Review of SPS 530
Investment Governance

Submission

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About The Conexus Institute

The Conexus Institute is an independent, not-for-profit research institution focused on improving retirement outcomes for Australian consumers. Philanthropically funded, The Institute is supported by the insights of a high-quality advisory board, whereby each member's involvement is on a pro-bono basis. The Institute adopts a research-for-impact model and frequently collaborates with researchers from academia, associations, and industry. Research is generally made open source to create transparency and accountability. The Conexus Institute exists with no commercial relationships. Further information here.

About David Bell

Dr David Bell is Executive Director of The Conexus Institute. Bell's career has been dedicated to the investment and retirement sector. He has worked with both commercial and profit-for-member firms, and ran his own consulting firm. Bell worked with APRA in the development of the APRA Heatmap. Academically, Bell taught for 12 years at Macquarie University and in 2020 completed his PhD at UNSW which focused on retirement investment problems. Full bio here.

***** The author is willing and able to participate in further consultation. *****

1. Summary and recommendations

APRA's Investment Governance framework is foundational to the way super funds structure and operate their investment activities. We believe that there is an opportunity to develop a framework which is more principles-based. This would improve its consistency with other areas of policy and regulation, while ensuring that the framework remains contemporary (we believe that prescriptive directions can age faster).

We detail a range of suggestions relating to the "key requirements" section, the most notable ones being:

1. Introduce a new requirement that trustees review their investment operating model.
2. Replace the stress testing requirement with the requirement for a comprehensive investment risk management framework.
3. Expand "liquidity management plan" to "liquidity management framework", with additional requirements for trustees to review the broad range of issues associated with investing into illiquid assets.
4. Introduce a new requirement that trustees review the member inequities that may exist in their investment management and product management activities.

2. Further detail

2.1. Principles-based rather than prescriptive

The draft investment governance framework remains quite prescriptive. This contrasts with other policy areas, such as retirement, where policy and regulation are being positioned as principles-based.

We believe the principles-based approach, accompanied by a strong engagement and feedback process, has multiple benefits. The investment governance framework would require less maintenance, while facilitating contemporary practices (as some prescriptive directions might become out-dated). Implemented well, the framework provides a constant feedback loop which, over time, can lift baseline standards and provide a basis for providing capability feedback to funds, especially those with relatively weak investment governance practices. This is framed in Figure 1.

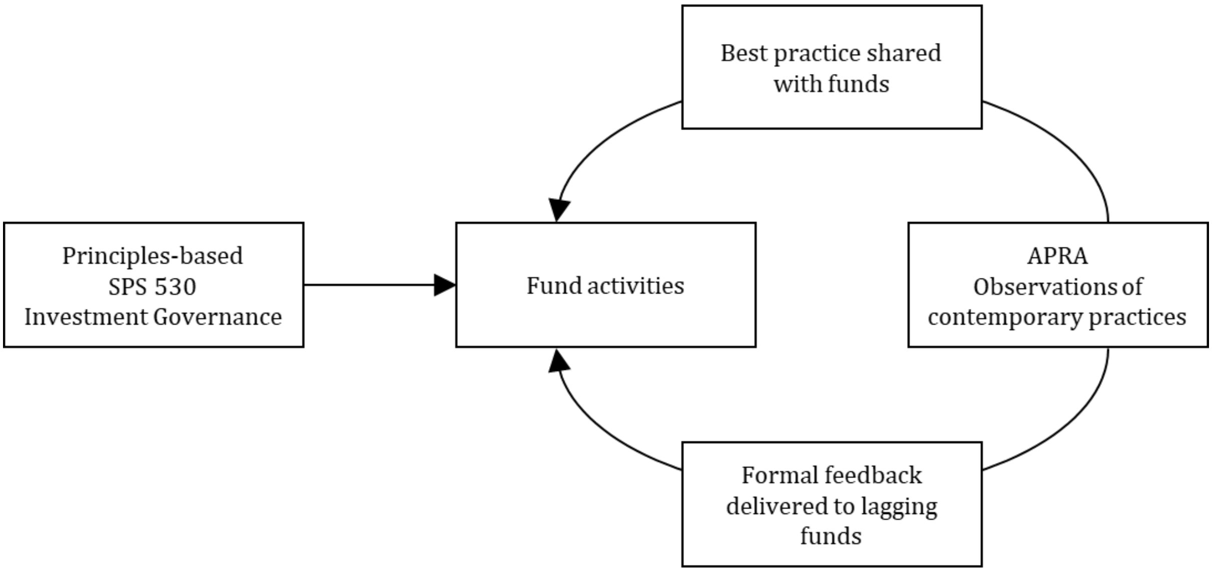

Figure 1: A well-functioning principles-based investment governance framework in concept.

2.2. Detailed requirements

The remainder of this document focuses on the key requirements listed in the draft Prudential Standard. They are listed as:

"The key requirements of this Prudential Standard are that an RSE licensee must:

- *formulate specific and measurable investment objectives for each investment option, including return and risk objectives;*
- *develop and implement an effective due diligence process for the selection of investments;*
- *determine appropriate measures to monitor the performance of investments on an ongoing basis;*
- *review the investment objectives and investment strategies on a periodic basis;*
- *develop and maintain a comprehensive investment stress testing program;*
- *formulate a liquidity management plan; and*
- *develop and implement an effective valuation governance framework."*

We recommend the following as an alternative list:

- Review the investment operating model to assess whether it is appropriate given investment market structure and competitive relative to the investment capabilities of other super funds.
- Formulate specific and measurable investment objectives for each investment option, including return and risk objectives.
- Develop, maintain and review an effective due diligence process for the implementation of portfolios.
- Determine, maintain and review appropriate processes to monitor and assess the performance of investment portfolios.
- Develop, implement and review a comprehensive investment risk management framework.
- Develop, implement and review a liquidity management framework.
- Develop, implement and review an effective valuation governance framework.

- Develop, implement and review an effective framework for assessing member inequities.

We now explore each recommended change in detail.

2.2.1. Investment operating model

The investment operating model is foundational to the investment outcomes that a super fund delivers for its members. Dimensions of an investment operating model include (but are not limited to):

- Investment model: such as a traditional SAA approach or a "total portfolio approach".
- Asset allocation approach: passive or varying degrees of active asset allocation.
- Active management: passive or varying degrees of active.
- Investment universe: from public through to private assets.
- Implementation: degrees of internal and external management.
- Resourcing: size of team.
- Research model: internal management through to extensive use of external consultants.

We suggest wording along the following lines:

"Review the investment operating model to assess whether it is appropriate given investment market structure and competitive relative to the investment capabilities of other super funds"

The above statement reflects our belief that the investment operating model needs to be through at least two lenses. The first is through the lens of absolute member outcomes, whereby the line of self-assessment may be whether the investment operating model is appropriate for the market environment. The second is through a relative lens, where the consideration needs to be whether the investment operating model has reasonable prospects of competing effectively against the investment operating models of other super funds.

An interesting reflection here is on fund size. It appears logic that investment operating models need to be appropriate relative to the size of the fund. However the relative (to peers) assessment would obligate trustees to consider the prospects of their fund relative to those of alternative offerings from funds of varying sizes.

2.2.2. Investment objectives

No change.

2.2.3. Due diligence process

We suggest that reference to due diligence should be refined to the following:

"Develop, maintain and review an effective due diligence process for the implementation of portfolios"

We view this as more appropriate given the broad range of investment operating models which exist. Here we focus on "implementation of portfolios" rather than "selection of investments". This broader framing better addresses important areas such as internal processes (asset allocation, security selection and manager selection), internal teams, and external consultancy arrangements.

2.2.4. Reviewing the performance of investment portfolios

We suggest a small change in wording to:

"Determine, maintain and review appropriate processes to monitor and assess the performance of investment portfolios"

We observe that performance assessment techniques need to be reviewed by trustees. Performance measurement is an active discipline and new assessment techniques emerge through time. Further, as funds review and evolve their investment operating model, the way performance is monitored and assessed may need to be reviewed.

We also suggest that extending "monitor" to "monitor and assess", as it creates a higher expectation for trustees, ensuring that performance assessment is more than a compliance exercise.

2.2.5. Comprehensive investment risk management framework

The draft framework positions investment stress testing as the primary investment risk management process:

"… an RSE licensee must:

develop and maintain a comprehensive investment stress testing program"

However there are many risk management practices which a best-practice RSE licensee should consider. In addition to stress testing, there are many other risk management techniques which provide valuable insights. This list (accompanied by brief definitions), is non-exhaustive:

- Factor exposures – determination of, and exposure to, different portfolio risk factors.
- Sensitivity analysis – sensitivity to different risk factors.
- Scenario analysis – which considers the impact of scenarios (which affect multiple variables) on portfolio performance (technically stress testing considers only one variable).
- Pre-mortems – prospective hindsight analysis for failure to deliver targeted investment outcomes.
- aR analysis including VaR (Value-at-Risk).
- Intertemporal considerations (different timeframes may incorporate market structure considerations and portfolio management responses such as re-balancing).
- Portfolio event role plays (where a hypothetical event is "walked through" to assess response and outcomes).
- Measures which are specific to ESG and sustainability.

Each piece of risk management provides marginal, but valuable, insight. Indeed a mosaic approach to risk management (which considers the insights drawn from multiple risk management techniques) is considered to be good practice.

We believe broader wording may be more appropriate:

"Develop, implement and review a comprehensive investment risk management framework"

2.2.6. Liquidity management framework

In conjunction with CFA Societies Australia, we undertook a project to explore the various governance issues associated with superannuation portfolios investing into illiquid assets. Background to the project is here and all the project resources can be accessed here.

We identify that beyond the primary risk issue of insolvency resides some important secondary issues:

1. The member inequities that may arise from transacting at 'stale' prices.
2. The loss of portfolio quality in a market crisis (e.g. illiquid assets may become a larger component of the portfolio).
3. The cost of restoring portfolio quality (borne by remaining members of the fund).

These considerations are nuanced but we believe they are important and warrant explicit consideration by trustees. As such we advocate for a "liquidity management framework" which we believe extends upon the concept of a liquidity management plan.

2.2.7. Valuation governance framework

No change bar the suggestion that it should be stated clearly that a valuation governance framework should be subject to ongoing review.

2.2.8. Assessing member inequities

Trustees undertake many activities which may generate member inequities. Examples include cross-subsidisation activities and investment strategy / product design issues (e.g. the liquidity issues detailed in 2.2.6).

Anecdotally we believe that some funds don't have formal frameworks for assessing member inequities. We consider this an important area for trustees to be accountable for. Over time it should integrate with the outcome measures in SPS 515 Strategic Planning and Member Outcomes.

As such we recommend an additional key requirement:

"Develop, implement and review an effective framework for assessing member inequities"

We acknowledge that addressing this area would require a combination of subjective and objective techniques and may take time for some funds to formalise.

Further, we acknowledge that there are likely member inequities linked to non-investment management areas (for instance administration fees and insurance). Perhaps a similar requirement could be made of trustees in the relevant prudential standard.