



BANK OF PAPUA NEW GUINEA

**SUPERANNUATION PRUDENTIAL STANDARD
1/2008**

**AUTHORISED SUPERANNUATION FUND
INVESTMENTS**

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PART 1—PRELIMINARY

- 1) **Title:** This Standard may be cited as *Superannuation Prudential Standard 1/2008 Authorised Superannuation Fund Investments*.
- 2) **Authorization:** The Bank of Papua New Guinea (“Central Bank”), acting under Section 43 of the *Superannuation (General Provisions) Act 2000* and all other powers enabling it, determines this Standard.
- 3) **Application:** This Standard prescribes requirements about Authorised Superannuation Fund (ASF) investments and related matters. All ASFs and relevant licence holders must comply with it.
- 4) **Interpretation:** In this Standard, unless the contrary intention appears—
 - a) “Act” means the *Superannuation (General Provisions) Act 2000*, and regulations, other prudential standards, licences, authorities and other instruments made under or for the purposes of that Act.
 - b) “associate”, in relation to a person, means any of the following—
 - i) a relative of the person;
 - ii) a body corporate of which the person is a director;
 - iii) an employee or partner of the person;
 - iv) if the person is a company—
 - (1) a director of the company; or
 - (2) a subsidiary of the company; or
 - (3) a director or employee of a subsidiary of the company;
 - v) in relation to a body corporate or a trust—if the person has an agreement or arrangement with another person with respect to the acquisition, holding or disposal of shares or other interests in the body corporate or trust, or under which they undertake to act together in exercising their voting power in relation to the body corporate or trust—the other person.
 - c) “custodian” means a person that provides services generally called custody services to licensed trustees or licensed investment managers of ASFs.

Commentary

1. Custody services include services such as clearing, settlements, safekeeping of assets, investment administration and reporting to the trustees or investment managers. They do not include investment management services.

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- d) “derivative” means a financial asset or liability the value of which depends on or is derived from other assets, liabilities or indexes.
- e) “investment management agreement” means an agreement between the licensed trustee of an ASF and an investment manager for the provision of investment management services for the ASF.
- f) “market value” of an asset means the amount that it would be reasonable to expect a buyer to pay for the asset if the parties to the transaction were dealing with each other at arm’s length.
- g) “security” or “securities” as defined in the *Securities Act 1997* means any interest or right to participate in any capital, assets, earnings, royalties, or other property of any body corporate, and includes–
 - i) equity securities, debt securities, or units, or any interest in or right thereto; and
 - ii) any interest in or right to be paid money that is, or is to be, deposited with, lent to, or otherwise owing by any person (whether or not the interest or right is secured by a charge over any property); and
 - iii) an interest in or right to a share in the capital of a unit trust; and
 - iv) any such interest or right, or class or kind of interest or right that is declared by the Minister, acting on a recommendation of the Securities Commission, by notice in the National Gazette to be securities for the purposes of the *Securities Act 1997*; and
 - v) any option to acquire, or renewal or variation of the terms or conditions of any thing, right or interest referred to in Paragraphs (g)(i) to (iv) (inclusive),

but does not include any such interest or right, or class or kind of interest or right that is declared by the Minister, acting on a recommendation of the Securities Commission, by notice in the National Gazette not to be securities for the purposes of the *Securities Act 1997*;

Commentary

1. Assets acquired for no consideration, for less than market value or for more than market value are valued at market value. In particular, the ASF’s interest in leased property (either as lessor or lessee) is valued at the market value of its interest in the property.

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Commentary on definitions

1. The following are defined in section 3 of the Act:
 - “ASF”
 - “entity”
 - “group”
 - “financial accommodation”
 - “member”
 - “property”
 - “relative”

- 5) **Market value:** For the purposes of this Standard, the value of an asset of an ASF is its market value. It is irrelevant what consideration was paid to acquire the asset.
- 6) **Commentary:** Commentary in this Standard is included for guidance.

PART II—STATEMENT OF POLICY

- 7) **Purpose:** This Standard prescribes requirements about ASF investments and related matters.
- 8) **Scope:** All ASFs and relevant licence holders must comply with this Standard.
- 9) **Responsibility:** It is the responsibility of the board of directors of the licensed trustee company and relevant licence holders to comply with this standard.

PART III—INVESTMENT MANAGERS AND CUSTODIANS

10) *Appointing Investment Managers*

- a) The licensed trustee of an ASF must not advertise or seek expressions of interest for appointment of a licensed investment manager before it has notified the Central Bank as required by section 126B of the Act.

Commentary

1. Section 126B of the Act requires the licensed trustee to inform the Central Bank when contemplating appointing or changing investment managers. The Central Bank may then require the licensed trustee to:
 - appoint an independent probity officer, to advise the licensed trustee on matters of transparency and probity connected with the appointment, and
 - report to the Central Bank on the appointment process.
- b) In selecting a licensed investment manager, the licensed trustee of an ASF must—
 - i) use proper tendering and selection processes; and
 - ii) conduct all necessary and appropriate “due diligence” inquiries into proposed licensed investment managers.

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- c) An appointment of a licensed investment manager for an ASF must be in writing.

11) Investment Management Agreements

- a) The licensed trustee of an ASF must ensure that, so long as the appointment of a licensed investment manager lasts, there is in force at all times a written investment management agreement between the licensed investment manager and the licensed trustee that complies with the Act and this standard.
- b) An investment management agreement must—
 - i) clearly set out the terms on which the licensed investment manager is engaged, including the fees payable to the licensed investment manager and how the costs and expenses incurred by the licensed investment manager are to be borne; and
 - ii) clearly set out the functions and duties that each party is to perform; and
 - iii) require the licensed investment manager to comply at all times with the Act and this standard; and
 - iv) clearly specify each of the following—
 - (1) the parameters, constraints, performance standards and benchmarks for investments and investment decisions;
 - (2) performance indicators for the licensed investment manager;
 - (3) the ownership of and rights of access to books and records relevant to the investment management agreement;
 - (4) the processes for resolving disputes between the parties;
 - (5) the rights of each party to indemnity from the other;
 - (6) the term of the agreement;
 - (7) the rights of each party to terminate the agreement;
 - (8) the obligations of each party on termination of the agreement; and

Commentary

1. For subparagraph (iv)(1)—the “parameters, constraints, performance standards and benchmarks for investments and investment decisions” include the investment objectives and investment strategy for the ASF, and provide for what happens when the licensed trustee varies them.
2. For subparagraph (iv)(4)—subsections 74 (6) and (7) of the Act require disputes about investment matters to be referred to the Central Bank.
3. For subparagraph (iv)(5)—subsection 48 (2) of the Act says that an investment management agreement cannot derogate or diminish the responsibilities of the licensed trustee under the Act.

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- v) require the licensed investment manager to report at least monthly to the licensed trustee, and specify the contents of reports; and
- vi) require the licensed investment manager to comply with any request for information relevant to the assets of the ASF, the investment management agreement or the ability of the licensed investment manager to perform its obligations under the investment management agreement; and
- vii) without limiting subparagraph (iv) (7)—entitle the licensed trustee to terminate the agreement if the licence of the investment manager is suspended or revoked; and
- viii) require the licensed investment manager to remit any brokerage or commissions to the licensed trustee.

12) Custodian

- a) The licensed trustee, in consultation with the licensed investment manager, will ensure custodial arrangements for all its investments are satisfactory to the Central Bank.
- b) The licensed trustee of an ASF must ensure that, so long as the appointment of a custodian lasts, there is in force at all times a written agreement between the custodian, the licensed investment manager and the licensed trustee.

PART IV—INVESTMENT OBJECTIVES AND INVESTMENT STRATEGIES

13) Investment Objectives

- a) The licensed trustee of an ASF must formulate an investment objective for the ASF. It must record the investment objective in writing.
- b) An investment objective for an ASF must—
 - i) specify the desired investment outcome for the ASF; and
 - ii) be capable of being clearly communicated so that members can understand the investment approach of the ASF; and
 - iii) be such that the extent to which the investment objective has been met can be easily determined.

Commentary

1. Investment objectives must be measurable. A suitable investment objective would state a performance benchmark or a desired level of

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return, for example, “The Fund’s investment objective is to earn, on average over a 5 year period, at least 2% above CPI”. Actual results can then be easily measured against the investment objective and reported to members.

- c) In formulating and reviewing an investment objective for the ASF, the licensed trustee must seek and take into account advice from the ASF’s licensed investment manager.

14) Trustee Determinations related to Investment Strategies

- a) For the purpose of formulating an investment strategy, the licensed trustee of an ASF must determine—
- i) the level of risk, and the level of volatility of returns, that it considers the members are prepared to accept in connection with investments of the ASF; and
 - ii) the desired level of liquidity for the ASF.
- b) A determination under this section must be in writing.
- c) In making a determination under subsection (a), the licensed trustee must—
- i) have regard to all the circumstances of the ASF; and
 - ii) seek and take into account advice from the ASF’s licensed investment manager.
- d) In making a determination under paragraph (a) (ii), the licensed trustee must also take into account—
- i) the amount it considers should be invested in cash or in assets readily convertible to cash; and
 - ii) the expected timing of investment income and contributions; and
 - iii) actual or contingent expenditure requirements, for example, taxation or payment of member entitlements.

15) Investment Strategies

Commentary

1. Paragraph 71 (2) (f) of the Act requires the licensed trustee of an ASF to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the ASF including, but not limited to, the following—

- the risk involved in making, holding and realising, and the likely return from, the ASF’s investments having regard to its objectives and its expected cash flow requirements; and
- composition of the ASF’s investments as a whole including the extent to which the investments are diverse or involve

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the entity being exposed to risks from inadequate diversification; and

- the liquidity of the ASF's investments having regard to its expected cash flow requirements; and
- the ability of the entity to discharge its existing and prospective liabilities.

- a) An investment strategy for an ASF must be in writing.
- b) An investment strategy for an ASF must specify each of the following—
 - i) performance benchmarks for the returns the trustee is seeking to achieve;
 - ii) determinations under paragraph 14;
 - iii) the diversification to be maintained within asset classes and between asset classes;
 - iv) if there are to be restrictions or prohibitions on investing in assets of a particular category—what those restrictions and prohibitions are;
 - v) any restrictions on the ASF's holding investments in a single entity or group;
 - vi) any minimum liquidity standards for particular categories of investments;
 - vii) factors that are peculiar to the ASF.

Commentary

1. For paragraph (b)(iii)—see subparagraph 71 (2) (f) (ii) of the Act. The Central Bank notes that diversification is generally expected to result in a lower overall level of risk to achieve a specified return. Diversification may involve spreading investments—
 - over a number of individual assets, asset classes (domestic equities, property, fixed interest, cash, international equities);
 - within each asset class, such as investing in commercial and residential property, and in long and short term fixed interest investments.
 2. The desirable level of diversification and how it is achieved will depend on the size and circumstances of the ASF.
 3. For paragraph (c)(vii)—for example, that the average age of the ASF members is over 50.
- c) In formulating and reviewing an investment strategy for the ASF, the licensed trustee must—
 - i) seek and take into account advice from the ASF's licensed investment manager; and
 - ii) take into account the following (in addition to the matters that it must take into account under paragraph 71 (2) (f) of the Act)—

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- (1) the membership profile of the ASF (including the ages of members);
- (2) the reasonable expectations of members;
- (3) the nature and expected timing of members' entitlements;
- (4) the size of the ASF;
- (5) taxation considerations relevant to the ASF and to members;
- (6) the likelihood of future support by employers;
- (7) limitations and constraints on investments imposed by law or by some other instrument, including the ASF's governing rules;
- (8) any reports from experts or other qualified professionals;
- (9) any actual or potential conflicts of interest involving the trustee, the licensed investment manager or an associate of the trustee or the licensed investment manager.

Commentary

1. In supervising ASFs, the Central Bank will look for evidence that the specific matters under the covenant in paragraph 71 (2) (f) of the Act, and under this section, have been taken into account when formulating the investment strategy. This may be demonstrated through Board minutes and by other documentation (say, reports from investment advisers) and by the actual wording of the investment strategy.
 2. For subparagraph (c) (ii) (3)— In particular, the licensed trustee must take into account whether the entitlements are defined benefits or accumulation entitlements.
 3. For subparagraph (c) (ii) (7)—“ethical” or environment-friendly investment rules may be examples of these limitations.
- d) An investment strategy for an ASF must be clearly expressed, so that members and prospective members can readily understand it, and can assess the investment performance and management of the ASF.

Commentary

1. A widely used method is to set formal asset allocation ranges of minimum and maximum exposure permitted for each asset class with a benchmark for each asset class.

PART V—MAKING INVESTMENTS

Commentary

1. Giving effect to (or implementing) the strategy is a separate process from formulating it. Implementing a strategy involves considerations such as the value of ASF's assets, the expertise of the licensed trustee, the availability of appropriate advice, administrative capacity and the costs of managing investments. It may involve direct investment, indirect investment (say, through collective investments), using investment vehicles or managers or a combination of these approaches.

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2. It is recognised that ASFs will invest in a range of assets including some that may be regarded as not readily marketable such as unlisted equities and property.
3. Investment in non-listed securities will often result in difficulty in obtaining an appropriate market value. The Central Bank holds the view that ASFs should restrict holdings of non-listed investments to those in PNG.

Division 1—General Rules

16) Investments to be consistent with investment strategy

- a) The licensed trustee and the licensed investment manager of an ASF must not make an investment of the ASF unless the investment is consistent with the investment strategy for the ASF.
- b) If investments of an ASF cease to be consistent with the investment strategy of the ASF:
 - i) the licensed investment manager for the ASF must notify the licensed trustee as soon as practicable; and
 - ii) the licensed trustee and the licensed investment manager of the ASF must take appropriate steps to ensure that the ASF's investments are consistent with the investment strategy of the ASF.

17) Offshore Investments

- a) An ASF may, if its investment strategy permits, invest offshore by way of -
 - i) deposits with financial institutions in jurisdictions where the institution is rated not less than AA or equivalent by an international rating agency;
 - ii) securities listed on a stock exchange that is a member of the World Federation of Exchanges;
 - iii) securities issued by foreign governments where the security is rated not less than AA or equivalent by an international rating agency;
 - iv) collective investments such as unit trusts and property trusts: and
 - v) other investments so long as the aggregate of such investments does not exceed 5% of net assets the ASF.

Commentary

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1. There are a number of international rating agencies. The major agencies recognised in most investment markets as of high repute are Moody's, Standard and Poor's and Fitch.
 2. The range of available investments that would be regarded as 'other' is wide and continually changing. Investments that maybe suited in certain markets, where, for example, member choice of investments is available, may not be suited to the risks acceptable to an ASF. Trustees are reminded of the need to seek suitable advice and the obligation to understand the risks of the investment being undertaken.
 3. Collective investments may be listed or unlisted. Trustees are reminded that the quality of these investments and their operators can vary. Trustees need to satisfy themselves that the scheme is managed in accord with prevailing laws in the home jurisdiction by organisations of appropriate integrity.
 4. Trustees are reminded some investments are extremely complex and may involve risks that are not readily identifiable. The Central Bank expects that trustees will only invest in assets where they understand the risks involved.
- b) An ASF that holds, at the date this standard is signed, investments that would be authorised by clause v) above in excess of limit in that clause, may continue to hold such assets but may not add to such assets until the aggregate of those assets falls below the limit stated.

18) Requirement to Report Where Large Exposures

- a) The licensed investment manager for the ASF must report to the Central Bank and to the licensed trustee of the ASF if 5% or more of the value of the ASF's assets consist of investments in a single entity or a single group. The report must be made no later than 5 working days after the licensed investment manager becomes aware of the matter.

Commentary

1. Large exposures may arise from acquisition, through market movements in valuation, or through asset valuation.
- b) New investments by the licensed trustee and licensed investment manager above 10% of the value of the ASF's assets require prior consultation with the Central Bank; in general, approval would only be given if some special factor applies.
- c) If market movements in valuation or asset revaluation cause the percentage holding to rise above 10% of the value of the ASF's assets, the Central Bank expects the licensed investment manager to develop a diversification strategy

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satisfactory to the Central Bank to reduce the holding below 10% of the value of the ASF's assets.

- d) A report under this section 18 must set out:
- i) the identity of the entity or group; and
 - ii) the percentage of the value of the ASF's assets that consist of investments in the entity or group; and
 - iii) the divestment arrangements reflecting the nature of the market situation; and
 - iv) the period within which the licensed investment manager and licensed trustee will reduce the holding below 10% of the value of the ASF's assets.

Division 2—Financial Accommodation

19) Prohibition on giving Financial Accommodation to Members

- a) Except as permitted by the Act or a prudential standard, a licensed trustee, in its capacity as trustee of an ASF, must not give any financial accommodation to a member of the ASF or to a relative of a member of the ASF using the assets of the ASF.

Commentary

1. Paragraph 75 (1) (a) of the Act prohibits a licensed trustee, in its capacity as trustee, from lending money of the ASF to a member of the ASF or a relative of a member. This rule:
 - helps to prevent avoidance of the preservation rules by preventing early access to members' account balances, and
 - helps to protect and enhance the retirement benefits of members by limiting the exposure of these benefits to unnecessary risk.
2. Subsection 19(a) extends this protection by prohibiting, for example, the giving of a guarantee or other form of credit enhancement for the benefit of a member or a relative of a member. Subsection 90 (4) of the Act specifically authorises early access to entitlements for housing purposes, subject to a number of conditions.

- b) Subsection 19(a) does not prevent the following—
- i) payment of wages and salary to a member who is an employee of the licensed trustee, and related payments;
 - ii) payment of benefits or entitlements permitted by regulations made for the purposes of subsection 126 (2) of the Act.

Commentary

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1. Regulations made under subsection 126 (2) of the Act removed restrictions on Existing Funds and Existing Trustees (as defined in Part XVIII of the Act) paying—
 - benefits or entitlements if the right to the benefit or entitlement accrued on or before 30 June 2003 and the payment was required or permitted by the governing rules of the ASF as in force immediately before the commencement of the Act;
 - housing benefits or entitlements in respect of an application made to the trustee of the ASF before the commencement of the Act;
 - benefits or entitlements by way of funding for primary, secondary, and tertiary education in respect of an application made to the trustee of the ASF before the commencement of the Act;
 - benefits or entitlements by way of funding for medical expenses;
 - life insurance benefits or entitlements.

Division 3—Arm’s length, in-house assets and dealing with associates and related parties

20) Investments in Associates to be Arm’s Length—Records

The licensed trustee or licensed investment manager of an ASF must not make an investment for the ASF in an associate of the ASF, the licensed trustee or the licensed investment manager unless it has recorded in writing the reasons why it considers that the investment will be conducted at arm’s length.

General commentary on arm’s length transactions

1. Section 74 (1) of the Act requires that all ASF investments be conducted at arm’s length. Section 74 (1) applies to both trustees and investment managers, as both make investment decisions for the ASF.
2. The “arm’s length” requirement in section 74 (1) of the Act does not itself prevent investments in related parties of the ASF. (The broader investment rules in paragraphs 75 (1) (a)-(e) of the Act may prevent or limit such transactions.)
3. The Central Bank considers that an ASF conducts an investment at arm’s length if a prudent person, acting with proper regard for its own commercial and financial interests, would have done what the ASF did. The Central Bank considers that whether an investment complies with this rule must be determined in the light of all the circumstances of the investment, including—
 - whether the asking price is fair, given the expected return on the asset, the risks to which the asset is exposed and its relative liquidity; and
 - whether the projected returns of income and capital are in line with market expectations;
 - whether the investment contract adequately protects the ASF and clearly identifies the parties’ rights and obligations; and
 - any valuations of the investment; and
 - whether the asset is a depreciating asset.

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4. The Central Bank expects that all ASF investments will be entered into and maintained on commercial terms, or on terms that are no more favourable to the other party than would reasonably be expected if the dealing were at arm's length in similar circumstances. For example, the purchase price of an investment should be at market value (or a value more favourable to the ASF than to the other party), and the agreed or expected return from the investment should be at not less than a true market rate.

21) Investments with Associates as Joint Tenants

- a) The licensed trustee or licensed investment manager of an ASF must not make an investment for the ASF if:
 - i) the investment is made together with an associate of the licensed trustee or licensed investment manager; and
 - ii) the associate and the licensed trustee or licensed investment manager hold the investment as tenants in common; and
 - iii) the licensed trustee or licensed investment manager knows or ought to know that the associate intended to use its interest in the investment by way of security.

Commentary

1. It is imprudent for an ASF to enter into such a transaction.

22) Limit on In-House Assets

Commentary

1. In-house assets restrictions in this standard are designed to help protect and enhance members' retirement benefits by limiting exposures to unnecessary risks, in particular, the risk of failure of the business activities of an employer or other related party.
 2. The Central Bank recognises that it is inevitable that ASFs will invest in related parties due to the limited range of suitable investment opportunities in PNG. Such investments should be disclosed and should only prove problematic if the in-house investments limits are exceeded.
 3. The Central Bank recognises that dealings with a licensed investment manager may fall within the ambit of a related party transaction due to the ownership of such businesses.
- a) The licensed trustee and licensed investment manager of an ASF must ensure that, at all times, the value of the in-house assets of the ASF as a percentage of the total value of the ASF's assets is no more than 5 %.
 - b) If at any time, the value of the in-house assets of an ASF is more than 5% of the total value of the ASF's assets, the licensed trustee and licensed investment

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manager of the ASF must notify the Central Bank of the matter as soon as they become aware of it and consult the Central Bank on steps to ensure that the percentage of the ASF's in-house assets is reduced to the satisfaction of the Central Bank.

c) In this section—

i) “in-house asset” means—

- (1) a loan by an ASF to, or an investment by an ASF in, a related party of the ASF or a related trust of the ASF; or
- (2) an asset of the ASF subject to a lease or lease arrangement between the ASF and a related party of the ASF or a related trust of the ASF; but does not include—
 - (3) a life policy issued by a life insurance company licensed under the *Life Insurance Act 2000*;
 - (4) a deposit with an authorized institution under the *Savings and Loans (Amendment) Act 1995* or the *Banks and Financial Institutions Act 2000*;
 - (5) Papua New Guinea Government Notes or securities;
 - (6) a loan to, or an investment in, a trust that is a widely held trust;
 - (7) an asset declared by the Central Bank not to be an in-house asset.

Commentary

1. ASFs with in-house assets consisting of loans to related parties often agree to capitalise earnings on such loans rather than receive regular interest payments. Such capitalised interest payments may be an addition to the level of in-house assets of the ASF. Where an ASF does not receive due interest payments, and these are not capitalised, the ASF may be in breach of the arm's length rule. A factor in determining whether a breach has occurred may be the extent of any attempts by the trustee to secure repayment of the loan.

ii) “employer”, in relation to an ASF, means an employer that makes employer contributions to the ASF in respect of its employees that are members of the ASF.

iii) “related party”, of an ASF, means any of the following—

- (1) a member of the ASF;
- (2) an employer;
- (3) an associate of an employer.

iv) “related trust”, of an ASF, means a trust that a member or employer directly or indirectly controls, but does not include a trust where the

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licensed trustee or licensed investment manager of the ASF makes an investment under which a listed security is held in trust until the purchase price of the security is fully paid.

- d) For the purposes of this section, a trust is a widely held trust if more than 20 entities between them are:
 - i) beneficially entitled to 75% or more of the income of the trust; or
 - ii) beneficially entitled to 75% or more of the capital of the trust.For this purpose, an entity and its associates are taken to be a single entity.
- e) Without limiting paragraph 22(c)(i)(7) of the definition of “in-house asset”, a declaration under that paragraph may be for a class of assets or a class of ASFs.

23) Rights against Associates and Related Parties to be Enforced

- a) Each of the licensed trustee and licensed investment manager of an ASF must enforce its rights in respect of an investment of the ASF with an entity that is:
 - i) an associate of the licensed trustee or licensed investment manager; or
 - ii) a related party of the ASF;

in the same way, and to the same extent, as it would enforce similar rights in similar circumstances against a person that was not such an associate or related party.

General commentary on Division 3

No encumbrances

1. Section 74 (2) of the Act requires that all ASF assets be unencumbered, and thus, not charged or used as security for financial or other obligations.

Acquiring assets from members

2. Paragraph 75 (1) (b) prohibits the licensed trustee of an ASF, in its capacity as trustee, from intentionally acquiring assets from a member of the ASF or a relative of a member of the ASF, unless the Act permits it. The purpose of this provision is to ensure that the retirement incomes policy objectives and taxation concessions of superannuation benefits are not compromised.
3. The prohibition applies to buying assets and also contributions of assets “in specie” (assets other than money). Assets mean any form of property, including money, real property (such as house and land) and personal property.
4. The prohibition is not restricted to purchase, but prohibits acquisition by any means.

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5. The prohibition only applies to acquisitions from the member or relative. Therefore, acquisitions occurring when 2 ASFs merge do not contravene the prohibition, because these acquisitions are from someone other than the member or a relative.

Borrowing by and financial accommodation for ASFs

6. The Act imposes borrowing restriction to help protect and enhance the retirement benefits of members by limiting the exposure of such benefits to unnecessary risk. Borrowing restrictions ensure that benefits are not directly exposed to risks associated with geared investments and, in particular, stop lenders from acquiring claims over the ASF's assets that might rank ahead of members' entitlements. Transactions that give rise to debtor-creditor relationships are not necessarily loans or financial accommodation.
7. Under paragraph 75 (1) (c) of the Act, a licensed trustee of an ASF is prohibited from obtaining financial accommodation or maintaining existing financial accommodation. Borrowings are a form of financial accommodation.
8. Subsection 75 (2) of the Act permits certain limited financial accommodation, where—
 - it is to enable the licensed trustee to make a payment of members' entitlements as required by law or the ASF's governing rules and that, apart from the financial accommodation, the licensed trustee would not be able to make; and
 - the period of the financial accommodation does not exceed 14 days (counting extensions, roll overs and other concessions); and
 - if the financial accommodation were to take place, the total financial accommodation would not exceed 10% of the value of the ASF's assets.
9. This type of borrowing should only be required in exceptional circumstances. The Central Bank expects the ASF's investment strategy will minimise the need for borrowing for this purpose. Borrowing to fund payments to members could demonstrate a lack of trustee diligence.
10. Borrowing or financial accommodation to fund acquisitions is not permitted.

Division 4—Derivatives

24) Derivatives

- a) In this section:
 - i) 'basis risk' means the risk that a derivative position will not move in line with a physical position;
 - ii) 'counterparty' means the other party with whom a derivatives contract is made;

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- iii) 'derivative' means a financial instrument whose value depends upon (or is derived from) other assets, liabilities or indexes (the 'underlying assets');
- iv) 'derivative exposure' means the effective proportion of an ASF's investment portfolio that is invested in derivatives;
- v) 'futures' mean legally binding agreements to buy or sell a commodity, currency or security at a fixed time in the future at a price agreed on today;
- vi) 'net exposure' means the total of physical and derivative exposure;
- vii) 'physical exposure' is the proportion of an ASF's investment portfolio which is invested in the 'physical' or actual securities, as opposed to derivative securities;
- viii) 'options' mean instruments providing investors with the right but not the obligation to buy or sell a commodity, currency, security or futures contract;
- ix) 'swaps' mean agreements between two parties to exchange (swap) their respective obligations (loan repayments or interest payments) so that they can manage their cash flows more effectively;
- x) 'underlying asset' is the physical asset on which the derivative contract is based;
- xi) 'warrants' mean instruments that give the holder the right but not the obligation to buy a specified commodity, currency, security or futures contract at a designated price on or before a certain date in the future;

Commentary

1. The definition of derivatives can be expanded along the lines of 'an instrument where the value and underlying marketability is derived from, or linked to, the value of an underlying security, commodity, or index that represents either direct ownership of an asset or the direct obligation of an issuer, otherwise known as the physical instrument'.
 2. Derivatives include instruments such as futures, swaps, forwards, warrants and options.
- b) The licensed trustee of an ASF may include the use of derivatives in the investment strategy for the ASF.
 - c) The use of derivatives as part of the investment strategy may include:
 - i) to mitigate risk or hedge against movements in interest rates, values or prices in relation to permitted investments and movements in foreign currency exposures held within the ASF;

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- ii) to achieve or reduce exposure to assets, all or part of any asset class and foreign currency; and
- iii) to achieve transactional efficiency or reduce the transactional cost of achieving required exposures.
- d) Derivatives shall not be used for speculative purposes.
- e) Derivatives shall not be used for investment activity where the derivative exposure combined with the physical exposure results in a net exposure for that asset class or the portfolio as a whole that is inconsistent with the investment strategy.
- f) A derivative position should be undertaken in such manner that the changes in value of the underlying asset and the corresponding derivative are such that basis risk is minimised.
- g) All derivatives must be in the form of a derivative over the same asset class as the physical instrument.
- h) Derivatives must not be used to leverage the portfolio of the ASF.
- i) The licensed trustee must have in place satisfactory risk management practices for derivatives as evidenced by the risk management statement.

Commentary

1. The use of derivatives or other risk mitigation tools should not be undertaken lightly. Many of the arrangements are complex and may lead to increased risk rather than reduced risk. Directors of the licensed trustee must familiarise themselves with the nature of the risks being undertaken. The Bank is of the view that if directors do not fully understand the proposed transaction, it should not be undertaken.
 2. The use of derivatives may require the pledging and/or mortgaging of an asset held by the ASF. The pledge and/or mortgage will be only of the asset that its risk is mitigated and limited to the amount needed for this purpose.
- j) A licensed trustee may authorise a licensed investment manager to use derivatives in the execution of the ASF's investment strategy.
 - k) Such authorisation shall form part of the investment strategy and be communicated in writing and include the requirement for the licensed investment manager to have in place satisfactory risk management practices for derivatives evidenced by a risk management statement.

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- l) The licensed investment manager will be required to provide the licensed trustee with a copy of its current policies relating to derivatives usage and to manage its derivative exposures in accordance with those policies.
- m) The risk management statement in section 24(k) of this standard, should exclude improper use of derivatives including investment activity that results in one or more of the following:
 - i) the net exposure of the fund to an asset class being outside of the limits set out in the ASF's investment strategy;
 - ii) the risk involved in the whole portfolio being outside that which the licensed trustee considered appropriate when the ASF's investment strategy was adopted;
 - iii) the ASF's total portfolio being 'geared up' through derivatives to circumvent any limitations imposed upon borrowing in the Act.
- n) The licensed investment manager may use the following instruments:
 - i) derivative instruments traded on recognised exchanges; or
 - ii) over-the-counter agreements where the counterparty has an investment grade rating as measured by at least two recognised rating agencies.
- o) The licensed investment manager must form a view, prior to entering into a derivative transaction, as to whether or not the derivative can be appropriately decomposed into physical, futures and options type characteristics for valuation and risk assessment purposes. Where that is not possible, use of those derivatives is not permitted.
- p) Appropriate contractual arrangements must be in place between the licensed investment manager and the counterparty in a form satisfactory to the licensed trustee.
- q) Derivatives used to increase exposure to any asset or asset class must be fully covered by cash or assets which are considered equivalent to cash and can be converted into cash within the settlement period.
- r) Derivatives used to decrease exposure to any asset or asset class must be fully covered by the underlying asset or asset class.

Commentary

1. The use of derivatives is aimed at insuring the ASF against loss. Where the objective is to decrease exposure, it can only be undertaken against an asset that is held in the ASF. Where the objective is to increase

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exposure, it can only be undertaken in respect of assets that the ASF would normally hold and must be undertaken against cash (or equivalents).

- s) The licensed investment manager shall obtain the explicit approval of the licensed trustee of the ASF prior to entering into a derivatives agreement.
- t) A licensed trustee may give a charge over assets so as to facilitate a risk mitigation strategy undertaken in accordance with this Standard.
- u) The power to give the charge under section 24(t) of this standard may be exercised by the licensed investment manager

Division 5—Monitoring and Review

25) Regular Review of Investments

- a) The licensed trustee and licensed investment manager of an ASF must conduct reviews of the ASF's investments to ensure that they are consistent with the ASF's investment objectives and investment strategy.
- b) The reviews must be carried out regularly, and as frequently as is appropriate having regard to the nature of the investments.

Commentary

1. The amount, complexity and type of investments will govern the frequency and style of monitoring. The Central Bank expects that such reviews will be undertaken at least every quarter.
2. If asset ranges are specified, investments must be regularly reviewed to ensure they are maintained within these ranges and that they are adjusted as necessary in the light of market movements.
3. The Central Bank expects that adequate and effective procedures will be in place to monitor direct investments in particular assets. This includes monitoring of performance to ensure that the investments remain relevant and appropriate, the receipt and recording of income and obtaining proper valuations.
4. Trustees should also ensure that adequate and effective procedures are in place to monitor indirect investments. This includes monitoring of performance to ensure that the investments remain relevant and appropriate, and the receipt of regular and timely transaction reports.

26) Regular Review of Investment Strategies

- a) The licensed trustee and the licensed investment manager for an ASF must conduct reviews of the ASF's investment strategy to ensure that it remains appropriate to circumstances of the ASF.

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- b) The reviews must be carried out regularly, and as frequently as is appropriate having regard to the nature of the investments.
- c) In conducting a review, the following must be taken into account:
 - i) all the circumstances of the ASF, including the matters specified in subparagraphs 71 (2) (f) (i) to (iv) of the Act; and
 - ii) any actual or proposed changes to the ASF or to external conditions; and
 - iii) without limiting paragraphs (a) and (b)—
 - (1) relevant amendments or proposed amendments to legislation; and
 - (2) growth or decline in membership; and
 - (3) changes in membership profile; and
 - (4) changes in the general economic climate or specific markets (including financial markets); and
 - (5) changes in service providers to the ASF.

PART VI—MISCELLANEOUS

27) *Record Keeping*

- a) The licensed trustee of an ASF must keep complete and accurate records of—
 - i) the steps it takes in selecting investment managers and custodians; and
 - ii) the steps it takes to monitor and review the performance of investment managers and custodians, and actions taken as a result of those reviews.
- b) The licensed investment manager of an ASF must keep complete and accurate records of—
 - i) the steps it takes in selecting custodians; and
 - ii) the steps it takes to monitor and review the performance of custodians, and actions taken as a result of those reviews.
- c) The licensed trustee and licensed investment manager of an ASF must keep complete and accurate records of—
 - i) the procedures adopted to monitor and review ASF investments (direct and indirect) and actions taken as a result of those reviews;
 - ii) the procedures adopted to monitor and review the ASF's investment strategy, and actions taken as a result of those reviews;
 - iii) the steps it takes in selecting agents and service providers for the ASF; and

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- iv) the steps it takes to monitor and review the performance of agents and service providers for the ASF, and actions taken as a result of those reviews.

General commentary on this standard

External compliance audit and review

- 1. Future prudential standards are intended to require external auditors to conduct a compliance audit of ASFs on the implementation of investment strategies. This will be in addition to the normal review functions to be undertaken by the Central Bank.

PART VII—CORRECTIVE MEASURES

28) Remedial Measures and Sanctions

- a) If a licence holder fails to comply with this standard, the Central Bank may impose or vary conditions on the licence to ensure compliance or, if necessary, suspend or revoke the licence. Any licence holder which experiences difficulty in complying with the standard should advise the Central Bank forthwith.

PART VIII—EFFECTIVE DATE

- 29) *Effective Date*: The effective date of this Prudential Standard shall be 1 December 2008.
- 30) *Supercedence*: This standard supersedes and replaces *Superannuation Prudential Standard 1/2006 Authorised Superannuation Funds Investments*.
- 31) *Questions and enquiries*: Questions and enquiries relating to this prudential standard should be addressed to:

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**Benny B M Popoitai, MBE
Acting Governor**