

## Submission to APRA Consultation on draft Prudential Practice Guide SPG 530

17 March 2023

We believe it is important to ensure Prudential Practice Guide SPG 530 Investment Governance, provides sufficient clarity to the industry to achieve its goal of supporting the implementation of Prudential Standard SPS 530 Investment Governance. It is also important to ensure consistency between SPS 530 and SPG 530. It is with this lens that we provide this submission to APRA.

### Summary of recommendations to improve SPG 530

#### Stress testing (SPG 530.78-89)

The focus on investment stress testing has been elevated and the extension in the guidance includes more detail on what is required for stress testing and scenario analysis, reflecting the important role of investment stress testing.

#### Frequency (SPG 530.79)

We note an inconsistency in stress testing frequency between the prudential standard and the prudential practice guide. The prudential standard SPS 530.32(b)-(c) calls for stress testing *“on at least an annual basis”*. This contrasts with the prudential practice guide SPG 530.79(d), which states the investment stress testing program would include such areas as... *“determining the frequency with which stress testing would be conducted. APRA expects this would be undertaken at least quarterly...”*. There should be consistency between the SPS and the SPG, unless they are intended to reference different obligations, in which case the respective obligations and associated timing for each should be clarified.

While there may be circumstances that warrant stress testing more frequently than annually, we note this is already sufficiently captured in SPS 530.33(e). This section of the SPS establishes the requirement to include within the comprehensive stress testing program *“circumstances that might lead to ad hoc investment stress testing, including triggers to indicate when ad hoc investment stress testing would be undertaken”*. Therefore, the SPS already appropriately captures scenarios that might warrant stress testing more frequently than annually.

Our recommendation is to reword SPG 530.79(d) to require stress testing *“on at least an annual basis”* to align with the SPS. This will also align with APRA’s response to the SPS 530 consultation period (dated 19 July 2022) where it was stated that *“APRA encourages RSE licensees to undertake a stress testing programme at least annually”*.

#### Stress testing based on actual asset allocation

Stress testing based on the actual asset allocation is mentioned in SPS 530.32(c) for the first time, yet there is no new guidance provided in SPG 530 that assists with implementation of the additional requirements, including no guidance given on the ‘as at’ date for the actual asset allocation data. Additional guidance would support the implementation of the updated SPS 530. We consider that using an ‘as at date’ based on the most recent quarter’s data (at latest) for the actual asset allocation is a practical approach; data older than this may be less reflective of the current asset allocation and hence the results may be less relevant.

Given stress testing based on the actual asset allocation is a new requirement in the SPS, guidance in the SPG that assists with implementation of the additional requirements would be beneficial and support the implementation of the updated SPS 530. Further, we recommend specifying the ‘as at date’ required for stress testing the actual asset allocation – our suggestion is that the (at least) annual assessment is ‘based on the most recent available data, being no older than end of the prior quarter’.

## Valuation governance (SPG 530.95-115)

### Valuation governance framework (SPG 530.95-98)

The draft SPG provides greater clarity of APRA's expectations around valuation governance, however we think the guidance could be clearer regarding expectations on aspects of valuation-related governance (e.g. valuation policy and procedures) by asset owners of their direct investments versus indirect/pooled investments. It is important to highlight that the valuation processes and oversight function for indirect/pooled investments is materially different. A key example is the RSE's inability to influence aspects of the valuation process (via independent experts or otherwise).

- For example, SPG 530.105 states that *"APRA expects an RSE licensee would document its approach for determining the assumptions used..."*. This is simply not possible for investments made via pooled investments – this is however where the role of initial and ongoing due diligence plays a key role.

We consider there are significant unintended consequences of not recognising this difference.

We consider that implementation would be assisted by clarity on any differing APRA expectations for valuation policy for direct investments versus indirect/pooled investments held via an external manager.

- Valuation processes conducted by third parties can be materially different where investments are held in an open or closed-end pooled vehicle, or pursuant to any arrangement where the beneficially-owned investment is structurally owned and/or managed by a fund manager.
- While there is currently some distinction in the SPG (SPG 530.95-115), we consider it would be beneficial for this to be made clearer. We consider these adjustments should acknowledge these different investment approaches (direct versus indirect/pooled investments) and the extent to which related valuation governance processes and procedures may not be as readily available (or even possible) for RSE Licensees where such investments are externally housed and managed by third party agents. This can, for example, impact valuation regularity, methodology, oversight and ability to make out-of-cycle adjustments.

Our recommendation is to formally recognise the different structures (e.g. direct investment, indirect/pooled investments) when considering valuation governance expectations, ensuring the approach is fit for purpose. Ultimately the valuation governance framework should focus more on the policy and processes, to ensure appropriate roles and responsibilities for monitoring and oversight based on the individual circumstances of the RSE licensee.

### Valuation Committee (SPG 530.99-100)

The reference in SPG 530 to this additional option within a fund's organisational and governance framework (SPG 530.99) potentially causes considerable uncertainty for RSE Licensees.

By way of feedback, we outline below our views on this topic:

- APRA could consider providing clearer guidance on the circumstances in which establishing a Valuation Committee would be preferred or expected.
- Whether a Valuation Committee is needed and would add value to the governance of unlisted valuation risks will depend upon fund-specific factors such as scale of portfolio allocations, complexity of the exposures, trustee office resources available and how the investments are originated, housed and managed.
- There may be more valuation risk associated with third party agent processes over which a superannuation fund as beneficial investor potentially has less transparency, knowledge and influence, or the ability to review and manage individual exposures, particularly in circumstances where a valuation becomes inaccurate due to significant/extreme market events/volatility. These risk scenarios would not necessarily be mitigated by having a Valuation Committee.

- Most superannuation funds (representing a significant proportion of total allocations to unlisted assets) already have well-developed valuation policy and procedures.

In addition to the above considerations, the establishment of a Valuation Committee by a superannuation fund trustee office would involve material levels of additional administrative cost and time commitment by both senior investment management and trustee directors, including the potential need for one or more independent non-executive directors.

We think good valuation governance is driven by the appropriate policies and processes. We believe RSE licensees are best placed to determine the governance structure that best and most effectively meets the needs of their entity, taking into account its size, business mix and complexity. We do not think that the establishment of a Valuation Committee structure should be a requirement.

Further, SPG 530.99 currently implies a Valuation Committee is optional – if APRA determines to retain this wording, the specific circumstances where APRA considers a Valuation Committee is appropriate (or expected) should be clarified for the benefit of industry.

### Member equity considerations (SPG 530.9)

We note APRA expects an RSE licensee to enforce a blackout period for members transacting in an MIC option “...around expected asset revaluation periods...”.

We question how workable such a mechanism would be, especially considering unlisted asset portfolio valuations are often staggered across the year. This would result in an effective ban on the right of members to switch for large periods of the calendar year, for which there is no legal or administrative precedent. For example:

- How would this be implemented (likely requiring changes to every relevant PDS), monitored and enforced?
- What is a reasonable period in which to enforce such a ban, equating to “around expected asset revaluation periods”? If it were 30 days prior to a revaluation date, each quarter, this would equate to one quarter of each year (or more) where members rights to switch are curtailed (assuming all valuations are undertaken at the same time each quarter).

To achieve member equity and fairness, it must be a balanced approach.

We think the current wording presents a serious risk of undermining confidence in the superannuation system and we strongly recommend either removing SPG 530.9 or consulting further with industry.

### Due diligence (SPG 530.65)

SPG 530.65 states, “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”. We believe the bold section above is particularly problematic and detracts from good governance.

In practice, there can be differing views, perspectives, priorities and/or disagreement about engaging or retaining an investment manager. This is part of a healthy due diligence process, through the considerations discussed in reaching a decision.

In addition, we consider the stated process, which currently covers decisions to engage or retain an investment manager, should specifically also include documenting the rationale for holding the manager, plus the fund’s expectations underpinning why a decision to invest, retain or terminate was made. This also helps future governance in properly assessing the satisfactory fulfillment or otherwise of a particular investment manager, hence any decision to retain or terminate an investment manager.

We recommend removing the identified problematic wording, “that recommendations from such consultants or advisors are consistent with the RSE licensee’s views” and suggest that SPG 530.65

reads as follows “Where an RSE licensee engages asset consultants or other advisors to support the due diligence process about whether an investment manager should be engaged, retained or terminated, that any potential conflicts of interest are appropriately identified and managed”.

An alternative is to re-word it as two distinct paragraphs, one focused on decisions to engage or retain (or terminate) an investment manager, and one focused on managing conflicts of interest during this process.

Alternative paragraph 1: “Appropriate due diligence must support any decision to engage, retain or terminate an investment manager, regardless of whether an RSE licensee engages an asset consultant or other advisors to support the due diligence process”.

Alternative paragraph 2: “Where an RSE licensee engages asset consultants or other advisors to support the due diligence process, an RSE licensee should ensure that any potential conflicts of interest are appropriately identified and managed”.

### **Additional ESG impacts (SPG 530.73-74)**

We view ESG considerations as a key investment consideration and we acknowledge that this is an evolving area.

SPG 530.74 refers to environmental or social impact related objectives as “*additional non-financial objectives*”.

We recommend removing the reference to “*non-financial*” given APRA has identified these as “*distinctly financial in nature*”. This would align with SPG 530.73 where it is simply referred to as “*additional objectives*”.

### **General comments**

#### **Frequency of periodic reviews**

References to the conduct of periodic reviews “*regularly*” – for the avoidance of doubt, APRA should provide a more specific review timeframe, as this term is subjective, open to a broad range of interpretation and so may not result in desired outcomes.

We recommend specifying a timeframe (e.g. at least annually) as opposed to using the term “*regularly*”.

#### **Linkages between SPS and SPG**

There are several sections in the integrated version of the SPG, where the link back to the quoted SPS section is unclear (e.g. page 29 of SPG 530 regarding liquidity management). In this example, it links SPS 530.37-38 which is about periodically reviewing key liquidity risk metrics and implementing liquidity stress testing as part of the comprehensive investment stress testing program, with SPG 530.94 which is about the potential impact to beneficiaries of secondary risks associated with liquidity risk.

We recommend reviewing linkages between SPS and SPG in the integrated version of SPG 530 to ensure linkages and related expectations are clear.

We trust APRA finds this of assistance to its consultation process.

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