations from this review, including APRA's expectations regarding prudent practice, are discussed in Chapter 4.

Chapter 2 - Prudential Standard SPS 515 Strategic Planning and Member Outcomes benchmarking review

2.1 Introduction

SPS 515 has been central to APRA's overarching goal of improving outcomes for superannuation members since it commenced in January 2020. RSE licensees must meet requirements relating to business planning, business performance and expenditure management. APRA's focus on RSE licensees' decision-making across these areas has intensified with the introduction of the YFYS reforms.

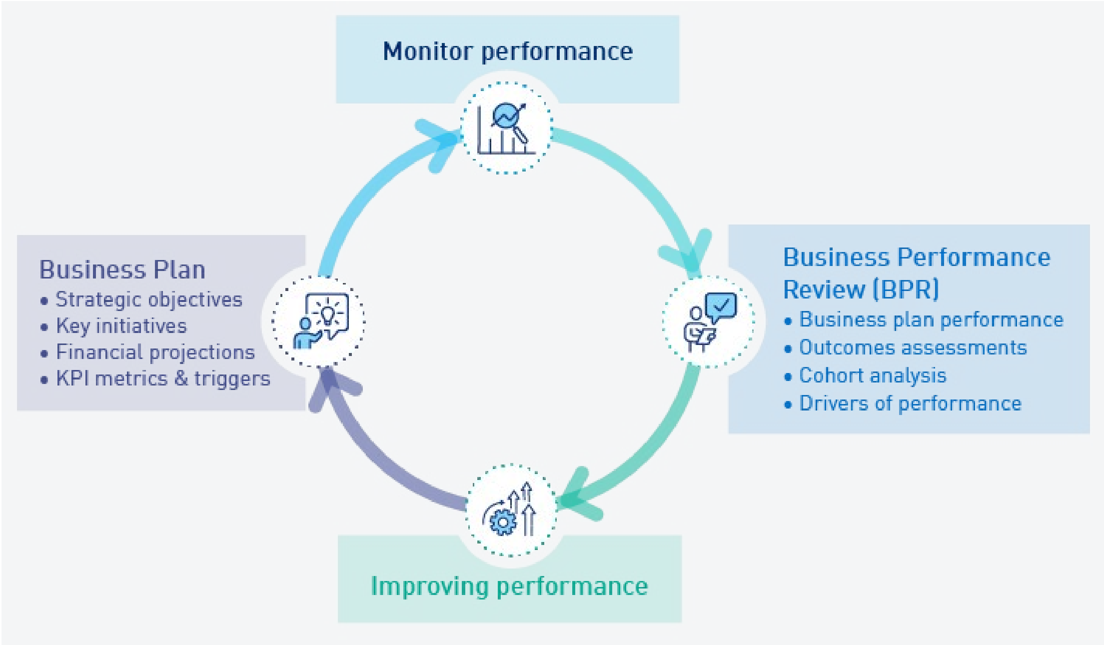
Encouragingly, RSE licensees have noted the value of meeting the requirements of SPS 515: RSE licensees look at their operations differently, and make deeper enquiries into previously unexplored areas. APRA welcomes this greater discipline - when RSE licensees embrace the intent of SPS 515, as well as complying with its requirements, their business decisions are well-informed, leading to improved outcomes for members.

2.2 SPS 515: business plans, BPRs and the cycle of continuous improvement

SPS 515 requires RSE licensees to reflect on the day-to-day operation of their business operations, via comprehensive planning and rigorous analysis in the form of:

- A board-approved business plan, which sets out its strategic objectives, and details how the RSE licensee expects to promote member outcomes over the following three years. Importantly, the business plan must specify the key initiatives that RSE licensees will undertake to achieve their strategic objectives, and the results they expect from each initiative.

- An annual BPR, where RSE licensees evaluate their performance in delivering the business plan, and determine whether they are on track to achieve their strategic objectives and deliver sound member outcomes into the future.



These two elements – the business plan and the BPR – are interconnected. Inherent in SPS 515 is a process of continuous improvement: when RSE licensees, through undertaking the BPR, identify areas of weakness in their business plan, they must seek to address these weaknesses in their next business plan to maintain focus on achieving their strategic objectives. SPS 515 requires RSE licensees to do more than simply set and review strategic objectives; RSE licensees must measure the progress of their objectives at least annually to identify learnings, and then incorporate those learnings into this cycle of continuous improvement.

2.3 Key observations

The benchmarking exercise sought to assess the progress of RSE licensees in implementing SPS 515. APRA has, as a result, identified areas where RSE licensees must strengthen their practices during the upcoming BPR and business planning cycle.

These areas include:

- creating better connection between BPR findings and updates to business plans;
- clearly explaining how strategic objectives support desired member outcomes;
- conducting more robust analysis of the drivers of business performance;
- considering the entirety of the RSE licensee's business operations as a whole, especially for RSE licensees with multiple RSEs;
- embedding stress testing of financial projections; and
- conducting robust and appropriate member cohort analysis.

2.4 Detailed findings

APRA's key findings are set out below. While not exhaustive, this section outlines APRA's expectations for strengthened RSE licensee practices.

2.4.1 Cohesiveness of business planning process

APRA found some RSE licensees did not reflect BPR findings in their business plan, to develop future activities or inform assumptions used in financial projections.

APRA expects an RSE licensee to clearly document and reflect BPR recommendations in their next business plan. APRA expects that strategic objectives and initiatives defined in business plans address the challenges and weaknesses identified in the BPR. For example, concerns arising from declining membership and challenges to attract new members could be addressed by specific steps to identify and pursue merger opportunities.

2.4.2 Consideration of member outcomes

APRA found that metrics used to monitor performance of strategic objectives in RSE licensees' business plans, especially the performance of initiatives, were not always aligned with the expected outcome for members.

APRA expects an RSE licensee to clearly describe how each strategic objective supports desired member outcomes. For example, APRA expects an RSE licensee with a strategic objective of 'increase scale' might explain the connection with member outcomes as follows: 'Increasing the scale of the fund by X per cent would lead to a reduction of members' fees by Y per cent.'

This discipline is likely to assist RSE licensees to demonstrate the sharper focus demanded by the duty to act in the best financial interests of beneficiaries.

2.4.3 Drivers of performance

APRA found that some RSE licensees, in their first BPR, failed to identify and assess the factors affecting business performance and member outcomes. While COVID-19 was cited as a factor affecting performance, in many instances, this was the only factor identified. The narrow focus in this analysis meant conclusions drawn in their BPRs could not be substantiated.

APRA expects RSE licensees, when assessing the drivers of performance, to consider both external (e.g. the investment market) and internal (e.g. complexity of the product offering) factors and explain how these factors drove the RSE licensee's outcomes. Understanding the root cause of the RSE licensee's performance supports well-informed future activities.

2.4.4 Complex business models

APRA found that, for more complex business models with multiple funds under trusteeship or a large number of products, RSE licensee analysis of the business performance across their entire business operations was limited. RSE licensees with such complexity tended to focus on each individual RSE, rather than taking a broader perspective.

APRA expects RSE licensees to:

- pursue initiatives across multiple RSEs in their business operations that are facing similar opportunities for improvement, such as an administration outsourcing tender.
- seek efficiency through simpler and cheaper operating models, for example, by reducing the number of products and funds, and streamlining outsourced arrangements.

2.4.5 Demonstration of financial soundness

APRA found that the majority of RSE licensees did not undertake stress testing of financial projections to demonstrate financial resilience of their business plans. In many cases, key assumptions were generally unsubstantiated and not aligned to historical trends, leading to questions about their credibility. Further, the level of detail in financial projections varied. Business plans which did not reflect expenditure linked to strategic initiatives placed doubt on the accuracy of projections.

APRA expects RSE licensees to:

- undertake stress testing under adverse internal and external scenarios to explore the range of projected outcomes to better understand the financial soundness of the business plan. For example, documenting downside scenarios such as decreased membership (for example, as a result of failing the performance test) and the impact of changes in key assumptions, such as investment earnings.
- implement a clear and well-documented approach for deciding assumptions. For example, APRA found that RSE licensees demonstrating better practice financial projections included detail about the cost and benefit of initiatives, the impact on projected financial reserves, and projected relevant financial measures such as net cashflow.

2.4.6 Cohort analysis

APRA found that many RSE licensees limited their cohort analysis to the letter of APRA's guidance in *Prudential Practice Guide SPG 516 Business Performance Review*. While APRA has accepted this approach by RSE licensees for their first attempt to implement SPS 515, APRA expects RSE licensees to now be focused on an approach tailored to their membership.

APRA expects RSE licensees to:

- Implement membership cohorts that demonstrates a deep understanding of their membership base. This understanding should go beyond age, product and investment options to include cohorts such as gender, employment sector, employment classification, super guarantee contribution/no super guarantee contribution, introduced by advisor/no advisor, or other attributes identified by (in-house or external) data analytic teams/tools.
- Extend the insights from a product basis to the impact of fees, investments, insurance and services on the fund's membership cohorts. For example, some RSE licensees that initially assessed their insurance product as providing an adequate level of insurance

cover while balancing the cost to members revised this assessment when the product was considered through the lens of the fund's membership cohorts.

Chapter 3 - RSE licensee expenditure thematic review

3.1 Introduction

From 1 July 2021, the SIS Act requires RSE licensees to evaluate whether expenditures are consistent with the sole purpose test and the best financial interests duty.

The implementation of SPS 515 forces RSE licensees to think more deeply about their strategic objectives and how they differentiate their offerings in the market.

Further, SPS 515 requires RSE licensees to ensure that decisions to incur significant fund expenditure support the achievement of strategic objectives and that those decisions are monitored against their expected outcomes. This means that there is a heightened importance that RSE licensees who consider spending more on marketing expenditures, ensure that those decisions are in the best financial interests of members.

The recently introduced duty to act in the best financial interests of beneficiaries demands higher standards on record keeping. The YFYS reforms additionally mean that, in civil proceedings, it will now be presumed that an RSE licensee did not perform its duties or exercise its powers in a manner consistent with the best financial interests duty, unless the RSE licensee adduces evidence that suggests a reasonable possibility that the RSE licensee was acting in the best financial interests of members.

3.2 Key observations

It is important to note that the expenditure examined as part of this review was subject to the best interests duty rather than the best financial interests duty. **APRA's view is that, given the YFYS reforms, some instances of expenditure examined did not have sufficient evidence to demonstrate that the expenditure would be in the best financial interests of members.** RSE licensees should reflect on whether existing practices meet the higher standards demanded by the new duty. This is explored further in section 3.3.5 below.

The review identified areas where industry practices need to be improved. Specifically, RSE licensees need to make a significant shift from broad reliance on qualitative judgements as a basis for decision making and instead apply robust processes in both the ex-ante (taking the decision) and ex-post (analysing the outcomes of the decision) phases. Further examples are outlined below together with APRA's expectations.

- Failure to rigorously measure and assess anticipated and achieved benefits to beneficiaries of expenditure on marketing campaigns and related activities, including:
  - a lack of evidence of clear metrics to assess the benefits of marketing expenditure to their members;

- limited evidence of ex-post review to demonstrate that the marketing expenditure has achieved its intended outcomes, again including the benefit to members; and
- an over-reliance on aggregate, or high level, considerations of marketing expenditure impact (e.g. changes in membership numbers) without demonstration of specific improved outcomes for members.

- Instances of RSE licensees being unable to demonstrate how additional benefits associated with sponsorships, that were provided to directors, executives and staff of the fund resulted in any improved outcomes for members.

3.3 Detailed findings

APRA's key findings are set out below. While not exhaustive, this section outlines APRA's expectations for strengthened RSE licensee practices.

3.3.1 Setting the marketing strategy and budget at an aggregate level

APRA found some RSE licensees were unable to articulate a clear and objective purpose for marketing expenditure at an aggregate level, as part of their annual strategic and business planning processes.

Example 1.1 Sponsorship

An RSE licensee entered into three different sponsorship arrangements over a number of years. The RSE licensee was unable to demonstrate ex ante or ex post the link between the expenditure and acquiring or retaining members or any other direct benefit to members.

Example 1.2 Business Plan

An RSE licensee made a significant marketing expenditure over a three-year period. There was no reference to marketing or advertising in the RSE licensee's Business Plan.

APRA expects:

- Where marketing is considered to be a necessary expenditure, the RSE licensee's Board would approve marketing budgets, business case and metrics for the overall marketing program as part of the annual business planning cycle. This approval would be informed by a comprehensive assessment of the outcomes of prior years' marketing expenditure, with monitoring and reviews undertaken at regular intervals.

- A clear and objective purpose for marketing expenditure at an aggregate and campaign level, consistent with the sole purpose test. The purpose should not only be in terms of broad observables, for example, increasing or maintaining membership or growing funds under management, but also in terms of how specifically the benefits of the marketing expenditure will be measured in terms of driving/delivering improved outcomes for members.

- A clear decision as to whether the amount of proposed expenditure is appropriate for the circumstances of the RSE in absolute and relative terms, for example, informed by the absolute dollar spend and the average cost and benefit per member.

3.3.2 Processes for measuring outcomes of marketing campaigns and activities

APRA found some RSE licensees were unable to demonstrate that robust processes existed to determine quantifiable expected outcomes from individual campaigns, including how the best interests of beneficiaries are promoted, prior to their commencement; or demonstrate robust assessment of outcomes achieved when renewal of campaigns is being considered.

Example 2.1 Sponsorship

An RSE licensee entered into a multi-year arrangement to sponsor a sporting team. No evidence was provided to indicate that a business case was considered by the Board at the commencement of the sponsorship arrangement.

Example 2.2 Renewals

APRA has identified a number of instances where RSE licensees approved the renewal of marketing campaigns and sponsorship arrangements without considering or documenting metrics demonstrating the effectiveness of individual campaigns in achieving marketing objectives; or providing demonstration of a link between expenditure decisions and improved outcomes for members. In many instances, no evidence was provided of regular/annual monitoring of the impact of the sponsorship arrangements to support the renewal or continuation of sponsorship arrangements.

APRA expects:

- Planned campaigns and activities are supported by business cases that clearly articulate the purpose and expected outcomes. Business cases should demonstrate how campaigns are consistent with, and supportive of, strategic initiatives in the business plan and the expected impact of these campaigns on changes in membership metrics and outcomes to members, for example an increase in members leading to a reduction in fees.

- Robust processes are in place to quantitatively monitor the impact of marketing campaigns and activities, for example, an RSE licensee should be asking whether the campaign is working, membership numbers are increasing as a result of the campaign and whether the benefit to members is being passed on through fee reductions and/or improvements in performance.

- Where actual performance against the stipulated metrics does not meet planned performance, a prudent RSE licensee would assess the discrepancy to inform decisions on those current and planned marketing activities that are best able to deliver improved financial outcomes to members, and whether existing marketing activities should cease.

- Decisions regarding the renewal or continuation of marketing campaigns are subject to the same rigour as initial decisions, allowing for changes in terms or market conditions that would affect expected outcomes to be considered.

3.3.3 Metrics to assess marketing campaign benefits

APRA found a lack of clear metrics to assess the benefits to members of specific marketing expenditure. RSE licensees typically attempted to demonstrate the aggregate impact of their overall marketing activities by considering changes in membership numbers and member activity (e.g. contribution levels). APRA observed limited evidence where RSE licensees could translate these changes into improved outcomes for members or demonstrate the value for money of the expenditure.

Example 3.1 Sponsorship renewal

An RSE licensee entered into an arrangement to sponsor a sporting team. Upon subsequent renewal of the sponsorship arrangement the RSE licensee's proposal to renew the arrangement did not provide any analysis of the impact of the sponsorship arrangement on fund metrics, nor any expectations regarding future impact of the arrangements. The key metrics included in the proposal included crowd attendance, club membership, and estimated size of TV audiences during games, while failing to demonstrate the link between these metrics, value to the fund and how this translated into improved outcomes for members.

Example 3.2 Analysis and metrics

An RSE licensee entered into an advertising campaign over a two-year period. The RSE licensee was unable to demonstrate that it had undertaken sufficient analysis, using metrics to assess the benefits of the expenditure, in order to support the advertising campaign.

APRA expects RSE licensees present business cases that clearly define:

- the metrics that will be used to measure the impact of the marketing activity or campaign;
- how these metrics measure improved financial outcomes for members; and
- a comprehensive risk assessment that addresses any potential adverse impacts of the marketing campaign or activity.

3.3.4 Additional benefits

As a general principle, a direct personal benefit to an RSE licensee director, executive or staff member obtained pursuant to entering into a marketing or sponsorship arrangement, with associated cost to the fund, would present an actual or perceived conflict.

APRA found instances where RSE licensees provided executives, directors and staff members with additional benefits that were connected to sponsorship arrangements, such as corporate tickets to sporting events, merchandise and other hospitality benefits to reward RSE licensee employees.

Example 4.1 Sponsorship

An RSE licensee entered into an arrangement to sponsor a sporting team. The sponsorship agreement included a range of additional benefits including corporate tickets to sporting events, and merchandise. The additional benefits were allocated to RSE licensee directors, executives and staff members. There was no evidence of any improved outcomes for members derived from these additional benefits.

Example 4.2 Sponsorship and hospitality

An RSE licensee entered into a sponsorship arrangement which included access being provided to staff members of the RSE licensee to hospitality tables at certain sporting events where it was envisaged employers whose staff were members of the fund also would be invited. The RSE licensee's rationale was that it provided an opportunity to build, strengthen and personalise relationships with employers. The fund was unable to demonstrate how the additional benefits awarded to directors and staff of the fund resulted in improved outcomes for members.

APRA expects:

- Any additional benefits obtained as part of an arrangement would be used only for purposes that are clearly consistent with improved outcomes for members and not for the benefit of directors, executives, staff or associates of the RSE licensee.

- Express assessments of how actual or perceived conflicts will be avoided or managed, including by declining to take up the additional benefits at all.

3.3.5 Expenditure under the best financial interests duty

The expenditures reviewed were undertaken when RSE licensees were subject to the best interests duty. It is APRA's view that in most cases there was a basis for making the decision to spend. However, too much of the expenditure on marketing by RSE licensees has been undertaken on the basis of qualitative judgement that the spend was in the best interests of beneficiaries. Overall, there has been a distinct lack of quantitative analysis, both ex-ante and ex-post, guiding these important decisions. In light of this, APRA is considering whether further action is required in relation to expenditure undertaken in some of the cases that were examined.

Since 1 July 2021, all expenditure decisions, regardless of the amount must demonstrably be made in the best financial interests of members, and accordingly, supported by strong analysis and evidence. Changes to the legislative framework also require significant improvement in transparency and record-keeping along with reversal of the onus of proof under the YFYS reforms.

In a number of cases subject to review, RSE licensees have since ceased those expenditures. Where, however, expenditure has continued beyond 1 July 2021, APRA has written to RSE licensees and is challenging them to demonstrate how they have considered the impact of the best financial interests duty on expenditure decisions, and their conclusions in relation to expenditure of the kinds identified in this report. Once these responses are reviewed, APRA will determine any action that may be necessitated by the requirements of the best financial interests duty.

APRA expects that all RSE licensees will review their approach to expenditures to reconsider which expenditures remain appropriate and cease those that are not.

More generally, all RSE licensees should review their practices to ensure they are compliant with the strengthened obligations under the YFYS reforms, and seek appropriate advice if necessary.

Chapter 4 - Unlisted asset valuation thematic review findings

4.1 Introduction

The heightened market volatility in early 2020 as a result of COVID-19 highlighted the importance of a prudent approach to valuing unlisted assets. Increased member switching, together with the Government's expansion of the early release of superannuation program, also led APRA to seek information on how member equity issues were being balanced by RSE licensees during the period.

To better understand practices in these areas, APRA undertook a thematic review to:

- enhance understanding of the range of practices across the industry;
- identify RSE licensees requiring heightened supervisory attention in relation to valuation governance; and
- provide the basis for enhanced requirements and guidance on unlisted asset valuation and member equity risk.

4.2 Key observations

The review identified areas where industry practices need to be improved. These are outlined below together with APRA's expectations. Encouragingly APRA found that most RSE licensees demonstrated a proactive approach to revaluing unlisted assets in response to the heightened market volatility in early 2020. Further, RSE licensees with valuation committees already in place typically had more robust valuation frameworks.

APRA also identified,:

- revaluation frameworks were typically inadequate, with no predefined revaluation triggers and weak or no processes for monitoring and adjusting revaluations;
- there was limited board engagement, an area of particular concern across a number of RSE licensees; and
- several RSE licensees had an over-reliance on external parties, including fund managers and asset consultants.

Further detail on these key conclusions is set out below.

4.3 Detailed findings

APRA's key findings are set out below. While not exhaustive, this section outlines APRA's expectations for strengthened RSE licensee practices.

4.3.1 Response to heightened market volatility

APRA found that most RSE licensees demonstrated a proactive approach to revaluing unlisted assets as a result of heightened market volatility experienced during the early stages of COVID-19. The majority of RSE licensees implemented their first revaluation in March 2020, and all RSE licensees which imposed revaluations had done so by the end of April 2020.

RSE licensees that adopted out-of-cycle valuations typically took one or more of the following actions:

- valuation discounts determined and applied by the RSE licensee;
- adoption of low-point estimates previously provided by independent valuers; or
- brought-forward fund manager or independent valuations.

APRA also observed better practice where RSE licensees increased:

- regular reporting to daily or weekly, from monthly or quarterly; and.
- the frequency of Investment Committee meetings.

Some RSE licensees introduced Valuation Committees in response to the market volatility, although some issues with potentially conflicted memberships were noted in these new committees.

4.3.2 Revaluation frameworks

APRA found that, while RSE licensees generally reacted promptly to the crisis, few had robust, pre-existing frameworks for implementing, monitoring and reverting to regular valuation approaches following out-of-cycle revaluation adjustments. Common issues observed in revaluation frameworks included:

- a lack of triggers for the consideration and imposition of valuation adjustments;
- the absence of formalised monitoring processes for valuation adjustments; and
- no framework for the alteration of valuation adjustments.

APRA also observed:

- inconsistent levels of RSE licensee consideration and action for different classes of unlisted assets;
- the introduction of potentially conflicted processes for the imposition and review or adjustment of revaluations; and
- board and management time dedicated to devising processes, rather than considering and challenging valuations.

In many instances it was not clear that there were adequate board-approved valuation policies to guide the actions taken by the RSE licensee. Internal policies were often vague, with unclear responsibilities, unspecified processes and undefined board expectations.

APRA expects RSE licensees to have robust board-approved valuation policies and procedures. The absence of robust policies and procedures for the imposition, monitoring and review/adjustment of revaluations creates the risk that decisions made by RSE licensees in a crisis are sub-optimal or are not made in a timely manner. This increases member equity risk.

4.3.3 Limited board engagement

APRA found that limited Board engagement often coincided with significant reliance on management discretion. This was problematic when combined with high level valuation policies that failed to clearly define Board expectations on valuation governance or clearly define delegations.

Common issues observed in relation to Board engagement included:

- a lack of demonstrated Board challenge or discussion of valuation decisions;
- broad delegations to management on valuation matters, often without limits; and
- delegations which include conflicted reported lines.

Consistent with having clear delegations and responsibilities, APRA expects RSE licensee Boards would:

- be well-informed and actively engage, particularly during heightened market volatility;
- be capable of challenging management and external parties, undertaking robust discussions of valuations;
- provide appropriate oversight and approval of out-of-cycle valuations via channels such as Audit Risk and Compliance Committees, Investment Committees or Valuation Committees; and
- clearly define delegations and responsibilities.

4.3.4 Over reliance on external parties

APRA found a number of RSE licensees were passive in their approach to revaluing unlisted assets, appearing to be overly reliant on external parties for the valuation of unlisted assets.

Frequently observed issues included:

- governance structures which were inadequate for the complexity of investments;
- RSE licensees failing to assess the appropriateness of valuations;
- reliance on fund managers' operational controls; and

- some RSE licensees failing to engage with fund managers promptly, potentially affecting member equity through delayed adoption of valuation adjustments.

Many RSE licensees routinely accepted valuations from their fund managers without any challenge on the appropriateness of these valuations. This was more apparent when reverting to normal valuation cycles, when many RSE licensees defaulted back to using manager valuations between June and September 2020 without conducting any assessment of their appropriateness. RSE licensees requiring a framework for review or adjustment at the time of the initial out-of-cycle valuation approval, with quantitative frameworks for reverting to normal valuation cycles in a consistent manner, is consistent with APRA's expectation for prudent practice.

Some RSE licensees obtained advice from their asset consultants on the re-valuation of their unlisted asset exposure through unitised trusts. While obtaining expert advice from external service provider is generally appropriate, RSE licensees should consider their ability to rely on this, and whether they will be able to receive timely and adequate advice when required.

APRA requires, consistent with SPS 530, an RSE licensee to:

- undertake robust initial and ongoing due diligence, particularly for unit trusts where the RSE licensee would not be able to influence the valuation methodology nor possess the requisite skills to apply their own valuation adjustments;
- proactively engage with fund managers and asset consultants;
- set expectations with fund managers on valuation frequency in periods of heightened market volatility; and
- set expectations on valuation frequency, methodology and hierarchy of information, against which fund managers can be assessed.

4.3.5 Valuation committees

APRA found that only six of the RSE licensees reviewed had dedicated valuation committees prior to the heightened market volatility of early 2020. Stronger overall governance was generally observed in these RSE licensees.

APRA also observed enhanced oversight capabilities contributing to better valuation practices.

Prudential Practice Guide SPG 531 Valuation makes clear that valuation decisions and committees should occur independently of investment decision-makers. There is a potential conflict where performance, bonus and/or remuneration of investment staff is dependent on the performance of a portfolio or components of a portfolio. There were several instances where valuation committees were headed by Chief Investment Officers and where the committee had the ability to determine or influence valuations. RSE licensees should mitigate potential conflicts in these situations, but this was not consistently observed.

Chapter 5 - Next steps

The findings from these three reviews are critical to enhancing RSE licensee practice across the important areas of business planning, expenditure management and investment governance.

For those RSE licensees that were included in the three reviews, APRA supervisors are directing their supervisory attention to how the RSE licensee has or continues to respond to their specific findings. Learnings and insights from the reviews will also inform broader supervisory and regulatory initiatives being undertaken by APRA.

This information paper presents an opportunity for all RSE licensees, at this critical flexion point in the superannuation industry, to turn a critical eye on their practices and identify those that require immediate improvement. APRA expects to see continued improvement in benefits for members, from a comprehensive and rigorous approach to the implementation of SPS 515, RSE licensee expenditure improvements and better unlisted asset valuation practices.