



GUIDANCE NOTE: MONITORING INVESTMENT RISK IN KIWISAVER SCHEMES

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Financial Markets Authority

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ABOUT THIS GUIDANCE NOTE

This Guidance Note is designed to assist Trustees of retail non-restricted KiwiSaver schemes (Trustees), in performing their functions effectively.

It outlines FMA's expectations of the monitoring activities that Trustees need to carry out in order to satisfy themselves that KiwiSaver managers (Managers) are complying with their relevant obligations, and appropriately and effectively managing investment risk.

We have identified investment risk as a key risk for KiwiSaver investors and expect Trustees to make the monitoring of KiwiSaver scheme investment risk management a priority in their role as frontline supervisors.

Trustees have asked that we provide guidance on the application of Rule 1C of the KiwiSaver scheme rules (Schedule 1 of the KiwiSaver Act 2006), and we set out our guidance on this Rule and FMA's expectations of Trustees in this Guidance Note.

Our guidance is based on regulatory requirements at December 2013, and should be read in conjunction with FMA's Guidance Note *Monitoring by Securities Trustees and Statutory Supervisors (June 2013)*, which sets out our general expectations of licensed securities trustees and statutory supervisors' monitoring activities.

This Guidance Note may also be of interest to Managers, as it explains how their Trustee may supervise their KiwiSaver scheme management.

OVERVIEW

Purpose of this Guidance Note

Issuing guidance is one of the ways we strive to be transparent about our regulatory approach. Our aim is to help market participants perform their roles and improve their understanding of FMA's approach and the way we interpret and intend to apply the law relating to Trustees' responsibilities.

This guidance note is intended to assist Trustees of retail non-restricted KiwiSaver schemes in carrying out their role effectively. It does not specify the processes and procedures each Trustee must undertake to effectively perform their role, but sets out our general expectations. Trustees should use the principle of investor protection as a guide when monitoring Managers.

We do not address the question of disclosure of investment risk to investors as this was addressed in our report to KiwiSaver Managers on Monitoring of KiwiSaver Offer Documents in June 2013. This report, and in particular our specific comments on ensuring that disclosures of investment policies and objectives, are consistent with Managers' actual investment strategies and sufficiently address applicable risks, should inform Trustees' approach in their monitoring of Managers' investment risk management.

While our expectation of Trustees as frontline supervisors is high, the success of the Trustees' supervision model will be increased by a productive relationship with FMA. We would like to develop a mutually supportive relationship with an emphasis on our joint roles of investor protection. This Guidance Note is intended to form part of that relationship.

Background

KiwiSaver is one of our key priorities. Effective regulation of the KiwiSaver sector is an important part of achieving our overarching objective of promoting confidence in New Zealand's financial markets.

For many New Zealanders, KiwiSaver will be the first investment they make and may represent a large part of their retirement savings and ultimate financial security. Many of these investors are inexperienced in investment matters and vulnerable as a result. A serious adverse outcome for investors in one KiwiSaver scheme may result in a wider loss of investor confidence in KiwiSaver as a whole, with serious negative consequences for our financial markets.

Ensuring high standards for KiwiSaver schemes is important. High performing, well managed KiwiSaver schemes will encourage New Zealanders to invest in KiwiSaver and will help to support the public's confidence in investment generally.

KiwiSaver represents a primary pillar of New Zealand's financial system and the economy more broadly. Participants involved in the management and distribution of KiwiSaver schemes need to ensure they meet regulatory standards and act with investor interests in mind.

FMA has identified a range of risks that could arise during a KiwiSaver scheme lifecycle and which could potentially, adversely impact on investor confidence in KiwiSaver. One key risk identified is that KiwiSaver Managers could fail to appropriately manage investment risk. This failure could result in sub-optimal returns for their KiwiSaver scheme members. Accordingly, monitoring KiwiSaver investment risk is a key focus for FMA.

Our intention is to control this risk by ensuring that there is adequate supervision of KiwiSaver Managers' investment management by the Trustees, and that KiwiSaver Managers are aware of their responsibilities.

Trustees are required to have adequate and appropriate supervision policies, procedures and controls in place for the monitoring of investment risk in order to comply with Rule 1A of the KiwiSaver Scheme Rules (Schedule 1 of the KiwiSaver Act 2006), under which a Trustee (when exercising its powers and performing its duties as a Trustee) must:

- act in the scheme members' best interests; and
- exercise the care, diligence and skill that a prudent person engaged in the profession or business of acting as a trustee would exercise in acting as the trustee of a KiwiSaver scheme.

The legal basis for requiring KiwiSaver Managers to have appropriate investment management policies, procedures and controls in place is derived from the materially corresponding provisions in Rules 1B and 1E of the KiwiSaver scheme rules.

Under Rule 1B, a Manager must:

- when exercising its powers and performing its duties as a Manager, act in the scheme members' best interests and (unless exercising a power of investment – see 'Rule 1E' below) exercise the care, diligence and skill that a prudent person engaged in the profession or business of acting as a Manager would exercise in managing others' affairs; and
- use its best endeavours and skill to ensure that the scheme's affairs are conducted in a proper and efficient manner.

Under Rule 1E:

- all money belonging to a scheme and available for investment must be invested in accordance with the Trustee Act 1956 provisions as to the investment of trust funds; and
- the Manager (and any investment manager) must, in exercising a power of investment, exercise the care, diligence and skill required of a trustee by section 13B or 13C of the Trustee Act (i.e. the care, diligence, and skill that a prudent person engaged in the profession, employment, or business of acting as a trustee or investing money on others' behalf would exercise in managing others' affairs).

MONITORING KIWISAVER INVESTMENT RISK MANAGEMENT

What is investment risk?

Investment risk is classified as the risk that:

- Managers fail to implement their investment strategies with the necessary standard of care, diligence and skill; and/or
- the scheme's investments are not made in accordance with:
 - the scheme's Statement of Investment Policies and Objectives (SIPO), or the equivalent document which establishes and records the scheme's investment strategy; and
 - the scheme's trust deed.

While investment strategies are determined by the Manager, the investment risk is ultimately borne by individual members of KiwiSaver schemes and the Manager's investment decisions have the potential to impact the value of members' investments.

This definition of investment risk does not include market risk. A Manager may act with the necessary standard of care, diligence and skill but, nevertheless the market values decrease. Market risk is a normal hazard of investing. FMA cannot require the Trustees, in performing their supervision of Managers and schemes, to remove market risk.

Our review of Trustees' KiwiSaver supervision plans

In mid-2013, as part of FMA's ongoing monitoring of the KiwiSaver sector, we undertook a thematic review of Trustees' supervision of KiwiSaver scheme investment risk management.

The primary purpose was to determine whether Trustees were adequately supervising Managers, to satisfy themselves that Managers:

- have appropriately detailed investment strategies in place¹
- carry out research and analysis with the necessary standard of care, diligence and skill before investing
- manage their investments with the necessary standard of care, diligence and skill
- implement their investment strategies in accordance with the SIPO or equivalent document which establishes and records the scheme's investment strategy
- implement their investment strategies in accordance with the trust deed.

During our review, we wrote to, and met with Trustees to discuss their supervision plans for monitoring KiwiSaver Managers and schemes. We asked for copies of their KiwiSaver supervision plans and reviewed and commented on them, with a particular focus on how Trustees were monitoring KiwiSaver Managers' investment risk management.

¹ Section 164(1) of the Financial Markets Conduct Act 2013 provides guidance in this regard.

FMA's review concluded that Trustees' supervision plans could be enhanced and tailored to provide more comprehensive and robust monitoring of Managers' investment risk management.

Summary

The results of our review showed that while Trustees are monitoring Managers' investment management, there is a need to develop more comprehensive and robust supervision plans.

Our post review feedback highlighted our expectations that Trustees should ensure:

- they take a proactive approach to monitoring Managers
- their supervision plans are specific to, and tailored for, KiwiSaver schemes and Managers
- they regularly review their supervision plans to ensure they continue to be relevant and adequately address the risks specific to each supervised scheme.

FMA expects that Trustees would review the following key components within Managers' investment management to satisfy themselves that Managers have the following robust processes in place:

- clearly defined governance structures and processes
- clear, current and appropriately detailed investment strategies
- robust investment management processes
- independent custodial management and reconciliation of scheme assets
- robust internal and external audit processes
- regular informal and formal reporting to both management and the scheme's Trustee.

Our expectation about the policies, procedures and controls that Trustees and Managers need to have in place is in line with what is usually required to meet the requirement to *exercise prudent professional care, diligence and skill* – as set out in Schedule 1 of the KiwiSaver Act: KiwiSaver scheme rules.

TRUSTEES' ROLE IN MONITORING INVESTMENT RISK MANAGEMENT

Under the KiwiSaver Act 2006 (as amended by the KiwiSaver Amendment Act 2011), Trustees of KiwiSaver schemes (other than restricted KiwiSaver schemes) must supervise the Manager's core functions, which include managing scheme investments and property. Trustees cannot delegate this function.

Managers have a fiduciary obligation to scheme members and supervision by the Trustee does not diminish or remove this obligation.

It is the responsibility of Managers, in the first instance, to ensure that they or their investment managers are investing in accordance with the SIPO and that the SIPO is appropriate for the scheme membership and reflects the trust deed and offer documents. Trustees are responsible for monitoring Managers' compliance with those obligations.

The KiwiSaver scheme rules provide statements of general principle, rather than detailing prescribed requirements for prudent professional Trustee practice and prudent professional Manager practice. This leaves it open for different practices to be appropriate to reflect the specific circumstances of each KiwiSaver scheme and allows Trustees to tailor their supervision.

Key components of investment risk management monitoring

FMA expects Trustees to ensure they have appropriate monitoring mechanisms in place to ensure Managers are adequately managing investment risk within KiwiSaver schemes. Trustees' monitoring should include the following:

1. Specific and tailored risk-based supervision plans:
 - Supervision plans should be appropriate to the individual Manager and scheme and should be regularly reviewed and adjusted over time
 - Trustees should have a clear understanding of, and appropriate monitoring strategies in place to reflect, the investment management strategy and specific risks of the Manager and scheme
 - Some KiwiSaver scheme investment management structures may make the monitoring and management of investment risk more complex. Trustees should tailor their monitoring and reporting requirements to reflect the structure and complexity of the scheme's investments.

For example:

- KiwiSaver schemes with a 'manager of managers' investment structure will have multiple investment managers and layers of management. Investment risk may be increased if the Manager has inadequate oversight of investments made by their sub-manager(s), including whether the assets of the scheme are being invested in accordance with the scheme's SIPO. Trustees' monitoring of these schemes should mitigate the specific risks created by such a structure.
 - FMA expects that Trustees' monitoring would be more comprehensive for multi-manager structures to reflect the more complex multiple manager layers.
2. Regular review to ensure the Trustee has an informed understanding of the investment risk applicable to each KiwiSaver scheme, including:
 - ensuring the supervision plan contains a clear focus on monitoring investment risk management and specifies the process for such monitoring
 - satisfying themselves that the Manager has an appropriate investment governance framework for setting scheme investment strategies and monitoring the Manager's investment decisions for consistency with these strategies
 - having a clear, current view on whether the Manager's investment strategies contain an appropriate level of detail and are consistent with the descriptions contained in the offer materials for the investment funds on offer within the scheme.
 3. A process to evaluate key risks and consider the Manager's controls over the risks, including obtaining, through appropriate testing, confidence that the Manager's risk controls adequately identify and mitigate factors that may lead to identified investment risks.

4. Use of pro-active monitoring tools, including:
 - regular formal and informal meetings with Managers to discuss the implementation of investment strategy and compliance with the SIPO and investment procedural requirements
 - regular evaluation of whether the SIPO retains an appropriate level of detail
 - regular monitoring of the consistency of the Manager's investment strategy with offer documents and the trust deed
 - obtaining regular updates of the Manager's performance and whether it is in line with the SIPO limit breaks, performance benchmarks and objectives.
5. Use of information from the Manager, including:
 - requiring tailored reporting from Managers, which should be regularly reviewed for appropriateness and include sufficient information to allow the Trustee to test, as appropriate, that investments remain within guidelines
 - developing procedures to satisfy themselves that the Manager escalates and remedies any issues or breaches expediently.

Good governance and processes minimise risk

FMA expects that Trustees' monitoring of Managers' investment management processes will include reference to monitoring, and reviewing as appropriate, the Manager's procedures. For example, this may include, where appropriate, the Manager's:

- investment governance arrangements (e.g. the investment committee's role/responsibility)
- oversight and controls (e.g. reporting requirements) in place for any sub-contracted managers
- process for making investment decisions, including the due diligence, risk assessment of, and approval process for, any new investments (including assessing whether decisions are being made by people with appropriate skills)
- process for rebalancing investment portfolios
- process and controls to ensure compliance with, and avoid breaches of, investment guidelines
- performance monitoring processes and reporting mechanisms
- issue management and escalation process (to ensure issues or breaches are identified and reported both internally to an appropriate governance level of management and externally to the Trustee)
- reconciliation processes and arms-length controls which are in place to ensure compliance, including internal and external audit controls
- robust record-keeping and reporting processes.

Detailed investment strategies help manage investment risk

KiwiSaver scheme investment strategies are determined by the KiwiSaver Manager. The scheme's SIPO should include clear, specific and measurable risk and return objectives, investment parameters and benchmark asset allocations for each investment fund within the KiwiSaver scheme.

We would expect that Trustees' supervision plans would include some form of the following to satisfy themselves that investments made by the Manager are 'appropriate' for both the scheme and its members and meet the criteria in the SIPO and the trust deed. We do not expect Trustees to second guess the

Manager's investment strategy, but consider it appropriate for Trustees to look at a scheme's investment strategy in terms of:

- reviewing the SIPO to satisfy themselves that the investment strategy is consistent with:
 - the scheme's overarching objectives and purpose
 - the scheme's trust deed
 - the scheme's offer documents
 - members' best interests,and that individual investment fund strategies are true to label (i.e. are reflective of their fund name)
- conducting a 'sense check' of the SIPO based on the Trustee's experience
- monitoring whether the SIPO is subject to appropriate review and stress testing on a periodic basis to ensure the investment strategy remains relevant and appropriate
- reviewing the adequacy of the policy and process in place to determine if and when there may be a need to review or change the SIPO
- requiring notification and explanation of any proposed changes to the SIPO
- reviewing the approach to research and process for approving new funds/investments to satisfy themselves that there is an effective due diligence process in place to ensure that selected new investments will fit within the SIPO and offer documents
- satisfying themselves that there are appropriate performance monitoring processes in place to measure and assess whether the investment objectives are being met and remain suitable.

The application of Rule 1C of the KiwiSaver scheme rules

Trustees have requested that FMA provide guidance on the application of Rule 1C of the KiwiSaver scheme rules. Rule 1C states:

- “(1) The trustee must comply with every direction of the manager relating to the acquisition or disposal of scheme investments and property, unless subclause (2) applies.*
- (2) The trustee must refuse to act on a direction of the manager relating to the acquisition or disposal of scheme investments or property if the trustee considers that the proposed acquisition or disposal:*
- (a) would be in breach of the trust deed or an enactment; or*
 - (b) would be manifestly not in the best interests of the members of the scheme.*
- (3) If the trustee refuses to act on a direction of the manager, the trustee must notify the manager and FMA in writing of the trustee's reasons for refusing to do so.”*

Rule 1C reflects the fact that the Manager is responsible for managing scheme investments. It also recognises that the Trustee holds all scheme investments on trust (either directly or through a custodian), and is therefore in a position to provide high level oversight of the Manager's investment decisions.

It is our expectation that Trustees should have a high level of oversight of Managers' investment decisions and the ability to intervene and take action if and when necessary. It is not intended the Trustee should have a high level of involvement in the Manager's investment decision-making process.

The practical application of Rule 1C will depend on the specific circumstances of each KiwiSaver scheme. Trustees will need to establish scheme-specific processes to ensure they give effect to Rule 1C in accordance with their duty to exercise appropriate care, diligence and skill.

We make the following general observations on the practical application of Rule 1C:

- (a) To meet the requirements of Rule 1C(2)(a), Trustees will need a clear and complete understanding of not only the trust deed provisions relating to the KiwiSaver scheme's investments but also the SIPO. Retail KiwiSaver schemes' trust deeds typically require the scheme's or a fund's assets to be invested in accordance with the investment policy for the scheme or that fund, meaning that if a proposed acquisition or disposal will breach a scheme's SIPO then it may trigger Rule 1C(2)(a).
- (b) Under Rule 1C(2)(b) if the Trustee considers that (despite complying with the trust deed and legislation) a proposed investment decision is manifestly not in the best interest of the members then it must refuse to act. A proposed decision may fall within Rule 1C(2)(b) even though it meets the investment criteria set out in the trust deed.

We consider that the specific use of "*manifestly*" indicates that a clear and obvious detriment to members must be identified before a Trustee must refuse to act on a Manager's direction. We consider it will be rare for a Trustee refusal to occur under Rule 1C(2)(b) in the context of investment decisions that:

- comply with an adequately detailed investment strategy that is reflected in offer documents and, therefore, involve risks which have been clearly identified and explained to investors; and
- relate to a KiwiSaver scheme that follows an '*orthodox*' investment strategy i.e. involving a diversified portfolio of investments from the major asset classes.

There may be greater scope for a Trustee refusal in the context of more targeted or specialised investment strategies, such as ethical investment or investment involving complex derivative instruments.

- (c) Based on the analysis of the trust deed and the SIPO and the specific circumstances of the KiwiSaver scheme, the Trustee will need to establish a robust process for checking whether it is required to refuse to act on an investment direction. This process will be informed by a number of factors, including:
 - The level of prescription contained in the trust deed and the SIPO – a higher level of prescription creates greater scope for breaches and therefore requires more robust monitoring under Rule 1C(2)(a).
 - The nature of the investment strategy – the checks that are appropriate under Rule 1C(2)(b) for a KiwiSaver scheme that follows an '*orthodox*' investment strategy may be different to those for a scheme with a more targeted or specialised investment strategy.
 - The Trustee's level of comfort with the Manager's investment governance policies, processes and controls.

(d) The Trustee's processes are likely to involve the identification of 'red flag' transactions that may warrant particular scrutiny and discussion with the Manager. The 'red flag' transactions will depend on the specifics of the scheme, but could include:

- Related party transactions
- Complex investment assets
- Large asset concentrations
- Significant reweighting of assets or between asset classes
- Unusual transaction volumes
- Investment decisions that appear unusual based on the Trustee's expertise, experience and judgment.

(e) In the context of a KiwiSaver scheme or investment fund that follows an 'orthodox' investment strategy, FMA recognises that it is unlikely to be practicable for the Trustee to authorise the Manager's daily investment buys/sells in advance. However, it will be important for the Trustee to have a high level of comfort around the Manager's internal investment governance procedures (including procedures around monitoring and reporting limit breaks) and clear visibility of investment decisions that are made.

Where a KiwiSaver scheme has a more targeted or specialised investment strategy we expect the Trustee to tailor its monitoring to suit. This may require applying a higher level of scrutiny to the investment decisions in order to satisfy itself that the investments made do not breach the scheme's trust deed and do not meet the '*manifestly*' test.

(f) As with all aspects of a Trustee's supervision plan, the process for overseeing Managers' investment decisions under Rule 1C must be regularly reviewed to ensure it continues to be relevant and adequately address the risks specific to each supervised KiwiSaver scheme.

In summary, FMA considers that Rule 1C provides a valuable layer of protection to investors through the provision of high-level oversight by Trustees, as experienced financial markets participants. Trustees are expected to fully utilise their expertise, experience and judgment in performing this function.

SUPPORTING GUIDANCE

When considering their role as a KiwiSaver Trustee, Trustees should also refer to our previous guidance:

- *Monitoring by Securities Trustees and Statutory Supervisors (June 2013)* – which sets out FMA’s general expectations of Licensed Securities Trustees and Statutory Supervisors monitoring activities.
- *Monitoring of KiwiSaver Offer Documents (June 2013)* – which sets out our view on the appropriate approach to disclosing in KiwiSaver scheme offer documents the Manager’s investment policies and objectives, the applicable investment risks and how those risks are mitigated.



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