



# PRUDENTIAL PRACTICE GUIDE

## Draft SPG 530 Investment Governance

Integrated version

November 2022

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# About this guide

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Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

*Prudential Standard SPS 530 Investment Governance* (SPS 530) sets out APRA's requirements in relation to investment governance for an RSE licensee's business operations.

This PPG, *Prudential Practice Guide SPG 530 Investment Governance* (SPG 530), provides guidance to RSE licensees in the formulation, implementation, maintenance and oversight of an investment strategy. It sets out prudent practices in relation to investment risk management arrangements to assist an RSE licensee in ensuring it:

- clearly articulates what its investments are designed to achieve and how this supports the delivery of member outcomes;
- has the capability and capacity to select and manage investments and associated risks; and
- has a clear, objective, operationally independent and robust performance assessment framework.

Subject to the requirements of SPS 530, an RSE licensee has the flexibility to structure its business operations in the way most suited to achieving its business objectives. Not all practices outlined in this PPG will be relevant for every RSE licensee and some aspects may vary depending upon the size, business mix and complexity of the RSE licensee's business operations.

This integrated version of SPG 530 maps APRA's guidance to the relevant paragraphs in SPS 530. Paragraphs from SPS 530, which are enforceable requirements, have been set out in blue boxes like this; the accompanying guidance follows outside the blue boxes.

# Glossary

<b>APRA</b>	Australian Prudential Regulation Authority
<b>Climate risk</b>	Financial risks arising from climate change, including physical (both acute risks associated with extreme weather events and chronic risks associated with gradual shifts in climate), transition and liability risks.
<b>CPG 229</b>	<i>Prudential Practice Guide CPG 229 Climate Change Financial Risks</i>
<b>ESG factors</b>	Either qualitative or quantitative Environmental, Social and Governance factors that may affect the risk-return profile of investments through their impact on assets, companies, industries, or markets generally.
<b>Investment option</b>	An investment that an RSE licensee makes available to members to select. It may comprise a mix of investments selected by an RSE licensee, investment in an externally managed investment option, investment in a lifecycle strategy, or a direct investment in one asset, such as an individual listed security, term-deposit or bond.
<b>Lifecycle strategy</b>	A strategy that varies the asset allocation for members according to the member's age and/or other prescribed factors in r. 9.47, <i>Superannuation Industry (Supervision) Regulations 1994</i> . It is represented by a 'glidepath' which is the transition of the asset allocation targets over the course of the lifecycle investment strategy.
<b>PPG</b>	Prudential practice guide
<b>Risk budgeting</b>	Risk budgeting considers how different risks drive the returns of different asset classes and derives the optimal asset allocation based on the expected return per unit of risk of each of those asset classes.
<b>RSE</b>	Registrable superannuation entity as defined in s. 10(1) of the <i>Superannuation Industry (Supervision) Act 1993</i> .
<b>RSE licensee</b>	As defined in s.10(1) of the <i>Superannuation Industry (Supervision) Act 1993</i> .
<b>SIS Act</b>	<i>Superannuation Industry (Supervision) Act 1993</i>
<b>SPS 530</b>	<i>Prudential Standard SPS 530 Investment Governance</i>

# The role of the board

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## Board responsibility

7. An RSE licensee is ultimately responsible for the sound and prudent management of the investments of each RSE within the RSE licensee's business operations.
  8. The Board of an RSE licensee (the Board) must, for the RSE licensee's business operations, at a minimum:
    - a) approve investment objectives for each investment option offered in each RSE;
    - b) approve an investment strategy, in respect of each RSE, that is consistent with the RSE licensee's duties to beneficiaries, including those in section 52(6) and (13) (if applicable) of the SIS Act and the requirements in this Prudential Standard:
      - i. for the whole of that RSE; and
      - ii. in respect of each investment option offered in that RSE;
    - c) monitor and assess regularly whether the investment objectives are being met; and
    - d) take appropriate and timely action regarding information contained in reports to the Board on investment matters.
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1. An RSE licensee's Board (the Board) is responsible for ensuring its governance of investments supports effective investment decisions that deliver quality retirement outcomes for members that are consistent with the strategic direction of each RSE within the RSE licensee's business operations.
  2. Consistent with *Prudential Standard SPS 510 Governance*, an effective Board balances the need to provide effective review and challenge, with appropriate delegation of authority to allow the Board to maintain appropriate oversight of key investment decisions.
  3. The Board would be able to demonstrate that it has:
    - a) an appropriate mix of investment skills and expertise;
    - b) clearly documented delegations that consider the roles and decision-making responsibilities within the RSE licensee, ensuring segregation of duties between those implementing investment decisions and those reviewing performance;
    - c) access to external experts to support the Board; and
    - d) appropriate oversight and reporting mechanisms.

4. When considering the appropriate level of Board oversight of investments, APRA expects the Board would be able to demonstrate how it effectively governs the volume and complexity of investment decisions and ensures an appropriate non-executive view of investment decisions.
5. APRA expects an RSE licensee would consider establishing a Board committee, such as a Board Investment Committee, to support the Board. It is important that the governance arrangements for this Board committee are well considered and documented in a charter or terms of reference, to ensure appropriate membership with expertise, diversity and the necessary resources to support its effective function.

## RSE licensee that are part of a group

9. Where an RSE licensee is part of a corporate group, and the RSE licensee utilises group policies or functions, the Board must approve the use of group policies and functions and must ensure that these policies and functions give appropriate regard to the RSE licensee's business operations.
6. The use of group policies may enable an RSE licensee to operate in a manner that is consistent with the group. When approving the use of group policies and functions, a Board would demonstrate why it considers the policies to be appropriate to deliver outcomes to members, including how conflicts between RSE licensee policies and group policies are to be managed, in accordance with the requirements of *Prudential Standard SPS 521 Conflicts of Interest*, as well as how the Board will be engaged in the process of reviewing these policies over time.

# Investment governance framework

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## Establishing the framework

10. An RSE licensee must at all times have an investment governance framework to manage investments to meet the RSE licensee's obligations to beneficiaries.
  11. An investment governance framework is the totality of systems, structures, policies, processes and people to address the RSE licensee's responsibilities with regard to investments of each RSE within the RSE licensee's business operations. An RSE licensee's responsibilities include generating returns to meet investment objectives while managing and monitoring all identified sources of investment risk.
  12. The Board is ultimately responsible for the establishment, implementation, oversight and maintenance of an RSE licensee's investment governance framework.
7. APRA expects the Board would demonstrate how it understands, in a practical way, its role in the investment governance framework and how it ensures that appropriate approvals to changes in the framework are managed.
  8. APRA expects the Board would provide clear strategic investment direction, including the setting of investment objectives and investment strategies. The Board would also demonstrate their involvement in the implementation of the investment governance framework, including how it goes about making key investment decisions and reviewing and challenging key investment reports to support oversight.

## Member equity considerations

9. APRA expects an RSE licensee would ensure that the investment governance framework appropriately considers member equity risk, including, but not limited to:
  - i) enforcing a blackout period for members transacting in the option around expected asset revaluation periods, relative to underlying asset liquidity;
  - ii) establishing processes for the monitoring and quantification of equity impacts arising from events such as interim valuation of assets, liquidity provider arrangements and transacting members; and
  - iii) monitoring arrangements for single sector investment options where the revaluation and liquidity impacts are amplified due to the greater concentration of exposures.

## Investment operating model

10. APRA expects an RSE licensee would determine the most appropriate investment operating model to support the implementation of its investment governance framework, with this operating model reviewed as needed to reflect changes in the RSE licensee's business operations. APRA expects this decision would be clearly documented,



demonstrating how the investment operating model is appropriate with reference to the size of the RSE licensee's operations and complexity of its investments.

11. When deciding to transition some, or all, of its investment functions internally, an RSE licensee would determine:
  - a) the governance model, including appropriate delegations, for overseeing the internal investment management function;
  - b) the monitoring and management of performance, particularly where under-performance is identified;
  - c) how it will attract, retain and remunerate appropriately skilled investment staff and manage potential cultural changes;
  - d) how it will manage exposure to potential internal errors; and
  - e) the cost-benefit analysis of moving to either a fully internalised or hybrid model.
12. Where an RSE licensee operates or is considering operating some, or all, of its investment functions internally, it would be able to demonstrate that it has systems, resources and processes that are commensurate with expertise and scope of service provided by external service providers.

## The investment governance framework

13. An RSE licensee's investment governance framework must, at a minimum, include:
  - a) investment objectives for each investment option offered by the RSE licensee;
  - b) a methodology for determining investment reporting measures;
  - c) the investment strategy for the whole of each RSE and for each investment option as required by section 52(6) of the SIS Act;
  - d) all Board policies relating to investment activities;
  - e) role statements that include the details of each role's responsibilities and reporting structures for all roles related to investment activities;
  - f) structures, policies and processes relating to investment activities, including for investment performance and risk measurement, assessment, stress-testing, valuations and reporting to the Board and senior management; and
  - g) a review process to ensure that the investment governance framework remains effective.
14. An RSE licensee's investment governance framework must be appropriate to the size, business mix and complexity of the RSE licensee's business operations.
15. An RSE licensee must have procedures to ensure that all persons in roles related to investment activities of the RSE licensee are made aware of, and have processes and controls for monitoring compliance with, the RSE licensee's investment governance framework.

### Roles and responsibilities

13. It is important that an RSE licensee clearly articulates the roles and responsibilities of senior management and/or external service providers across the range of investment functions, with these regularly reviewed to ensure they remain appropriate and the personnel conducting these functions have both capacity and capability to exercise their responsibilities.
14. An RSE licensee would ensure that all investment related policies and procedures clearly describe roles and responsibilities and delegated authorities. APRA expects these policies and procedures would be subject to regular review, at a minimum, as roles and responsibilities are reviewed or significantly amended or where there are significant resource changes.
15. An RSE licensee would be able to demonstrate clear and distinct roles and responsibilities for the range of investment functions that are performed, including, but not limited to:

- a) articulating roles and responsibilities and how these might vary under normal and stressed operating conditions;
  - b) clearly identifying decision makers consistent with the RSE licensee's delegations framework;
  - c) ensuring roles performing review functions are undertaken by persons independent of those performing the functions; and
  - d) ensuring the roles and responsibilities are updated over time to reflect material changes in investment strategy, investments, organisational structure or the external environment.
16. An RSE licensee would regularly assess the level of skills and experience of available personnel with respect to particular investments/asset classes and investment risks to identify and manage any gaps in capability.

### **Structures, policies and processes**

17. An RSE licensee would be able to demonstrate that the structure, policies, and processes are appropriate for its investment operating model and support adequate separation of duties and reporting lines.
18. APRA expects:
- a) that oversight functions relating to performance monitoring, valuation, and unit pricing would be independent from those that make or can influence investment decisions and outcomes; and
  - b) investment risk objectives would be monitored and managed objectively, separating persons responsible for making and/or implementing investment decisions and those responsible for investment risk management arrangements. This includes risk measures, limits and tolerances, and reporting used to monitor investment department activities.
19. An RSE licensee would ensure that policies and process are regularly reviewed and updated to reflect changes to operations and practices as they occur.

## **Review of the investment governance framework**

16. An RSE licensee must ensure that the appropriateness, effectiveness and adequacy of its investment governance framework are subject to a comprehensive review by operationally independent, appropriately trained and competent persons at least every three years.
17. The scope of the review of an RSE licensee's investment governance framework must have regard to the size, business mix and complexity of the RSE licensee's business operations, the extent of any change to those operations and any changes to the external environment in which the RSE licensee operates.

20. In addition to the required triennial comprehensive review of the framework, APRA expects an RSE licensee would review key components of the framework more regularly to reflect changes in the RSE licensee's business operations and emerging best practice, and to ensure the framework remains current and effective.
21. An RSE licensee would ensure that the triennial comprehensive review of the investment governance framework encompasses all components of the framework, including, but not limited to:
- a) oversight over the framework;
  - b) the appropriateness of delegations and accountabilities;
  - c) the necessary skills and experience of personnel;
  - d) the effectiveness of process and systems;
  - e) the effectiveness of investment and liquidity risk management arrangements;
  - f) the effectiveness of the framework in implementing the investment risk appetite and identifying new risks; and
  - g) all relevant policies and procedures.
22. An RSE licensee would ensure that all findings of the triennial comprehensive review are addressed in a timely manner, with appropriate persons accountable for their delivery and priority given to any key deficiencies identified.

# Formulating the investment strategy

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## Investment objectives

18. An RSE licensee must, when formulating the investment strategy for each investment option, set investment objectives that are:
  - a) aligned with the size, business mix and complexity of the RSE from which the investment option is offered; and
  - b) specific and measurable and, at a minimum, include:
    - (i) a return objective; and
    - (ii) a risk objective.
23. Investment objectives provide both a measurable target for RSE licensees to consider performance, and valuable information to assist members to select the investment options appropriate to their needs. It is, therefore, important that investment objectives are clearly and consistently explained, with reference to a range of quantifiable metrics over clear time horizons.
24. APRA expects an RSE licensee would demonstrate how the investment outcomes sought for each investment option support the outcomes sought for different member cohorts.
25. As investment risk can be particularly challenging for members to interpret and understand, an RSE licensee would consider how to articulate investment risk objectives to enhance member understanding of investment risk. This may include how risk appetite tools and qualitative statements support traditional quantitative metrics, for example, *no more than x negative investment returns in a period of y years*.
26. APRA expects an RSE licensee that applies screens or filters to potential investments would clearly document how such screens or filters accord with its investment philosophy and clearly communicate the potential effect of these screens to members.

## Formulating the strategy

19. When formulating each investment strategy for the whole of the RSE, and for each investment option, an RSE licensee must document how it has regard to each of the factors in section 52(6) of the SIS Act.
27. To support the formulation of the investment strategy, APRA expects an RSE licensee would consider clearly articulating an investment philosophy, including the extent to which Environmental, Social and Governance (ESG) considerations inform the philosophy.

This can help to provide a clear statement to beneficiaries and other key stakeholders, providing longer term guiding principles for investment decision-makers.

### **Lifecycle investment strategy**

28. A lifecycle investment strategy is typically characterised by a compilation of separate 'lifestages'. An RSE licensee would ensure that development, implementation and assessment of any lifecycle strategies are considered at the overall glidepath and individual stage level.
29. APRA expects that an RSE licensee would formally document its assumptions and considerations in determining the glidepath and the respective stages within the lifecycle strategy.
30. When determining the appropriate glidepath design and stages of a lifecycle strategy, an RSE licensee would consider matters such as:
  - a) its membership demographic profile;
  - b) factors that will determine the strategic asset allocation for a member to achieve retirement income goals;
  - c) the optimal number of increments;
  - d) the relevant investment time horizon for the entirety of the lifecycle strategy;
  - e) the glidepath structure to be adopted;
  - f) the availability of post-retirement products offered by the RSE licensee; and
  - g) the structure of the drawdown phase.
31. An RSE licensee would determine the investment risk appetite and objectives appropriate at each stage in the lifecycle investment strategy. The investment objectives would be consistent with the overarching lifecycle investment objective.
32. APRA expects an RSE licensee would determine the asset allocation target and ranges for each lifestage. When doing so, an RSE licensee may consider the trade-off between risk appetite and the investment horizon, which drives the proportion of growth assets in the final years before retirement. APRA considers the timing and market volatility just before and after a member's retirement to be particularly critical. Other considerations include asset class selection, rebalancing processes and the liquidity of the investment strategy at each lifestage.
33. When formulating a lifecycle investment strategy and glidepath, an RSE licensee would also consider the risks associated with implementation.

### **Derivatives**

34. An RSE licensee would establish a formal policy to govern the permitted range and use of derivatives, demonstrating how the use of derivatives is consistent with investment

objectives and establishing mechanisms to capture, monitor and manage potential risks associated with the use of derivatives.

35. An RSE licensee would have sufficient mechanisms to capture, monitor and manage the potential risks associated with the use of derivatives that are commensurate with the nature and complexity of derivative exposures within the investment strategy. These may include liquidity risk, basis risk, rollover risk and counterparty risk.
36. APRA expects that an RSE licensee would have formal, documented limits to ensure that risks arising from derivative exposures are managed within its established risk tolerances.
37. APRA expects that an RSE licensee would receive regular and timely reporting on its derivative exposures, together with details regarding any mandate breaches when appropriate.
38. An RSE licensee's due diligence would also review the internal control structure of the external investment manager to ensure that all derivative risk exposures are being appropriately monitored, mitigated and managed.

### **Currency exposures**

39. An RSE licensee would demonstrate how it manages potential risks arising from foreign currency exposures, including setting target currency exposures or hedge ratios, the approach to rebalancing and the monitoring and reporting on foreign currency exposures.
40. An RSE licensee would have mechanisms that adequately address the potential risks arising from foreign currency exposures within its investment strategy.
41. Policy documentation would outline an RSE licensee's approach to the management of currency exposure, including a framework for setting target currency exposures or hedge ratios, the approach to rebalancing and the roles and responsibilities.
42. APRA expects that an RSE licensee would establish regular reporting on the management of foreign currency exposures. Such reporting would typically include the current foreign currency exposures within the investment option, the contribution to investment returns, hedge effectiveness and counterparty exposures.
43. APRA expects that an RSE licensee would also regularly monitor the liquidity impact of maintaining a hedging strategy for each investment option. It would be prudent for an RSE licensee to assess the impact that any sudden or significant movement in exchange rates may have on the liquidity position of each investment option.

## Diversification

20. An RSE licensee must, when determining an appropriate level of diversification for each investment strategy:
- a) identify the risk factors, and sources of return with which the risk factors are associated;
  - b) where the strategy includes multiple assets and/or asset classes, identify how sources of returns are expected to interact, the variability in these interactions and the impact of these interactions on the overall diversification of the strategy in different market conditions;
  - c) determine the target exposure to the risk factors in paragraph 20(a); and
  - d) determine the asset classes and/or individual assets that it will invest in to achieve the desired risk exposure and whether making, holding and realising investments in those asset classes and/or individual assets can be implemented in a manner consistent with the interests of, and the RSE licensee's duties to, beneficiaries.

44. APRA expects an RSE licensee would demonstrate how each investment option (including single asset class options) achieves appropriate diversification to support long-term investment goals while minimising risk.

### Investment risk

45. It is important that an RSE licensee consider how various types of investment risk (for example, market risk, liquidity risk, climate risk, concentration risk) can manifest through their chosen investment strategy, how such risks can adversely affect investment outcomes for members and the extent to which the risk can be managed. An RSE licensee would undertake a formal investment risk assessment to identify and establish:

- a) investment risk factors and their potential impact on investment returns;
- b) investment risk mitigation strategies; and
- c) methods for monitoring and reporting on investment risk factors.

46. An RSE licensee would demonstrate how the investment risk assessment has informed the investment strategy and is consistent with appetite and tolerances for investment risk exposures. APRA expects that the key findings would be subject to dedicated discussion with the Board and Board committee, where relevant.

### ESG risk factors

47. APRA expects an RSE licensee would demonstrate an understanding of the risk and opportunities present in a range of ESG factors, and the extent to which they may have a material impact on the financial risk-return profile of the RSE licensee's investment portfolio, including an assessment of climate risk exposures.



48. An RSE licensee would demonstrate how ESG risk considerations are integrated into investment analysis, decision making and oversight, ensuring that the appropriate resources are available to identify and respond to material ESG factors. Where an RSE licensee determines that ESG risks are financially material, it would demonstrate how this is reflected in the investment strategy and document how the risks will be managed.
49. APRA expects an RSE licensee would articulate the particular ESG risk considerations that affect the portfolio and how these are to be reflected in terms of return and risk objectives.

## Asset allocation

21. An RSE licensee must, at a minimum, determine for each investment strategy for an investment option that includes multiple assets and/or asset classes:
- a) asset allocation targets and ranges that are appropriate to the investment objectives of the investment option;
  - b) the basis on which asset allocation targets and ranges would be changed; and
  - c) a policy to monitor and maintain the asset allocation within the determined ranges within a reasonable timeframe.
50. APRA expects an RSE licensee would be able to demonstrate:
- a) how the asset classes are expected to optimise returns for members, provide appropriate diversification and align with investment risk objectives; and
  - b) the range of permissible investments for the option, including any investment restrictions and how they reflect the RSE licensee's investment philosophy.
51. An RSE licensee's asset allocation targets and ranges would be:
- a) informed by the investment philosophy
  - b) appropriate to achieving investment objectives; and
  - c) supported by a clear and documented methodology that is underpinned by appropriate assumptions that are regularly reviewed. This would involve the RSE licensee considering how the methodology avoids overreliance on historical data and trends, achieves variation in asset class characteristics over time and responds to the challenges of modelling unlisted or illiquid assets.
52. Where an RSE licensee adopts a dynamic asset allocation, APRA expects it would be managed in accordance with a specific and formal policy that covers permitted ranges, internal reporting (including to the Board and Board committee, where relevant) and review and approval process for making changes to the asset allocation.

53. Where an RSE licensee employs tactical asset allocation, APRA expects an RSE licensee would be able to demonstrate the differences between dynamic and short-term tactical asset allocation decisions where both are used.

### **Modelling the asset allocation**

54. Where an RSE licensee uses modelling to determine its asset allocation, it would demonstrate it has sufficient expertise in evaluating any model-driven recommendations to enable assessment of the need for further analysis prior to investment decisions being made. It is important that an RSE licensee understands the strengths and weaknesses of any modelling approach and the underlying methodology employed.

55. APRA expects an RSE licensee would have a formal policy to determine and review the methodology and assumptions underlying such models, which considers the potential variation in asset class characteristics over time, including expected returns, risk exposures and interactions between asset classes. This approach would also consider the risks of over-reliance on historical data when determining model assumptions. An RSE licensee would particularly consider the modelling of unlisted or illiquid investments.

### **Risk budgeting**

56. An RSE licensee may consider risk budgeting to better understand and determine:

- a) the nature and quantum of risks underlying the proposed asset class;
- b) the appropriate amount of risk to be taken;
- c) how the risk would be allocated in the investment strategy (e.g. asset class, sub-asset class or sector); and
- d) the returns that can be expected for taking a certain amount of risk.

57. An RSE licensee using a risk budgeting approach would regularly review the impact of market movements on its risk allocation and the subsequent implications for the asset allocation of an investment option.

# Giving effect to the investment strategy

## Selection processes

23. An RSE licensee must have processes and criteria for selecting each investment to give effect to the investment strategy (investment selection process) to ensure that effective due diligence that is commensurate with the nature and characteristics of the investment is undertaken prior to the selection of an investment for an investment option.
24. An RSE licensee's investment selection process must enable the RSE licensee to ensure:
  - a) it has sufficient understanding and knowledge of the investment selected, including an assessment of any factors that could have a material impact on achieving the investment objectives of the investment option;
  - b) it has sufficient understanding of how the investment is expected to perform under the range of stress scenarios determined under paragraph 31; and
  - c) the investment is appropriate for the investment option.

## Due diligence

58. Effective due diligence is critical, in both the context of direct investments and the selection of investment managers, in selecting investments to deliver outcomes to members.
59. APRA expects an RSE licensee would have sufficient resources to undertake due diligence commensurate with size, nature, and complexity of the investments. For example, direct investment in an asset necessitates an understanding of the complexity and risk exposures of the asset, where offering an externally managed investment option involves understanding the asset allocation and underlying investments of that option.
60. APRA expects an RSE licensee would undertake appropriate analysis, including seeking evidence of the potential expected returns to assess ESG investment opportunities, demonstrating how the opportunity aligns with the overall investment strategy and satisfies the investment objectives.
61. APRA expects an RSE licence would be able to demonstrate how its due diligence process:
  - a) for **investments**:
    - i) assesses projected performance and the impact of fees (including performance-based fees), risk factors, liquidity, valuation methodology, transaction costs and the market conditions of the industry in which the investment operates;

- ii) incorporates the minimum standards which an RSE licensee expects an investee entity to adhere to, including ESG considerations; and
  - iii) **for unlisted assets:** covers ownership structure including information regarding Board membership and senior personnel, the business plan of the organisation, financial analysis of any private market for the investment, any future commitments required and any restrictions that limit the ability to exit the investment; and
- b) **for investment managers:** assesses investment manager approach, management of market and investment risk factors (including ESG), research approach, performance record, investment risk approach and reporting, quality and timeliness of valuations, stress testing and liquidity arrangements. Operational due diligence of the investment manager would assess organisational structure, governance, execution processes, compliance risk and monitoring, valuation policies, IT security, business continuity management, service provider oversight, and derivatives exposure management. An RSE licensee would also consider the additional risks introduced by derivative exposure and the extent to which this is consistent with the RSE licensee's investment strategy and risk appetite. Operational due diligence results would form an integral part of the manager selection process.
62. Where an RSE licensee manages assets internally, the RSE licensee would ensure due diligence is conducted in accordance with a specifically documented process to ensure that appropriate systems, data, processes and personnel are in place to manage investments. This would be conducted by persons independent to those managing the investments. APRA expects either the Board or Board committee, where relevant, would approve internally managed investment strategies.
63. Specific agency risks arise where an RSE licensee manages assets internally. APRA expects an RSE licensee would have a performance assessment process which takes into consideration these risks. Performance attribution, assessment and reporting would be conducted by a business unit or division with a reporting line to an executive other than the Chief Investment Officer (or equivalent role) and include a process for addressing underperformance.
64. An RSE licensee would have the appropriate skills and resources available to undertake the internal management of investment portfolios. The number of personnel, and their skills and experience, would be comparable to what would be expected of an external investment manager undertaking an equivalent activity. Further, the systems, data, operations and policies supporting internal investment management would be comparable to what would be expected of an external investment manager undertaking an equivalent activity.
65. Where an RSE licensee engages asset consultants or other advisors to support the due diligence process, an RSE licensee would ensure that recommendations from such consultants or advisors are consistent with the RSE licensee's views about whether an investment manager should be engaged or retained and that any potential conflicts of interest are appropriately identified and managed.

## Rebalancing

66. Rebalancing is an important mechanism for maintaining asset allocation within determined ranges in a reasonable timeframe. An RSE licensee may offer an internally developed investment option for the purposes of managing asset allocation, using either a strategic or dynamic asset allocation approach.
67. An RSE licensee would demonstrate how their approach to rebalancing considers:
- a) the timing of rebalancing through a combination of periodic rebalancing and established rebalancing triggers;
  - b) the use of derivatives to rebalance;
  - c) costs that may be incurred under normal and stressed operating conditions;
  - d) reporting to the Board and Board committee, where relevant; and
  - e) how significant deviations in asset allocations are disclosed to members.
68. Where an RSE licensee uses an investment option as a liquidity provider, an RSE licensee would be able to demonstrate and clearly document the appropriateness of this purpose with reference to liquidity impacts, member equity and how this is considered through stress testing. An RSE licensee would also ensure liquidity provider arrangements are subject to periodic review and regular oversight by the Board or Board committee, where relevant.

### **Transitioning investments**

69. An RSE licensee would demonstrate how it manages the transition of investments in the event of a change of investment strategy, investment manager or successor fund transfer to another RSE. For the transition of large or complex investments, an RSE licensee would establish a transition plan that specifies the objectives of the transition, timeframes to complete and measures to monitor the success of the transition.

## Monitoring investments

25. An RSE licensee must determine appropriate measures, for the purposes of monitoring performance on an ongoing basis, in respect of each MySuper product, each investment option and each investment within an investment option. These measures must include appropriate performance benchmarks and a methodology for setting performance benchmarks. These measures, other than performance benchmarks for each investment within an investment option, must be approved by the Board.
26. An RSE licensee must ensure that the performance of each investment option and each MySuper product is regularly reported to the Board and senior management. This reporting must include an assessment of the sources of out-performance and under-performance relative to appropriate performance benchmarks as determined by the RSE licensee under paragraph 25.
27. An RSE licensee must ensure that persons undertaking the assessment of performance, by applying and assessing the measures required in paragraph 25 are operationally independent from persons who are responsible for making the investment.

### Monitoring investment performance

70. While APRA expects performance of investment options would be reported to the Board on at least a quarterly basis, it is open to an RSE licensee to adopt a different approach to reporting on individual underlying investments where it provides the Board and/or Board committee with sufficient visibility over underperformance and the opportunity to better understand particular assets or asset classes.
71. APRA expects an RSE licensee would be able to demonstrate the approach for reporting to the Board and/or Board committee supports information about performance that is timely, relevant and enables effective challenge and understanding of the drivers of performance through attribution analysis. At a minimum, such monitoring would include information with respect to the legislated annual performance test and APRA heatmaps.
72. An RSE licensee would be able to demonstrate how they ensure oversight of the underperformance of assets or externally managed investment options, including by using 'watch-lists' or by restricting flows or closing options.

### Additional ESG impacts

73. An RSE licensee may pursue additional objectives from investments, such as environmental or social impacts, where it can demonstrate that pursuing such additional objectives is consistent with the delivery of investment outcomes to members.
74. Where investments are linked to additional non-financial objectives, such as environmental or social impact related objectives, APRA expects an RSE licensee would be able to demonstrate how it monitors the objectives, using recognised industry criteria.

75. An RSE licensee may consider how it uses its voting or investment power to generate value in investments to engage in stewardship activities. Where an RSE licensee engages in stewardship activities as part of its prudent management of investments, APRA expects an RSE licensee would be able to demonstrate how such stewardship activities:
- a) contribute to value creation over different time horizons and support delivering financial returns to beneficiaries;
  - b) are appropriate in the context of the RSE licensee's business operations, resources and investment mix and complexity;
  - c) are undertaken on a cost-effective basis, including where undertaken by way of a collective approach; and
  - d) are publicly disclosed.

## Reviewing the investment strategy

28. For each investment strategy, an RSE licensee must have a review policy that is approved by the Board and that, at a minimum, requires each investment strategy to be reviewed against its investment objectives on at least an annual basis. The policy must also include:
- a) the triggers that will cause an interim review of the investment strategy in addition to the annual review;
  - b) the processes for reporting the results of each review to the Board; and
  - c) the criteria that will determine whether the investment strategy must be changed.
29. On receipt of the results of a review of an investment strategy undertaken in accordance with the review policy, the Board must ensure that any decision to amend the investment strategy is supported by sufficient justification and analysis.

76. An RSE licensee would document the types of events that might trigger an interim review of the investment strategy, including, but not limited to, significant events in the economic environment, structural changes in the membership profile resulting from merger activity, material outflows or reduction in anticipated inflows.
77. An RSE licensee would document how, and for how long, it will monitor the impacts of specific amendments to the investment strategy to address underperformance to assess whether the desired outcome has been achieved.

# Stress testing

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## The stress testing program

30. An RSE licensee must have a comprehensive investment stress testing program that is approved by the Board and is integrated into an RSE licensee's investment governance framework.
31. An RSE licensee must, at a minimum, determine appropriate adverse stress scenarios for the investment strategy of each option. These adverse stress scenarios must cover a range of factors that can create extraordinary losses or make the control of risk within accepted tolerance level in the investment strategy difficult.
32. An RSE licensee's comprehensive investment stress testing program must provide for:
  - a) investment stress testing performed prior to the implementation of the investment strategy;
  - b) investment stress testing based on scenarios determined in paragraph 31 to confirm that each investment strategy, including the targets and ranges set under paragraph 20(c) and paragraph 21(a) remain appropriate on at least an annual basis; and
  - c) investment stress testing based on scenarios determined in paragraph 31, and other parameters deemed appropriate by the RSE licensee, to assess the performance of each investment option based on the actual asset allocation on at least an annual basis.
33. The comprehensive investment stress testing program must, at a minimum include:
  - (a) clearly articulated stress testing objectives, methodology, assumptions, frequency (at least annually), and risk factors, including the rationale for the severity of the adverse stress scenarios as required in paragraph 31;
  - (b) the roles and responsibilities of persons (both internal and external) involved in the design, implementation, review, reporting and oversight of investment stress testing, including the role of the Board, relevant Board committees and senior management;
  - (c) investment stress testing output or metrics that demonstrate the performance of each investment option under the stress scenarios required in paragraph 31;



- (d) processes for the regular review of stress testing methodology and assumptions;
- (e) circumstances that might lead to ad hoc investment stress testing, including triggers to indicate when ad hoc investment stress testing would be undertaken; and
- (f) processes for ensuring that relevant and reliable data are used in investment stress testing.

78. Stress testing is an important part of an RSE licensee's investment risk management process. APRA expects an RSE licensee would develop a structured, repeatable process that draws on a range of appropriate inputs. An RSE licensee would ensure that scenarios are designed with clear objectives in mind and that the forward-looking results are used to inform investment decisions.
79. APRA expects an RSE licensee would be able to clearly demonstrate how its stress testing program is commensurate with the risks and nature of its investment strategy, and that the scope of the program is regularly reviewed and refined. Specifically, the stress testing program would include areas such as:
- a) considering and adopting a range of scenarios across systemic/market-wide risks (e.g. liquidity, climate change), macroeconomic events (e.g. interest rate shocks, oil price shocks) and targeted events (e.g. market sector or stocks);
  - b) documenting how the scenarios are likely to transmit to the investment portfolio, through a range of techniques including sensitivity analysis (single factors) and scenario analysis (multiple events);
  - c) stating clearly the RSEs, products and investment options to which the stress test applies;
  - d) determining the frequency with which stress-testing would be conducted. APRA expects this would be undertaken at least quarterly, with an RSE licensee considering those factors that require more frequent or ad-hoc stress tests; and
  - e) considering how sensitivity analysis on individual factors in the stress test will aid understanding of the drivers behind the stress test.
80. Whilst the primary focus of investment stress testing is on the impact on investment returns, APRA expects an RSE licensee would ensure that other key areas are considered in its stress testing program. At a minimum, an RSE licensee would consider scenarios that address liquidity stress, to inform the liquidity management plan, and climate risk (in accordance with *Prudential Practice Guide CPG 229 Climate Change Financial Risks* (CPG 229)).
81. To enhance understanding of the RSE's liquidity profile and the impacts of an adverse liquidity environment, an RSE licensee would consider (both individually and as a simultaneous occurrence) liquidity stress factors in addition to those described in paragraph 81, such as:

- a) **member generated events:** changes in switching behaviour, redemptions and contributions;
- b) **investment manager events:** suspension of redemptions;
- c) **investment/asset specific events:** capital drawdowns, settlements of currency hedging instruments;
- d) **market driven events:** significant downturn in equity markets;
- e) **policy driven events:** a change in Government policy, for example, related to access to accrued member assets; and
- f) **RSE specific events:** large scale redundancies, economic downturns.

82. The use of climate risk scenarios can help to inform risk identification over the shorter- and longer-term. In this context, APRA expects an RSE licensee would:

- a) consider climate scenario analysis and stress testing to understand exposure to material climate risks and the potential impact of the investment strategy on market-wide risks over both the shorter- and longer-term. Such risk stress would be undertaken in a manner that is proportionate to the size and complexity of the investments; and
- b) consider scenarios that assess both physical and transition risks. APRA expects an RSE licensee would conduct quantitative analysis where data or proxies are available, supported by qualitative inputs as relevant.<sup>1</sup>

83. An RSE licensee would review its stress testing methodology at least annually to ensure assumptions remain appropriate. This review would account for changes in market conditions, investment strategy and circumstances that may affect the liquidity requirements of specific investment options.

84. An RSE licensee may consider it appropriate to use stress testing conducted by an external investment manager or external service provider where it is demonstrably consistent with the RSE licensee's overall stress testing program.

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<sup>1</sup> CPG 229 provides further guidance on the short and long-term scenarios that an RSE licensee would consider.

## Stress testing results

34. An RSE licensee must ensure that the results of the comprehensive investment stress testing program are:

- a) reviewed periodically by the Board, relevant Board committees, and senior management; and
- b) reflected in the RSE licensee's investment governance framework.

85. Clear and meaningful reporting to the Board and Board committees enables the Board to understand and challenge the insights from stress testing and the potential actions relating to investment decisions that might be taken to respond to the results.

86. APRA expects an RSE licensee would demonstrate how its stress testing program informs, at a minimum, its business planning process and investment strategy, including risk tolerances and liquidity management plan. APRA expects stress testing results would promote challenge from, and provide insights to, the Board about the potential impacts of different scenarios on outcomes for members.

## Stress testing methodology

35. The Board must document the methodology for stress scenario selection and how the results of the comprehensive stress testing program have been used in decision-making.

87. The Board would demonstrate how it provides input and challenge in the development and consideration of the plausible, but severe, scenarios most relevant to the RSE's investments.

88. An RSE licensee would demonstrate how the design of the comprehensive stress-testing program is appropriate to the RSEs, products and investment options offered by the RSE licensee. This includes, but is not limited to:

- a) how stress-testing by undertaking scenario analysis and stress-testing in the form of sensitivity analysis is appropriate given the nature of the investment option;
- b) how historical events and hypothetical events are to be used; and
- c) how assumptions are used to establish parameters in stress-testing.

89. An RSE licensee would ensure that reporting to the Board would explain the basis for choosing scenarios, the assumptions used, including any key limitations, the outcomes of the stress testing and potential actions that are to be considered, including any rebalancing or risk mitigation activities.

# Liquidity management

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## Liquidity management plan

36. An RSE licensee must, at a minimum, have a liquidity management plan, approved by the Board, for each RSE within its business operations that:
- a) covers each investment option in the RSE;
  - b) outlines the procedures determined by the RSE licensee for measuring and managing liquidity on an ongoing basis;
  - c) includes consideration of how the liquidity of investment options in an RSE can be managed in a range of stress scenarios;
  - d) identifies the circumstances the RSE licensee considers to be a significantly adverse liquidity outcome that requires action (liquidity event);
  - e) outlines what action the RSE licensee will take when a liquidity event occurs;
  - f) outlines the roles and responsibilities of persons involved in the management and oversight of liquidity risk, including the role of the Board, relevant Board committees and senior management; and
  - g) outlines information, including key metrics, that must be reported to the Board, relevant Board committees and senior management, to ensure adequate oversight of liquidity risk.

90. Liquidity management ensures that members can redeem investments, when required, in a range of market conditions. It is important that an RSE licensee has a deep understanding of the liquidity demands on the RSE, and each investment option, and how these demands might affect asset values and the RSE licensee's ability to meet portability and payment obligations.

91. APRA expects an RSE licensee would demonstrate understanding of the key sources of liquidity, their reliability and the potential for these sources to deteriorate, supported by stress testing.

92. APRA expects that an RSE licensee would demonstrate adequate liquidity management practices commensurate with the nature, risk and complexity of investments and business operations. An RSE licensee would demonstrate how their liquidity risk tolerances are informed by characteristics of the RSE and its investment options through consideration of benefit design, member demographics, the range of investment options offered and the level of transactional activity.

93. An RSE licensee would develop and monitor:

- a) early warning indicators to identify emerging liquidity risks;
- b) appropriate liquidity buffers within each option; and
- c) liquidity limits and/or triggers for deteriorating cash flow positions.

37. An RSE licensee must ensure that information, including key metrics referred to in paragraph 36(g) are periodically reviewed by the Board, relevant Board committees and senior management, to ensure that such information and key metrics remain suitable.

38. An RSE licensee must implement liquidity stress testing as part of the comprehensive investment stress testing program required in paragraph 31 and the RSE licensee's liquidity management plan.

94. APRA expects an RSE licensee would consider the potential impacts on beneficiaries of secondary risks associated with liquidity risk, including the impact of selling assets at 'stale' price, the impact on portfolio quality of an increasing proportion of illiquid assets and the cost of restoring the portfolio quality.

# Valuation governance

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## Valuation governance framework

39. An RSE licensee must have an adequate valuation governance framework, which consists of the structures, processes, procedures and controls necessary to identify and manage valuation risk of investments.

95. A rigorous and active approach to valuation governance ensures appropriate reflection of asset valuations, recognising the impact on performance and enabling the equitable distribution of investment earnings to beneficiaries. This is the case for both listed and unlisted investments. Certain sections of this guidance are specific to unlisted asset valuation considerations.

96. An RSE licensee's valuation framework would ensure:

- a) effective Board and management oversight, robust policies and processes, and the allocation of adequate expertise and resources to the valuation of investments. This would be supported by a Board approved valuation policy that is well understood by those responsible for its application;
- b) a consistent valuation methodology is applied, unless the RSE licensee decides, supported by appropriate documentation, that the methodology must be updated to achieve a more accurate valuation;
- c) valuations are supported by appropriate judgements and assumptions;
- d) valuation inputs are appropriately and regularly calibrated;
- e) operational and structural independence between the persons responsible for investment decision-making and those responsible for undertaking the valuation of investments; and
- f) adequate oversight by internal audit and external audit by, amongst other things, reviewing the control environment supporting the valuation process, assessing the availability and reliability of information or evidence used in the valuation process, and determining the validity of assumptions and estimated values used in undertaking a valuation.

97. Where an RSE licensee relies on valuations undertaken by external managers, APRA expects the RSE licensee would demonstrate:

- a) how their initial due diligence and ongoing monitoring supports the RSE licensee's ability to rely on the valuations, particularly where the RSE licensee is unable to influence the valuation methodology;

- b) how the external manager's valuation methodology, hierarchy of sources of information and frequency of valuations, in normal and stressed circumstances, are consistent with the terms of the arrangement with the external party and the RSE licensee's expectations; and
- c) how any potential conflicts of interest and any other identified material risks arising from the external manager providing its own valuations are to be managed.

98. Where an RSE licensee cannot satisfy itself about the quality of valuation information on the valuation of each unlisted investment selected, APRA expects that an RSE licensee would consider whether the investment is appropriate for selection or, where already invested, should continue to be held.

## Valuation policy

40. The valuation governance framework must include a Board-approved valuation policy which, at a minimum, outlines:

- a) the roles and responsibilities of persons for the oversight and management of valuation processes and procedures, including the Board, relevant Board committees and senior management;

99. It is important that the Board has adequate expertise and resources available to it to support a robust valuations framework. A Board may consider delegating oversight of valuation processes to a Board committee, for example, the Board Investment Committee or a Valuation Committee.

100. Where a Board delegates oversight of valuation processes to a Board committee, APRA expects that the committee would be comprised of persons who have sufficient skills, knowledge and information to provide meaningful oversight of valuation processes.

101. Where an RSE licensee offers an externally managed investment option, an RSE licensee would ensure the investment manager's valuation policy is appropriate and consistent with its own valuation policy.

## Key metrics

40. b) the key metrics and information that must be reported to the Board, relevant Board committees and senior management, and the frequency of that reporting;

102. APRA expects an RSE licensee would consider increasing the level and frequency of reporting and valuation oversight during times of heightened market volatility.

## Valuation methodology

40. c) the valuation methodology employed for each asset class (and sub-asset class and instrument/holding vehicle type where relevant), including the sources of valuation inputs;

103. An appropriate valuation methodology is one that ensures valuations are reflective of the asset's true value, are completed in a timely and objective manner and employs more than one method, by using a range of alternative approaches, for example, to arrive at a better estimate, where appropriate to do so.
104. APRA expects an RSE licensee would demonstrate how they have determined the most appropriate approach for assets considered, including the sources of valuations, the hierarchy applied and the inputs and assumptions to the valuation methodology. An RSE licensee would also demonstrate how it ensures it has access to the relevant data to support an approach.
105. APRA expects an RSE licensee would document its approach for determining the assumptions used, have a formal process to monitor and regularly review the appropriateness of the valuation assumptions, and apply these assumptions consistently when undertaking valuations.
106. APRA expects an RSE licensee would demonstrate how they have applied the chosen valuation approach in a consistent manner, including how any changes to that approach result in greater accuracy of the valuations.
107. An RSE licensee may consider adopting guidance issued by relevant industry associations or international standard setting organisations to support the development of a robust valuation methodology.
108. An RSE licensee would:
- a) document the hierarchy of its valuation sources, including the strengths and weaknesses of each, the extent to which they are derived from independent sources and how any identified weakness may be mitigated;
  - b) demonstrate how it prioritises valuation sources that reflect quoted market prices of identical or similar investments in active markets, considering:
    - i) whether the market price is binding or indicative;
    - ii) the proximity of the price to the valuation date;
    - iii) the frequency with which prices are set; and
    - iv) whether a stale price is realisable; and
  - c) demonstrate how the valuation methodology of investments that do not have a quoted market price is determined, considering:
    - i) the nature of the industry of the assets and the market conditions of the industry; and
    - ii) stage of development of industry.



## Independent external valuations

40. d) the circumstances under which independent external valuations are to be obtained;

109. It is open to an RSE licensee to determine where it will seek independent external valuations to supplement either internal or external investment manager valuations.

110. APRA expects an RSE licensee would consider seeking regular independent valuations across asset classes, either on a sample or rotational basis. Reporting to the Board, or Board committee, on independent valuations would ordinarily include the number and type of independent valuations conducted and any key findings or deviations (delta) between methodologies.

## Frequency

40. e) the frequency of valuation of investments having regard to the prevailing market, economic environment, member equity considerations and matters concerning the ongoing appropriateness of the asset valuation;

111. APRA expects an RSE licensee would undertake valuations on at least a quarterly basis. Where an RSE licensee chooses to undertake valuations less frequently, APRA expects the RSE licensee would demonstrate how it has determined that the valuation frequency is appropriate. Factors that would inform valuation frequency include, but are not limited to, the frequency with which member transactions are permitted, how valuation data is incorporated in unit prices/crediting rates, access to valuation information and costs.

112. An RSE licensee would consider triggers that would warrant more frequent valuations including market volatility and the external operating environment, including changes in Government policy settings.

## Interim valuations

40. f) the circumstances in which interim valuations are to be made, to ensure the approach taken is consistent and transparent;

113. APRA expects an RSE licensee using an index or benchmark as a proxy for the movement in the value of an asset would be able to demonstrate how using that index or benchmark remains appropriate on an ongoing basis. This would include, for example, demonstrating how the movement in the proxy has maintained consistency with movements in the asset's valuation, the tolerances that are in effect around significant movements and the period for which the proxy remains relevant.

114. The policy would also set out protocols for when and how the interim valuations are reviewed for appropriateness and to determine whether any adjustments or reversals need to be made for unit pricing purposes.

- 40. g) the triggers that would require an interim valuation of investments outside of the frequency determined under paragraph 40(e) and which reflect the circumstances identified in paragraph 40(f);
  - h) a review process to ensure that the valuation policy remains effective;
  - i) the validation of valuation outputs including any back-testing procedures; and
  - j) the circumstances as to when to accept, reject or reassess valuations of investments to ensure that an RSE licensee's valuations remain appropriate, including an escalation procedure for the resolution of any disputed valuations.
41. An RSE licensee must ensure that the key metrics and information referred to in paragraph 40(b) are periodically reviewed by the Board, relevant Board committees and senior management, to ensure that such information and the key metrics remain appropriate to enable sufficient oversight of valuation risk.

115. APRA expects an RSE licensee would determine the circumstances in which valuations would be reported to the Board and management.



 **APRA**