Prudential Practice Guide

SPG 531 – Valuation

November 2013

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About this guide

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 aims to assist an RSE licensee in complying with those requirements and, more generally, to outline prudent practices in relation to the valuation of assets.

This PPG is intended to be read in conjunction with *Prudential Practice Guide SPG 530 Investment Governance* (SPG 530), which aims to assist an RSE licensee in complying with the requirements in SPS 530 relating to the development and implementation of an investment strategy. SPG 530 also provides guidance regarding investment risk management assessment and measurement tools that might be relevant when developing an RSE licensee's valuation governance arrangements and methodology.

For the purposes of this guide, and consistent with the application of SPS 530, 'RSE licensee' and 'registrable superannuation entity (RSE)' have the meaning given in the *Superannuation Industry (Supervision) Act 1993* (SIS Act). In addition, an RSE investment in a collection of assets is referred to as 'investments', while the underlying individual exposures that constitute such investments are referred to as 'assets'.

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.

Contents

Introduction

1. The SIS Act and SPS 530 require an RSE licensee to consider the availability of reliable asset valuation information when formulating, implementing and reviewing an investment strategy.[1] Subsections 52(2)(e) and (f) of the SIS Act also impose duties on an RSE licensee to act fairly in dealing with classes of beneficiaries within an RSE and with beneficiaries in a class.

2. In keeping with these obligations, APRA expects that an RSE licensee would have appropriate arrangements and processes so that asset values are measured reliably and valuation risk is adequately managed. Valuations are a critical input into the calculation of investment performance, enabling the equitable distribution of investment earnings to beneficiaries.

3. This PPG provides guidance to assist an RSE licensee in implementing appropriate governance arrangements for the valuation of investments. This includes establishing valuation policies and procedures, and adopting valuation methodologies. While the guidance applies to both listed and unlisted investments, the main focus of this PPG is on unlisted investments where valuation risk is generally considered to be higher.

4. Listed investments generally have readily available quoted market prices as they trade through exchanges or central clearing agents. There are, however, a number of valuation decisions an RSE licensee may need to consider for listed investments on matters such as the timing of the valuation, the frequency of revaluation, the nature of the investment, the relevance of quoted market prices and the treatment of exchange rates.

5. Unlisted investments do not trade through exchanges or central clearing agents and do not have readily available prices. Unlisted investments can present valuation challenges due to factors such as multiple management layers, complex investment structures, lack of transaction data, and/or underlying assets that are opaque in nature or where undertaking frequent valuations is costly and/or time consuming.

1 Refer to s. 52(6)(iv) of the SIS Act.

Valuation governance

6. When developing, implementing and monitoring appropriate valuation governance arrangements, an RSE licensee would ordinarily align these arrangements with its investment governance framework and risk management framework. Effective valuation governance arrangements would typically include, amongst other things, effective Board and management oversight, robust policies and processes, and the allocation of adequate expertise and resources to the valuation of investments. APRA expects that such arrangements would be governed by a Board-approved valuation policy that is well understood by those responsible for its application.

7. APRA expects that an RSE licensee would develop policies and procedures to identify and manage the valuation risks associated with the investments of the RSE. In managing such risks, an RSE licensee would review and, where necessary, query the appropriateness of the adopted valuation methodology and assess any assumptions used, in the context of the complexity of the underlying investments.

8. The Board of an RSE licensee may consider providing appropriate delegations to a body such as a separate Valuation Committee or the Investment Committee to oversee its valuation procedures. Where such a body is established, APRA expects that it would ordinarily be comprised of persons who are not directly involved in determining the valuation of investments, and who also have sufficient skills and knowledge to provide meaningful oversight of valuation processes.

9. APRA expects that an RSE licensee would establish adequate independence between the persons responsible for investment decision-making and those responsible for undertaking the valuation of investments.

10. Where relevant expertise largely resides within an internal investment team, there may be some practical constraints in enforcing strict segregation of duties with respect to the valuation process. For example, personnel who may be best placed to design and implement the valuation procedures may also be the only and/or most reliable source of information for pricing investments such as unlisted assets. In these circumstances, APRA expects that an RSE licensee would appropriately mitigate and manage any potential conflicts of interest, with the RSE licensee's approach documented in its valuation policy.

11. Irrespective of whether valuations are conducted internally or externally, a prudent RSE licensee would review and monitor the extent of independence in the valuation process on a regular basis, including any mitigating controls in place.

12. A prudent RSE licensee would consider the role of internal and external audit in its valuation governance arrangements. Internal audit and external audit may, amongst other things, review the control environment supporting the valuation process, assess the availability and reliability of information or evidence used in the valuation process, and determine the validity of assumptions and estimated values used in undertaking a valuation.

13. The complexity and opacity of unlisted investment structures, in particular multi-layered 'fund of fund' arrangements, can present a number of significant valuation risks. APRA expects that an RSE licensee would have robust valuation governance arrangements that provide sufficient comfort on the valuation of each unlisted investment selected. Where an RSE licensee cannot satisfy itself about the quality of valuation information, APRA expects that an RSE licensee would consider whether the investment is appropriate for selection or, where already invested, should continue to be held.

14. Attachment A outlines possible valuation risks that might arise given the unique composition or characteristics of certain unlisted investments. APRA expects that a prudent RSE licensee would ordinarily consider these valuation risks, amongst others that may also be identified, when developing its valuation practices and when undertaking a valuation.

Valuation policy and procedures

15. APRA expects that an RSE licensee would have a formally documented valuation policy approved by the Board that outlines the RSE licensee's valuation procedures.

16. A prudent valuation policy would ordinarily address, together with any other relevant matter, the following:

    (a) the roles and responsibilities of the Board, the committee with delegated responsibilities for the oversight of valuation procedures, and other relevant personnel;

    (b) the various stages of the valuation process;

    (c) the valuation methodology employed for each asset class (and sub-asset class where relevant), including the frequency of review, the use of valuation models and specific valuation techniques;

    (d) the established hierarchy of valuation data sources for various types of assets, including identifying those responsible for determining the hierarchy;

    (e) the validation of valuation outputs including any back-testing procedures;

    (f) the process for rejecting or reassessing a valuation;

    (g) the use of external valuers and their periodic rotation;

(h) the reporting of valuations to the committee with delegated responsibilities for the oversight of valuations;

(i) the circumstances in which valuations would be reported to the Board and management; and

(j) the frequency and method for reviewing, revising and approving the valuation policy and the circumstances that would trigger an interim review outside of the regular timeframe.

17. Where an RSE licensee offers an externally managed investment option, a prudent RSE licensee would ensure the investment manager's valuation policy, including its valuation methodology and procedures, are appropriate and consistent with its own valuation policy.

Methodology

Sources of valuation

18. APRA expects that an RSE licensee would ordinarily document its valuation sources and the hierarchy of these sources in its valuation policy.

19. APRA envisages that an RSE licensee would obtain independent external valuation of assets where available.

20. A prudent RSE licensee would also evaluate the strengths and weaknesses of each possible source of valuation, and subsequently determine the steps that would be taken to mitigate any potential risks associated with the chosen source of valuation.

21. There are a number of sources of industry guidance on valuation and APRA expects that an RSE licensee would consider the appropriateness of such guidance. An RSE licensee would typically take the valuation hierarchy into account when considering the nature of the particular investment and the underlying assets. The hierarchy of valuation sources may be determined as:

(a) quoted market prices for investments in active markets that are objective, observable and unadjusted. If these are not available, then

(b) objective, observable quoted market prices for similar investments in active markets. If these are not available, then

(c) quoted prices for identical or similar investments in markets that are not active. If these are not available, then

(d) market-based inputs, other than quoted prices, that are observable for the investments. If these are not available, then

(e) subjective, unobservable inputs for investments where markets are not active.

Valuation approaches

22. There are a number of valuation approaches that an RSE licensee may adopt depending on the type and nature of the investments or the underlying asset. APRA expects that an RSE licensee would also consider appropriate guidance issued by industry associations and/or international standard-setting organisations when developing its valuation methodology.

23. APRA expects that an RSE licensee would use observable quoted market prices or inputs in the valuation process where they are available and appropriate. When using quoted market prices an RSE licensee may consider, in relation to the hierarchy of valuation sources, such factors as:

(a) the characteristics of the asset;

(b) whether the quoted price represents a binding offer or an indicative price, such that a binding offer is given more weight over an indicative price in the valuation process;

(c) the proximity of the quoted price to the valuation date or time;

(d) the market for the asset and current market conditions, including the volume or level of activity; and

(e) the frequency with which prices are made available, which may indicate whether the market for a particular asset is active or inactive.

24. Where the quoted price is a stale price, an RSE licensee would typically consider whether the quoted price is realisable if the asset is sold as of the valuation date. Appropriate adjustments to the quoted market price may be necessary to estimate the price at which the asset can be sold in an arm's-length transaction as of the valuation date.

25. When determining the valuation methodology of investments that do not have quoted market prices, a prudent RSE licensee would consider matters including:

    (a) the nature of the industry of the underlying assets and the current market conditions for that industry;

    (b) the stage of development of the investment (where appropriate); and

    (c) considerations unique to the investment.

26. A prudent RSE licensee would consistently apply the chosen valuation methodology until a change in the methodology is determined to be appropriate to achieve a more accurate valuation in the future. Any changes to the valuation methodology would ordinarily be supported by documentation providing the rationale for the change.

27. Physical assets, such as property and infrastructure, may be valued using a sales comparison approach, where the valuation is based on similar assets. An RSE licensee would ordinarily source and analyse data from the recent sales of similar physical assets, and apply any necessary adjustments to account for differences in the asset to be valued.

28. A sales comparison approach is usually considered by APRA to be appropriate where adequate comparable sales exist. However, the robustness of the valuation may vary with the depth of the particular market for the underlying physical asset (e.g. property type and geographic location).

29. Discounted Cash Flow (DCF) modelling is a common methodology used to value unlisted assets, and may also be used for assets such as direct property and infrastructure, as well as certain fixed-interest and derivative securities. APRA expects that where an RSE licensee has determined DCF modelling to be appropriate, it would source sufficient and statistically reliable market data to derive the necessary model inputs and parameters.

30. When valuing a property asset using DCF modelling, an RSE licensee would review the robustness of the market data used in the DCF model, e.g. rental income, expenses and vacancies. It would also consider other factors that could impact on the valuation assumptions in the DCF model, such as the quality of tenants, length of tenancy, the property condition and the facilities included in the case of a physical property.

31. Where infrastructure assets are valued using DCF modelling, APRA expects that an RSE licensee would be mindful of the sensitivity of the valuation to matters such as operating assumptions, future cash flow generation, investment terms, tax treatment and the risk-adjusted discount rate applied, amongst other things.

32. To provide independent reasonableness checks of the values of the physical asset derived using a particular valuation approach, a prudent RSE licensee would consider applying a range of relevant alternate valuation methodologies. Based on the results of such checks, an RSE licensee would determine whether an adjustment of the existing valuation, or the valuation approach is necessary, e.g. where there is significant dispersion in valuation results.

Interim valuation

33. In the period between a formal valuation of an unlisted investment, a prudent RSE licensee may obtain an interim valuation (e.g. monthly) based on, for example, estimates of a 'roll-forward' of the adopted valuation methodology.
34. An interim valuation would ordinarily incorporate any material changes and information about the underlying asset and current financial market conditions that may alter the value of the investment since the previous formal valuation.
35. The interim valuation may be estimated using a proxy valuation approach, where an index or benchmark is used as a proxy for the movement in the value of an investment in the interim period. APRA expects that an RSE licensee would be mindful that movements in the proxy could depart significantly from the actual movement of the investment value.
36. APRA expects an RSE licensee would ordinarily have a monitoring and review process to ensure that the use of a proxy valuation approach continues to be appropriate. The monitoring process may include:
    - (a) regularly assessing the appropriateness of indices to proxy the movement of the asset value;
    - (b) monitoring the consistency of movements between benchmarks and actual asset values;
    - (c) setting tolerance limits where movements in excess of these limits would trigger a review and/or escalation; and
    - (d) defining the length of time for which an index or benchmark can be used as a proxy for interim valuations.

Assumptions and estimates

37. It is good practice for an RSE licensee to review the reliability and timeliness of the data used when formulating the relevant assumptions that underpin a valuation.
38. There are a number of factors that may have a material impact on the assumptions used in a valuation methodology. For example, an increase or decrease in the cost of equity or debt may require a change in the discount rate used in DCF modelling.
39. An RSE licensee would ordinarily 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.
40. Sensitivity analysis may assist an RSE licensee to evaluate the robustness of assumptions and the extent of potential variability of the valuation to changes in those assumptions.

Models

41. The use of models when determining the value of an investment and/or asset may expose an RSE licensee to potential valuation risks. These risks may arise due to a lack of validity and robustness in the model. As such, APRA expects that an RSE licensee would consider, amongst other things, the following matters when determining the appropriateness of a valuation model:
    - (a) sufficient analysis and justification for the use of the model and its assumptions;
    - (b) the functional scope and limitations of the model;
    - (c) the comprehensiveness of the model in relation to the investment and/or underlying asset to be valued; and
    - (d) circumstances where it would be inappropriate to use the model.

42. Where an RSE licensee has chosen to develop a valuation model in-house, a prudent RSE licensee would have governance arrangements for the adoption and maintenance of the valuation model. This would include:
    (a) formal documentation of the methodology, assumptions and underlying data used;
    (b) formal review and approval procedures, including the role and responsibility of the committee with delegated responsibilities for the oversight of valuations and other relevant persons;
    (c) detection mechanisms to identify inputs and outputs that may be considered invalid or exceed established tolerance ranges;
    (d) checks and reconciliation processes to ensure the ongoing validity of the model;
    (e) periodic testing of the model to identify limitations and assess the effectiveness of the model;
    (f) establishing change controls to maintain an audit trail when changes to the model are required; and
    (g) independent validation and review of the valuation model from time to time.

Use of external parties

Valuation by external investment managers

43. Where an RSE licensee offers an externally managed investment option, a prudent RSE licensee would review the appropriateness of the external investment manager's valuation procedures and controls as part of its due diligence process prior to including the investment in its investment strategy.
44. APRA envisages that an RSE licensee would also develop controls to minimise the risk of subjectivity in valuations obtained from external investment managers. This may be achieved by implementing appropriate checks to monitor the reasonableness of such valuations, which may include tolerance limits for increases or decreases in a valuation that trigger an appropriate review of exceptions.
45. A prudent RSE licensee would also establish documented procedures to manage circumstances where the valuation provided by the external investment manager is considered unsuitable by the RSE licensee.
46. In addition, an RSE licensee's valuation policy would ordinarily outline how any potential conflicts of interest and/or any other identified material risks arising from the external investment manager providing its own valuations might be managed.

Independent external valuers

47. An RSE licensee may consider engaging a service provider to assist with the valuation process. In APRA's view a prudent RSE licensee, as part of its due diligence process, would typically consider the valuation methodology, resourcing, qualification, areas of specialisation and experience of the external valuer prior to their appointment.
48. As with all examples of reliance on external advice, APRA expects that an RSE licensee would ordinarily take appropriate steps to assess the results of the advice provided. This may include, for example, querying the basis for a valuation that appears to depart from movements in fundamental economic factors.

Independent assurance

49. Where considered appropriate, an RSE licensee may engage an external auditor to provide assurance and/or verification of a valuation. APRA expects that an RSE licensee would document the scenarios that would give rise to engaging an external auditor, including the type of engagement and its scope. APRA expects that the external auditor's findings would ordinarily be presented to the committee with delegated responsibility for valuation, or to the Board as required.

Frequency

50. In order to minimise any potential inequity to beneficiaries and the risk of valuation arbitrage, an RSE licensee when determining the frequency of undertaking a valuation, would ordinarily take into account factors such as:

    (a) the permitted frequency of member transactions;

    (b) the frequency of unit pricing/crediting rate updates;

    (c) the type of asset and its investment horizon (e.g. infrastructure);

    (d) access to and sources of valuation information;

    (e) the cost of obtaining a valuation; and

    (f) the prevailing market/economic environment (e.g. greater market volatility resulting in the need for more frequent valuations).

51. In respect of unlisted investments, APRA envisages that an RSE licensee would reconsider on at least a quarterly basis the appropriateness of the investment's valuation. An RSE licensee is expected to consider whether there have been any material changes or other factors that may have caused, or are causing, the existing valuation of the unlisted investment to now be inappropriate. APRA expects that an RSE licensee's assessment would ensure that the current valuation remains appropriate or, where circumstances have changed, would involve undertaking a valuation to determine a more appropriate value. An RSE licensee may also consider undertaking more frequent valuations depending on the characteristics of the investments (e.g. infrequently traded) or where there are changes in market conditions (e.g. greater volatility).

52. Where an investment option contains unlisted investments that are valued periodically, a prudent RSE licensee would generally be expected to stagger the valuations of the investments in that option over the interim period between the valuation dates for the whole investment option to reduce the likelihood of a large fluctuation in the value of the investment option at that valuation date.

53. APRA envisages that there would be a clear basis for determining the frequency of obtaining an independent valuation, and a policy indicating circumstances that would necessitate an immediate revaluation in-between periodic independent valuations. APRA also expects that a prudent RSE licensee would periodically review how frequently each investment is valued to ensure investments continue to accurately reflect their value.

Attachment A – Types of valuation risks

Investment structures

Direct investment

1. Direct investments typically provide an RSE licensee with greater transparency over the valuation process. However, it is the responsibility of an RSE licensee to ensure that the valuation obtained is based on sound and robust methodologies, using reliable data and appropriate assumptions. In addition, APRA expects that an RSE licensee's valuation policy would address how and when direct investments would be revalued in order to reflect current market conditions.

Pooled investment

2. An RSE licensee invested in a pooled investment will generally rely on the valuation provided by the investment manager(s) of the underlying assets and/or the investment manager of the pooled investment. APRA considers it prudent for an RSE licensee to undertake a robust due diligence process of the pooled investment, which would generally include, but is not limited to, gaining an understanding of the nature of the underlying asset(s), the performance reporting framework of the investment manager, and the valuation methodology that is applied by the investment manager to obtain the valuation.
3. A 'fund of funds' structure is where a pooled investment vehicle invests into other distinct sub-vehicles/funds. An RSE licensee may have added difficulty in obtaining details on the underlying exposures due to the complexity of investment layers and/or the opacity of specific underlying sub-funds. As such, APRA expects that an RSE licensee would have sufficient understanding of the nature of assets underlying the investment, and have assessed the quality of the investment manager's valuation and risk management policies and processes as part of the RSE licensee's investment due diligence.
4. In some cases, an RSE licensee may invest through a master life insurance policy issued by a life insurer. This investment structure is similar to investing through a master trust structure, where the life policy represents an additional investment layer and is managed by either a related investment manager or an external investment manager. Accordingly, it remains an RSE licensee's obligation to be fully cognisant of any potential valuation risks or issues that might arise in such arrangements.
5. Where external audit reports of underlying assets are used to provide assurance around a valuation in a pooled investment structure, APRA expects that an RSE licensee would be mindful of the type of opinion/report that has been issued. APRA considers it prudent for an RSE licensee to consider, amongst other things, matters such as:
   (a) the scope of the audit;
   (b) the basis of the opinion;
   (c) the exceptions within a qualified opinion report and their significance to beneficiaries;
   (d) any other regular reviews conducted outside of the audit process; and
   (e) any possible impediments to the auditor's independence and how they were addressed.
6. Some pooled investment vehicles are only revalued at the time of divestment of the underlying assets (e.g. private equity), with the underlying assets generally held at the lower of either cost or net realisable value during the interim period. APRA expects that an RSE licensee would source alternative interim valuation estimates to ensure that the valuation reflects that which can be reasonably expected to be realised. In this case, APRA expects that an RSE licensee would ordinarily consider and formally determine the alternative approach as part of its due diligence process prior to undertaking the investment.

Asset classes

Direct property and infrastructure

7. The valuation of physical assets such as direct property and infrastructure is generally performed less frequently and is highly dependent on the underlying assumptions and the valuation methodology. As the frequency of market transactions is also lower relative to listed assets, there is the potential for misalignment between the valuation and the current market value. As such, APRA expects that an RSE licensee would be cognisant of the potential for misalignment and have appropriate mechanisms to minimise any divergences.

8. A prudent RSE licensee would ordinarily analyse the valuation of assets such as direct property with comparable assets and transactions to assess the reasonableness of the valuation given the current economic environment. APRA considers this particularly important during volatile market conditions. However, APRA expects that an RSE licensee would also consider the limitations of any valuation comparisons given the idiosyncratic features of physical assets.

Private equity

9. For direct private equity investments, the value of the underlying asset, which is typically a business, provides a base for an RSE licensee to estimate the fair value of their portion of ownership in that investment. The value of private equity is largely driven by the achievement of key milestones and the level of investment in the underlying business. Consequently, APRA expects that an RSE licensee would analyse the performance and the financial impact of these activities in order for them to be appropriately incorporated into the valuation of the investment.

10. Private equity may also be influenced by the economy and environment in which the underlying business operates, and the complex interaction of other factors such as geography, credit risk, foreign currency, equity prices and volatility (where relevant). As such, APRA expects that an RSE licensee's valuation process would consider these potential risks when determining the valuation estimates for such an investment.

11. In addition, the valuation of directly held private equity investments may sometimes occur less frequently. Therefore, APRA expects that an RSE licensee would take into consideration and make appropriate allowances that a valuation may not incorporate the impact of any rapidly changing economic conditions in the interim.

Structured unlisted securities

12. Structured unlisted securities, such as collateralised debt obligations (CDOs), collateralised loan obligations (CLOs) and hybrid products (which typically contain features of both debt and equity in varying combinations), may lead to potential valuation issues due to the opaque and complex structure of these investments. For example, CDOs and CLOs are often issued in a number of tranches, creating a hierarchy in terms of the applicable interest and principal obligations of these investments. These reflect different levels of credit exposure for an RSE licensee.

13. Hybrid products may be structured with embedded options and conversion mechanisms that can be triggered under different scenarios (e.g. a corporate event). APRA expects that an RSE licensee would be mindful that the valuation provided by the broker/price-maker would also typically incorporate the illiquidity premium in the market and the individual views of the price-maker in question.

14. In assessing the tradable market value of a structured security, APRA expects that an RSE licensee would have a sufficient understanding and knowledge of, among others, the following determining factors:

    (a) the valuation of the embedded derivatives (e.g. options);

    (b) the degree of subordination of the security in the issuer's capital structure;

    (c) the credit quality of the portfolio;

    (d) the recovery rate that is used to calculate the net loss resulting from a credit event;

    (e) the correlation between the reference entities within the portfolio; and

    (f) the width of the tranches within a structured debt security such as a CDO or CLO. The smaller the tranches within the structure, the fewer the number of credit events required to occur before subsequent losses are borne by the next most junior tranche, therefore increasing the risk of loss to an RSE licensee.

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