The governance of unlisted investment valuations

May 2023

Introduction

For the superannuation industry, the governance of unlisted investment valuations is ultimately all about member equity.

To protect and improve member financial interests, it's crucial to ensure accurate pricing of each member account and therefore each asset in the fund's portfolio that impacts the member's balance. Since members have the freedom to transfer their accounts at any time, this responsibility is ongoing and essential.

Unlisted investments create unique valuation challenges for funds, both under business-as-usual conditions and (particularly) through periods of market volatility.

To manage these challenges responsibly and thoroughly, and to mitigate the associated risks inherent in unlisted investment valuations, valuation governance frameworks must be carefully structured and regularly reviewed. This ensures they are fit for purpose in a constantly changing regulatory environment.

Regulatory backdrop

The Australian Prudential Regulation Authority (APRA) supervises institutions across banking, insurance and superannuation to promote financial system stability in Australia. However, financial markets are often far from stable, sometimes for considerable periods, and for unlisted or illiquid investments, this raises a variety of valuation issues that require their own, carefully crafted system of governance.

Recognising these challenges for Registered Superannuation Entity (RSE) licensees (i.e. most superannuation funds), APRA has been increasingly scrutinising and re-regulating the governance of unlisted valuations.

An unlisted asset valuation thematic review was launched in October 2021 in response to heightened market vulnerability prompted by COVID-19; increased member switching; and the Government's expansion of the early release of the superannuation program. The review examined unlisted asset valuation practices among 31 trustees selected according to their level of exposure to unlisted assets and known competency in valuation governance.

Key findings included:
- trustees demonstrated a proactive approach to revaluing unlisted assets in response to heightened market volatility
- revaluation frameworks needed improvement
- board engagement was often limited
- some trustees relied overly on external parties
- trustees with pre-existing valuation committees typically had more robust valuation frameworks.

APRA concluded that the review:
- highlighted the risks and vulnerabilities that trustees must have front of mind to drive better practices and improve outcomes for members
- gave cause for RSE trustees to review the governance issues raised, including revaluation frameworks and the extent of board engagement, plus whether the size of the fund's allocation to unlisted assets warranted the establishment of a valuation committee.

New regulation

2022 changes to SPS 530 (Investment Governance)

The governance of valuations was previously not included within any Prudential Standard at all. Valuations were covered in the 2013 SPG 531, a Prudential Practice Guide which unlike an SPS entails no legal obligation, so this is a significant change. Most clients we have worked with have a documented section on valuation governance, albeit in some cases less detailed than what is now in the SPS.

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.

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

- Roles and responsibilities for the oversight and management of valuation processes and procedures, including of the board, relevant board committees and senior management (valuation authorities).
- Key metrics and information that must be reported to the valuation authorities and the frequency of that reporting.
- Valuation methodology employed for each asset class (and sub-asset class and instrument/holding vehicle type where relevant), including the sources of valuation inputs.
- Circumstances where independent external valuations must be obtained.
- 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.
- Circumstances where interim valuations are required to ensure the approach taken is consistent and transparent.
- Added emphasis relative to SPG 531, in particular, escalation processes.

Clearly there is a lot in these regulatory obligations in terms of the necessary valuation governance framework to monitor and maintain accurate unlisted investment valuations. This includes a greater focus on valuation-related inputs being understood by the RSE licensee board, effectively delegating upwards these framework obligations.

2022/23 changes to SPG 530 (Investment Governance)

APRA's 1 January 2023 changes to Prudential Standard SPS 530 marked its first update in a decade to this key regulatory standard for superannuation funds.

This was followed by significant changes proposed (and opened to industry consultation until March 2023) to SPG 530, the Prudential Practice Guide designed to assist RSE Licensees interpret and implement SPS 530. Frontier lodged our own submission to the APRA SPG 530 consultation process.

Frontier also issued a Regulatory Update providing a summary analysis of these changes and outlining how to assist trustee boards and management adjust their governance frameworks and systems in response.

Ultimately each fund's response involves a customised solution. One which is fit for purpose to the fund's organisational structure, portfolio allocations to private markets, approach to accessing unlisted/illiquid assets and its existing policy and delegation framework.

SPG 530 (draft) changes

APRA expects an RSE licensee to ensure the investment governance framework appropriately considers member equity risk, including:

- enforcing a blackout period for members transacting in the option around expected asset revaluation periods, relative to underlying asset liquidity – *this is an extremely difficult operational and fiduciary challenge*
- 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
- monitoring arrangements for single sector investment options where the revaluation and liquidity impacts are amplified due to the greater concentration of exposures.

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.

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.

While this key principle and responsibility is the case for both listed and unlisted investments, much of the guidance is specific to unlisted asset valuation considerations.

The SPG does not clearly differentiate regulatory expectations for valuation governance involving co-investments or direct investments relative to investments originated or accessed via an external manager. There are differing levels of transparency and control over valuation processes depending on each fund's approach to investing in private markets.

An RSE licensee's valuation framework should ensure:

- Effective board and management oversight, robust policies and processes, and the allocation of adequate expertise and resources to the valuation of investments.
- A board approved valuation policy that is well understood by those responsible for its application.
- 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.
- Valuations are supported by appropriate judgements and assumptions.
- Valuation inputs are appropriately and regularly calibrated.

A key requirement is the obligation (and desirability) of achieving operational and structural independence between those responsible for investment decision-making and those responsible for undertaking the valuation of investments. This can be difficult to achieve in practice, particularly where some level of internalisation is in place or being implemented.

Somewhat related, and a key mitigant to the risks of potential and perceived conflicts in valuation governance, is the requirement for adequate oversight and assurance – both by internal staff and external independent third parties – this process would review the control environment supporting the valuation process, assess 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.

Where an RSE licensee relies on valuations undertaken by external managers, APRA expects the RSE licensee to be able to demonstrate:

- 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.
- 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.
- 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.

It is important 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. For some funds, particularly those with larger and more complex portfolio operations, the use of a valuations committee is increasingly looking like an attractive structuring option to lift the standards and capability of a fund's unlisted investment valuation governance framework.

There are a variety of additional valuation governance responsibilities requiring consideration and potentially adjustments to frameworks and implementation, including:

- Where a board delegates oversight of valuation processes to a board committee, APRA expects the committee would be made up of people with sufficient skills, knowledge and information to provide meaningful oversight of valuation processes.
- Where an RSE licensee offers an externally managed investment option, they should review the investment manager's valuation policy to determine whether it is appropriate and consistent relative to its own valuation policy.
- Valuation methodologies should ensure valuations are reflective of the asset's true value, are completed in a timely and objective manner and can employ more than one method to arrive at a better estimate, where appropriate to do so. There is a lot more in this area to consider!
- APRA expects an RSE licensee would determine the circumstances where valuations will be reported to the board and management. This likely includes the governance of out-of-cycle, interim or disputed valuations.

Conclusions

Both the SIS Act and Prudential Standard SPS 530 require trustees to "develop, maintain and implement an effective valuation governance framework". Trustees also have an obligation to treat all members equitably, so having reliable valuation processes and information are critical to achieving fiduciary responsibility.

Trustees need to pay particular attention to unlisted investments held both by their fund managers and held directly or via co-investment and other often complex multi-layered ownership and taxation structures. Increasingly funds are establishing or considering separate valuation governance committees. Frontier can help set up and operate those bodies, along with the structuring of more detailed valuation governance policy frameworks targeting leading industry practice in this increasingly key area of investment governance.

Frontier Advisors' Investment Governance Team offers a range of services to assist RSE licensees address the regulatory risk in this area. We offer independent reviews of frameworks, provide advice and assurance, identify and mitigate risks, recommend procedure adjustments and upgrades, and facilitate ongoing oversight of governance policies and systems.