

About AIST

The Australian Institute of Superannuation Trustees is a national not-for-profit organisation whose membership consists of the trustee directors and staff of industry, corporate and public sector superannuation funds.

As the principal advocate and peak representative body for the \$1.7 trillion profit-to-members superannuation sector, AIST plays a key role in policy development and is a leading provider of research.

AIST advocates for financial wellbeing in retirement for all Australians regardless of gender, culture, education, or socio-economic background. Through leadership and excellence, AIST supports profit-to-member funds to achieve member-first outcomes and fairness across the retirement system.

Submission

AIST thanks APRA for the opportunity to respond to the Draft Prudential Practice Guide SPG 530 Investment Governance in this submission, and for the many other interactions with APRA where we were able to raise investment governance issues.

The proposed revision of the Prudential Practice Guide on Investment Governance is an important exercise and integral to how superannuation funds structure and operate their investment operations.

In our submission to the consultation on Prudential Standard SPS 530 Investment Governance, we requested guidance (rather than prescription) to better reflect current investment practices and issues, and to support the implementation of the updated SPS 530. The draft SPG does this in part but could be enhanced by more examples and scenarios (as well as better structuring about the application of guidance to internally versus externally managed assets).

Sequencing changes to prudential architecture

The sequencing of the Modernising Prudential Architecture project alongside the review of SPS 530 Investment Governance, and the commencement of SPS 530 on 1 January 2023 during the midst of consultations on a revised SPG 530 Investment Governance (and also incorporating SPG 531 Valuations) is an example of confusing sequencing, that results in uncertainty amongst super funds about meeting APRA's expectations.

There are considerable interdependencies between each element, and it is difficult to assess the implications of each element when related elements are also in flux.

We make this point again because investment governance has been an early focus of the Modernising Prudential Architecture project, and we strongly encourage APRA to consider the effective and appropriate sequencing of subsequent reviews.

Investment operating models and insourcing

There is an assumption in paragraph 12 that the outsourcing of investment management functions provides the bar to which internal investment management should aspire, that is, that outsourced arrangements are better.

AIST challenges this assumption which sets an arbitrary and changeable comparator in any event and is flawed in a number of ways. For example, the quality and capabilities of external investment managers varies significantly; it would be nonsensical to suggest that a fund should compare itself to an underperforming manager or one with inadequate capabilities.

AIST submits that there should be an objective test provided in the practice guide for internal investment management .

AIST recommends that the expressions used in section 912A of the Corporations Act for the general obligations of a financial services licensee be employed to amend paragraph 12, and that it read:

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 in place the organisational competence including systems, resources and processes to ensure that these functions are undertaken efficiently, honestly and fairly.

This incorrect assumption is also at work in paragraph 64, where internal management activities are asked to aspire to the presumably superior personnel, skills and experience of external managers. This is challenged on the same basis as we gave for paragraph 12.

AIST recommends that paragraph 64 be amended to read:

An RSE licensee would have the appropriate skills and resources available to undertake the internal management of investment portfolios. The number of personnel, their skills and experience, and the RSE licensee's systems, data, operations and policies supporting internal investment management would enable it to do all things necessary to ensure that the functions are undertaken efficiently, honestly and fairly.

Board responsibility and delegations to management

Within profit-to-member superannuation funds, valuations and valuation methodology are subject to rigorous oversight by a combination of Board and management processes.

Requirements for investment monitoring should clarify that while the super fund boards should monitor investment performance including methodology and performance against benchmarks, detailed consideration of each investment in each investment option and each MySuper product can and should be delegated to management in accordance with the investment governance framework.

The level of detail provided to the Board should be scaled to the Board's decision-making framework, with the Board maintaining visibility and knowledge of delegations and how they have been acquitted.

A fund should determine appropriate measures approved by the Board, to monitor the performance of each investment in each investment option and each MySuper product, including the methodology for performance benchmarks, on an ongoing basis.

The management and oversight of investment monitoring, liquidity risk, and the valuation governance framework should not necessarily require the establishment of a stand-alone board committee for each area (although a fund may determine to do so).

Each fund should determine the governance processes, including delegated responsibilities, that best and most effectively meets the needs of their entity while acknowledging the Board's ultimate responsibility for these matters.

The reference in paragraph 2 to the appropriate delegation of authority to allow the Board to maintain appropriate oversight of key investment decisions (and the reference in paragraph 10 about determining the most appropriate investment operating model) should be extended to make this clear.

In relation to valuations, the SPG should not just require the description and documentation of delegations but should also make it clear that large super funds have appropriate governance processes that do not necessarily require a stand-alone Board valuation committee.

Paragraph 99 includes the comment that: *'A Board may consider delegating oversight of valuation processes to a Board committee, for example, the Board Investment Committee or a Valuation Committee'.*

AIST recommends that an additional paragraph be inserted in the SPG after paragraph 100 along the lines of:

Where an RSE licensee delegates valuation processes to management, APRA expects that a Board or a Board committee would maintain robust policies, processes, and monitoring to ensure that its ultimate responsibility for the sound and prudent management of its investments and their valuation is fulfilled and can be demonstrated.

Following are examples from a range of large AIST member funds that demonstrate effective governance procedures for valuation of internally managed directly held assets, and how the Board of each fund has line of sight to these procedures:

Large fund A:

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The valuation of internally managed directly held assets of very large fund A are managed by a dedicated Valuations team which is separate from the team making investment decisions. This team is comprised of valuation specialists who report to a Finance, Strategy and Transformation Executive.

Recommendations are presented to the Valuations Committee, which comprises of senior leaders and executives and is chaired by the Group Executive of Finance, Strategy and Transformation. Whilst the investments team participates in the Committee decisions, they are not members of the Committee.

The Audit, Risk and Compliance Board Sub-committee receives regular updates on the valuations of unlisted assets, including approved valuations and any issues considered by the Committee, and is provided with an opportunity to ask valuation-related questions.

Valuation decisions are made independently of investment decision-makers. The Investments Team that manages valuations is separate from the team making investment decisions, and all recommendations are presented to a Valuations Committee. In addition, the fund has a Conflicts of Interest Policy under which all personnel (including Investment Team members) must consider and disclose potential conflicts of interest that may arise in their personal capacity.

The Valuation Committee acts on the behalf of the Audit, Risk and Compliance Sub-committee and provides an independent governance and oversight function for valuations. Whilst the Committee is not a direct Board sub-committee, it consists of senior leaders and executives from various functions who are independent of the Investments Team.

The Committee members are able to draw upon their business and commercial expertise to investigate or review valuation recommendations and make prompt decisions to ensure that member unit prices reflect the most up-to-date valuations.

Prompt decision making is particularly necessary for certain valuations (e.g., out of cycle valuations), and this would not always be possible if recommendations were being made directly to a Board sub-committee due to time constraints and difficulties in ensuring availability of members.

Large fund B

Large fund B's Valuation Policy documents the key principles, methodologies and guidelines the Fund adopts to ensure it uses the most reliable and accurate underlying asset values for the benefit of its members and regulatory reporting.

Management is primarily responsible for monitoring the implementation of the Valuation Policy and ensuring that appropriate valuation procedures are in place. Additionally, notwithstanding that appropriate valuation procedures may exist, rapidly changing economic circumstances may require Management to consider whether a change to the carrying value of a particular asset is warranted through the Valuation Review Committee (VRC).

The VRC makes decisions on unlisted asset valuations at times of significant market movements or where there is a potential material asset valuation change per the trigger events for revaluation. The VRC monitors whether any significant changes are required to the unlisted asset valuation processes, guidelines or relevant policies.

The Valuation Oversight Committee (VOC) is a sub-board committee comprising of the chair of the board, the chair of the Investment Committee (IC) and the chair of the Audit Risk and Finance Committee (AFRC) and is responsible for reviewing the activities of the VRC from a trustee perspective, to ensure that the valuation of assets, and subsequent decisions to amend/not amend unit prices, are timely, prudent and in the best interest of members.

Valuation decisions are made independently of investment decision-makers. The VRC is comprised of large fund B's CFO, CIO, CRO and Head of Investment Operations & Performance. Valuation Oversight & Compliance (VO&C) team also operate independently from valuation decision makers and have robust out-of-cycle valuation processes in place which include quantitative and qualitative monitoring and attestations from the Investment team to ensure unlisted valuations are fairly valued.

Processes are in place to address potential conflicts of interest. When appointing managers, the Investment Team aims to negotiate fee structures that align manager motivations with member outcomes. This is achieved by negotiating incentive fee structures that are only paid upon realisation of an asset or over long-term performance periods (e.g., five or ten years) and includes claw back mechanisms if paid prior to realisation. Given this fee structure there is little incentive for managers to temporarily inflate valuations to manipulate incentive fee payments which are often the main drivers of their revenue base.

Furthermore, should an out-of-cycle valuation decision be made by the VRC there is a standard conflicts of interest declaration at the beginning of each meeting which is documented in each meeting minutes.

The Board and/or its investment committee is able to monitor and oversight valuations and address issues arising. All VRC decisions are reported to the AFRC and VOC. Additionally,

every year there is an investment deep dive focused on unlisted assets and their governance. This is reported to a joint IC and AFRC.

Overall, this framework provides governance processes are in place to ensure appropriate valuation governance and oversight capabilities through:

- Independence of Committees and decisions from investment decision makers
- VO&C operating independently from valuation decision makers with regular monitoring of asset specific and macro events
- Regular checking of unlisted asset movements against agreed and documented tolerances
- Regular reporting of all VRC decisions through to relevant board committees

Large fund C

The Board of large fund C has line of sight to governance procedures for valuation of internally managed directly held assets. An Independent Valuation Team manages all day-to-day valuation related matters and reports to the Finance Valuation Committee (FVC) monthly. The FVC is chaired by the CFO and includes a senior big-4 accounting firm valuations partner as an external member. All decisions need to be unanimous.

The Valuation Policy is Board approved and there is quarterly reporting of key valuation matters to the Audit and Finance Committee (AFC) and annual reporting to the Board. Valuation Policy incorporates various escalation thresholds where the FVC will need to refer matters directly to the AFC.

Valuation decisions are made independently of investment decision-makers. The investment team supports valuation team with information requests and factual accuracy checks only. The CIO and DCIO are non-voting members of the FVC.

Processes are in place to address potential conflicts of interest. The valuation team is operationally and structurally separate from the investment team.

The Board is able to monitor and oversight valuations and address issues through regular reporting and escalation framework.

Issues are typically dealt with monthly at the FVC level. Large fund C has developed a comprehensive Valuation Policy and Unlisted Asset Valuation Protocol that sets out clear thresholds and processes under different situations to provide strong requirements & guidance to management.

This framework provides at least as appropriate valuation governance as a dedicated Board valuation committee, and supports oversight capabilities contributing to better valuation practices.

- The FVC and AFC independent of key investment decision makers.
- The FVC meets frequently, at least monthly and includes oversight from external valuations expert. FVC more capacity to address wider range of valuation matters and delve deeper into issues.
- The Valuation Policy is Board approved.
- The AFC is a sub board committee – receives valuation reporting quarterly

Some large AIST member funds also largely invest using external managers and can also demonstrate effective governance procedures for valuation of these assets, and how the Board of each fund has line of sight to these procedures:

Large fund D

Large fund D largely invests in unlisted assets such property, infrastructure and private equity using externally managed investment vehicles. These external managers use a combination of valuations from independent valuers and valuations undertaken in-house.

Large fund D Valuation Policy is approved by the Board Investment Committee, under delegation from the Board.

To ensure operational segregation between the Investment Management team and the valuation process, the Valuation Policy is owned by the Head of Investment Execution who is responsible for the implementation of the Policy. The Head of Investment Execution directly reports to the Chief Operating Officer, rather than the Chief Investment Officer to manage any potential conflicts.

For all external managers, large fund D undertakes comprehensive operational due diligence at the time of investing with the manager. Initial operational due diligence is undertaken by an external provider, overseen by the Portfolio Compliance team, who ultimately reports to the Head of Investment Execution (independent of the Investment Management team).

As part of this initial operational due diligence, large fund D assesses whether,

- the external manager's valuation policy aligns with the Fund's,
- the valuation approaches and methodologies outlined in the policy are consistent with market practise for the types of assets managed,
- is consistent with other industry guidance such as International Valuation Standards, International Property Measurement Standards or International Private Equity Guidelines or their Australian equivalents.

The external manager's control processes around valuation (such as whether the valuation is completed independent of the asset management team and the use of an independent valuation committee to review and approve valuations) is analysed and assessed.

As part of the annual due diligence process, external managers are asked to attest compliance with their valuation policy, as well as communicate any departures or changes from the policy.

On a quarterly basis, the investment management team responsible for monitoring the external manager formally engages with the external investment manager to discuss the investment, and valuation including consideration of the following:

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- Was the valuation in compliance with manager's valuation policy
- What was \$/% change in the valuation?
- Was change material (+/- 5%)
- List key drivers of movements, including changes in key assumptions
- Any additional comments on valuation; and
- Whether the valuation overall appears consistent with fair value

These external manager valuations, particularly items of material concern or of a significant size to the portfolio, are further reviewed and discussed as part of the Quarterly Unlisted Asset forum. The Head of Investment Execution, or delegate, and a representative from 2nd line Risk also attend this quarterly forum.

The Investment Operations team (also part of Investment Execution) monitor whether valuation statements received from managers have been correctly booked by the custodian, and managers are providing updated valuation statements when expected.

Large fund D's Valuation Policy outlines portfolio-wide triggers which when reached require additional scrutiny oversight of valuations. These triggers are monitored by the Portfolio Compliance team daily. When one or more of these triggers are activated or when an asset specific valuation issue is identified above a certain tolerance, the "Out-of-Cycle Valuation Group" is activated to determine whether further action is required.

For unlisted investments, this will typically mean further discussion with external managers to assist in determining whether out of cycle valuations are required. The Group may also provide advice to the Head of Investment Execution, in some circumstances, to override external manager valuations. Any decisions to override valuations are reported to the Investment Committee in line with the Valuation Policy.

Monitoring investments – stewardship

Stewardship practices have long been considered a risk management tool and a key component of fiduciary duty. Through stewardship and active ownership, asset owners can protect and enhance investment outcomes.

AIST welcomes APRA's acknowledgement of stewardship considerations in proposed paragraph 75 but suggests that the text be changed to increase clarity.

There is a risk the current draft of SPG530 might be read as confining stewardship to just proxy voting, whereas this is only one aspect of active ownership. We suggest the SPG recognise a wider definition of stewardship that includes other stewardship activities such as engagement, policy and advocacy.

AIST also recommends proposed paragraph 75 (a)-(d) be reworded to better align with the members best financial interests duty. Sub-sections (a) and (c) refer to considerations that are comprehended by the best financial interests duty. AIST therefore recommends that the text directly require RSE licensees to align their stewardship practices to their best financial interest duty as follows:

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 are in members best financial interests and are publicly disclosed.

If APRA is encouraging disclosure of stewardship activity, we recommend that it also provide some guidance as to the appropriate level of disclosure. Better practice is likely to involve disclosure in line with an existing stewardship Code.

AIST also suggests that proposed paragraph be given its own heading 'Stewardship'. By locating proposed paragraph 75 in a section considering additional ESG impacts, it suggests that stewardship activity is just related to themes of ethical investing, which is confusing, given the broader application of stewardship activity.

Stress testing

As for valuation arrangements, guidance for determining roles and responsibilities for investment stress testing must be appropriate for the increasing size and complexity of superannuation funds, and the increasing complexity of investment structures. AIST

AIST welcomes the list of events that are given as examples of adverse stress events in paragraph 81, including the addition of '*policy-driven events*'.

The example given in relation to government policy is about '*access to accrued member assets*' which was not identified as a risk factor prior to the Covid pandemic; is not mentioned in the current SPG 530; and is apparently a response to the Early Release of Superannuation (ERS) scheme.

It is noted that Prudential Practice Guide CPG 233 Pandemic Planning anticipates that access issues might arise from member-initiated actions. In paragraph 32, it states:

RSE licensees and other management investments may find it prudent to consider the potential liquidity and operational implications of early withdrawals or liquidation of assets.

The point is that risk factors in a stress testing program may be determined by either historical or hypothetical events but that event hypothetical events are likely to be tailored from historic events and rarely arise from 'blue-sky' thinking.

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AIST suggests that consideration be given to three additional approaches to assist with anticipating the unexpected:

1. APRA should undertake annual simulation events with industry representatives to generate hypothetical events, and to workshop, improve and test hypothetical and historic scenarios. A regular and robust industry program would help assure the effectiveness of the stress testing and stress testing plans at both an industry and RSE level.

Simulations provide the opportunity to work through the critical decisions in a collective forum and identify the appropriate response strategies and methodologies. This approach has been successfully used in ATO (Australian Taxation Office) exercises with the superannuation industry in relation to business continuity management and cyber-security.

2. SPG 530 should identify reverse stress testing, that is, starting with the adverse outcome and working backwards to consider which scenarios and risk factors may cause the outcome , as an approach for funds to consider. This approach is identified in the current SPG 530.
3. APRA should consider the addition of more examples of actual events, including the potential impacts of different scenarios on outcomes for different cohorts of members (eg, members approaching retirement or members with low account balances).

Valuation methodology

The reference in paragraph 103 to 'true value' should be defined and clarified, especially in relation to the definition of fair value in IFRS 13 where it is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (IFRS 13.9). In other words, it is a current exit price, and it is applicable regardless of whether an entity intends to use an asset or to sell it.

Under AASB 1056 Financial Reporting for Superannuation Plans super funds are required to value investments at fair value. Inconsistency would be problematic as a difference in the valuations used for financial reporting versus member liabilities will impact on a fund's investment reserve.

Valuation of externally-managed investments

The profit-to-member sector uses outsourced service providers to a greater extent than many financial service entities. While RSE licensees adhere to the outsourcing prudential standard and recognise that the Trustee has ultimate responsibility for their fund, the relationship between the controls they use and APRA expectations needs to be more clearly articulated in the SPG.

The applicability of independent external valuations (especially where an investment is already valued by an external manager) should also be balanced with members best financial interests, especially in relation to assets which are immaterial to a member investment option.

AIST submit that APRA's expectations on the valuation of externally managed investments, and the relationship between proposed paragraph 97 and other aspects of the chapter on valuation governance (paragraphs 95 to 115) require further clarification and elaboration in the final version of revised SPG 530.

The proposed guidance on valuation guidance is largely focused on the valuation of directly held investments rather than those held by an external manager and may not be applicable to the significant number of funds that do not invest directly.

AIST understand that most funds do not undertake valuations in-house as a matter of course but outsource valuations to an expert third party provider or use the valuations and valuation methodology of external managers. Any issues identified with valuations are addressed through manager engagement and consideration of appropriate measures to resolve issues.

For example, the meaning and expectation of the independent external valuation guidance in proposed paragraphs 109 and 110 is unclear, both in their own terms and in relation to the rest of the section on valuation methodology.

Proposed paragraph 109 states:

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.

It is unclear if the discretion in proposed paragraph 109 is qualified by the expectation in proposed paragraph 110 that assets will be independently valued or if the expectation applies in circumstances where the RSE licensee has determined to seek independent external valuations.

Presumably it is the latter because otherwise the comment "*it is open for an RSE licensee to determine...*" has no work to do.

In order to resolve this ambiguity, AIST propose that the opening sentence of proposed paragraph 110 be amended to read:

Where an RSE licensee has determined to seek independent external valuations, APRA expects an RSE licensee to assess if these should be sought across asset classes, either on a sample or rotational basis.

Our thinking is that funds would consider if investments have been valued by an external manager, and if this has been done by an independent valuer, and may determine that these circumstances do not require further valuations.

Independent external valuations come at a cost that has to be balanced against the benefit of the additional valuation. Funds will typically take into account the size (including relative size) and nature of the investment, the frequency, methodology and nature of valuation undertaken by the external manager.

Similar issues arise in relation to the other aspects of the chapter on valuation policy. The guidance appears to have been primarily written from the perspective of internally managed assets. In contrast, the valuation methodology of external managers is set by those managers and not by the fund. The fund will not have chosen the valuation approach of the external manager, but will monitor and assess the valuation approach taken by the manager in an appropriate way.

AIST submits that proposed paragraphs 97, 109 and 110 sit uneasily in the current iteration of the chapter on valuation governance, and suggests there be clearer and more separate guidance for the valuation of externally managed assets.

This could be done by specifically identifying whether or not the guidance is applicable to externally and internally managed investments or both, and to express guidance on externally managed investments in a way that better recognises the way in which the valuation of these investments are appropriately managed.

AIST is not suggesting that ultimate responsibility for externally managed investments shifts from the RSE licensee but that there be clearer identification in the SPG of the circumstance in which funds can use external valuations.

For further information regarding our submission, please contact [REDACTED]

[REDACTED]
Yours sincerely,

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