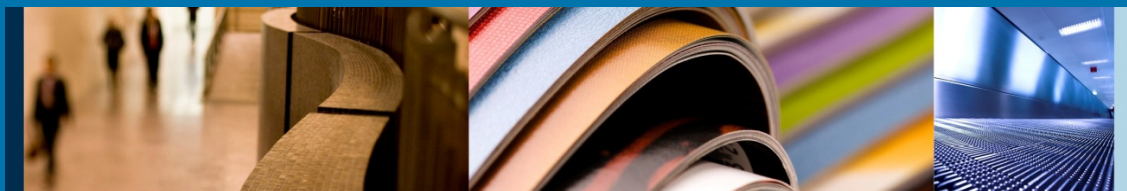


# AMP Capital Derivatives Risk Statement



15 March 2017

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## AMP CAPITAL INVESTORS LIMITED - DERIVATIVES RISK STATEMENT

### 1. Responsible party

This Derivatives Risk Statement (DRS) has been prepared by AMP Capital Investors Limited (AMP Capital) as:

- investment manager of funds for separately managed clients where AMP Capital's relationship with these clients are governed by an investment management agreement (IMA);
- investment manager of funds invested by unit holders in registered managed investment schemes established by AMP Capital Funds Management Limited (as the responsible entity) where AMP Capital's relationship with these unit holders is governed by an investment management agreement; and
- trustee and investment manager of funds invested by members in pooled trusts where AMP Capital's relationship with these members is governed by a trust deed.

### 2. Objective of the DRS

The objective of this DRS is to provide a brief description of the:

- policies that are in place for the use and control of derivatives; and
- processes and procedures that are in place for assessing compliance with those controls.

The format of this DRS has been prepared in accordance with the former Australian Prudential Regulation Authority (APRA) Superannuation Circular No II.D.7. The risk management principles as set out in the AMP Enterprise Risk Management Policy have been considered in preparing this DRS. This DRS is reviewed and updated as required for significant changes. Changes are approved by AMP Capital's Managing Director.

This DRS is provided to all relevant staff who are responsible for managing, monitoring or implementing the investment processes of AMP Capital and is readily accessible to all staff and clients as required.

### 3. Definition of derivatives

A derivative is defined as "a financial contract whose value depends on, or is derived from other assets, liabilities or indices (the underlying asset)".

Derivative transactions include a wide assortment of instruments such as futures, options, swaps, forwards, warrants and other related instruments.

Derivatives can be broadly categorised into two classes:

- exchange-traded derivatives - standardised contracts traded on securities exchanges; and
- over-the-counter (OTC) derivatives - privately negotiated contracts.

### 4. Relationship to the investment strategy

The investment strategy or guidelines of a fund or portfolio will be set out in the relevant IMA, investment mandate, trust deed, constitution or offer document (including Information Memorandum or/and Product Disclosure Statements that are provided to potential investors). These documents will be collectively referred to as "Governing Documents" in this DRS.

The use of derivatives is subordinate to the investment strategy or guidelines as set out in the Governing Documents. The use of derivatives must comply with the investment strategy, and where the investment strategy specifically states that derivatives may be used in other ways, e.g. to leverage returns, the specifics of that strategy will apply. Derivatives will not be used where their use will result in conflict with the strategy, investment objectives or constraints of a fund or portfolio.

## 5. Purpose of using derivatives

Derivatives are typically used in portfolio management for risk management, performance enhancement or to optimise investment strategy implementation. Derivatives use is not considered in isolation but rather as part of the overall investment strategy of a fund or portfolio.

Specifically derivatives may be used under the following circumstances:

- (a) Hedging:
  - manage risk, reduce volatility or help to minimise impact of fluctuations in market values; and
  - hedge against changes in foreign currency values.
- (b) Transaction efficiency and cost reduction:
  - achieve transactional efficiencies that cannot be obtained through the use of underlying assets through reduced transaction costs;
  - obtain better prices that may not be available in the physical underlying assets market; and
  - alter investment holdings quickly and at low cost.
- (c) Tactical investment reasons:
  - adjust security or asset class exposures within the parameters set in the investment strategy of the fund or portfolio;
  - enhance yields or adjusting the yield curves;
  - control the impact of significant transactions on portfolio valuations;
  - adjust the duration of fixed income portfolios;
  - manage credit risk;
  - manage asset allocation in a controlled manner; and
  - take advantage of market imperfections.

## 6. Restrictions on the use of derivatives

AMP Capital permits the use of derivatives based on the following guiding principles:

- their use is within the strategy, objectives and constraints permitted by the Governing Documents;
- unless specified otherwise in the investment strategy, derivatives will not be used to obtain exposure that is substantially different from that which could be obtained through physical securities;

- gearing of fund or portfolio through derivatives is only permitted if it is required as part of the investment strategy;
- there is adequate underlying asset cover to meet any obligations arising from the use of derivatives;
- proper consideration is given to liquidity management having regard to the particular fund or portfolio strategy; and
- derivatives are executed by staff that are qualified, knowledgeable and trained in the use of derivatives.

In addition, derivatives will not be used for speculation. Speculation may include the following situations:

- the net exposure of the fund or portfolio to an asset class exceeds the limits set out in the fund or portfolio's investment strategy;
- the fund or portfolio is outside the risk limits specified by the investment strategy;
- the fund or portfolio holds uncovered derivatives outside the risk limits specified by the investment strategy; or
- the fund or portfolio's total portfolio is 'geared up' through derivatives in violation of regulations or the fund's investment strategy.

Controls restricting the use of derivatives include:

- approval by the Chief Investment Officer (CIO) or individual(s) delegated by the CIO must be obtained before trading in a new derivative instrument can commence;
- only instruments approved for trading including derivatives can be traded;
- appropriate limits in accordance with the fund's or portfolio's investment strategy and objectives are established; and
- adherence to set limits is monitored by a team independent of the investment management team which reports any breaches to the appropriate governance committees.

In addition, the following operational aspects are considered while setting limits for derivative usage:

- ease or difficulty of measurement of potential derivative exposure;
- ease or difficulty in closing derivative position;
- market liquidity of the derivative;
- independent valuation; and
- counterparties to the derivative transaction.

The AMP Capital Trade Management Policy also outlines the principles to be followed when executing trade orders including derivatives transactions to ensure the best possible results are obtained for orders executed for the funds or portfolios and AMP Capital acts in the best interest of its clients. Additionally, AMP Capital's Enterprise Risk Management team is responsible for monitoring adherence to regulatory requirements, licence authorisations and internal policies. The investment rules and limitations as set out in the Governing Documents are also monitored by a team independent of the investment management team.

## 7. Risk analysis

The key risks associated with the use of derivatives and the relevant controls AMP Capital has in place to identify, assess, remedy, monitor and manage these risks, are set out below.

### Market risk

Market risk represents the risk of adverse movements in markets (including asset prices, volatility, changes in yield curve, implied option volatility or other market variables) for the derivative or underlying asset, reference rate or index to which the derivative relates. In particular, derivatives give rise to the risk that the value of the derivative(s) used may not move in line with the underlying asset(s) value (basis risk).

The following controls are in place to manage market risk:

- strategic ranges and limits for each fund and portfolio are established in accordance with its investment strategy, which control the exposure to any asset class including derivatives positions;
- net derivative positions are monitored on a regular basis to ensure that effective exposures stay within designated ranges and limits. Any breaches identified are properly and promptly reported to appropriate levels of management;
- appropriate cover requirements for all derivatives transactions are established to ensure that adequate cash or readily realisable assets are maintained to meet all potential obligations arising from derivative positions that create exposure and, in the case of options, at least to the extent of the delta-weighted value; and
- where the fund's or portfolio's investment strategy permits using derivatives which result in the fund or portfolio being geared or leveraged, appropriate gearing limits are established and monitored on a regular basis.

Where appropriate, regular stress testing is undertaken to determine the impact of a range of market circumstances on the value of the funds or portfolios and the impact of any derivative positions. Such testing is undertaken to determine whether investment restrictions and guidelines are complied with even in adverse circumstances.

### Liquidity risk

Liquidity risk exists in two forms:

- a) the risk that a particular position cannot be unwound; and
- b) the risk that the fund or portfolio will not be able to meet its obligations resulting from its derivatives activities.

The following controls are in place to manage liquidity risk:

- derivative exposures are monitored by the investment management teams as part of the portfolio management process in accordance with investment mandates/strategy. Derivatives trading will be subject to appropriate levels of overview by the senior investment managers;
- liquidity rules have been entered into the trading systems which automatically flag exceptions when they arise; and
- new types of derivative instruments are analysed and approved by the CIO or individual(s) delegated by the CIO prior to trading. The analysis includes assessing the market depth of

the instrument to be traded.

### **Counterparty (Credit) risk**

Counterparty risk refers to the risk that the other party to the derivative transaction may not honour their contractual obligations.

The following controls, as set out in the AMP Capital Trade Management Policy, have been implemented to manage counterparty risk:

- derivatives transactions should only be executed with approved brokers / counterparties on the approved lists which are maintained in the trading system by a team independent of the investment management team;
- brokers/counterparties are evaluated and monitored for their effectiveness, cost efficiency, execution quality and credit worthiness as part of the initial approval and ongoing review process;
- credit risk tolerances or credit constraints are established in the trading systems and monitored in accordance with IMAs and the Trade Management Policy;
- derivative transactions for exchange traded derivatives are conducted through recognised exchanges;
- in respect of OTC derivatives, AMP Capital ensures that there are appropriate agreements in place with each counterparty (e.g. an International Swaps and Derivatives Association recommended agreement and bi-lateral credit support annexure) including appropriate Cleared Derivatives Execution Agreement (CDEA) where derivatives are centrally cleared;
- the AMP Capital Legal team is responsible for reviewing the adequacy of legal agreements with respect to derivatives and that counterparties are able to legally enter such transactions; and
- documentation such as transaction agreements and settlement details are securely held independently of the Investment Management teams.

### **Operational risk**

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.

AMP Capital has an operational risk framework which outlines the procedures to be adopted by the business in managing operational risk. The framework considers the elements of risk and control assessment, policy and compliance management, incident management including breach reporting, governance and risk reporting. Compliance with internal controls and processes are monitored by the business on a regular basis through the control self-assessment process and the results of the assessment are reported to the senior management and appropriate governance committees.

The following controls are in place to manage operational risk:

- organisational and reporting structures ensure the separation of functions between investment management and investment administration (including custodial) to ensure proper segregation of duties;
- compliance monitoring such as limits monitoring and mandate compliance are performed and managed independently of the investment management teams. These functions have independent lines of reporting, including to the Board (or its delegated sub-committee), as appropriate;
- all portfolio management activities including the use of derivatives are performed in accordance with a formally documented set of investment delegations of authority approved

by the AMP Capital Board and executed in accordance with the AMP Capital Trade Management Policy;

- internal procedures and system controls require that trades are undertaken by authorised staff who are delegated with appropriate authority limits. Derivative trading will be subject to appropriate levels of overview by the senior investment managers;
- external independent custodian is used to perform custody and settlement functions, hold physical investments and record derivative positions. Exchange-traded futures positions are held by derivative clearing houses;
- through custodian arrangements, all accounts including derivative positions are reconciled with external sources. Derivatives and cash positions are regularly reconciled to third parties and discrepancies identified and resolved;
- derivatives are regularly marked to market on both a market value and a delta-adjusted exposure basis, based on independently sourced data and according to AMP Capital's Asset Valuation Policy;
- derivative transactions are recorded in AMP Capital systems and the control environment is regularly audited by internal and external auditors to ensure controls are in place to provide comfort over the integrity of the information generated through the computer systems; and
- before approval is granted for trading in new derivative instruments, the adequacy of the supporting operating systems is assessed.

### **Currency risk**

Foreign currency exposure will naturally arise from investment in overseas assets. As part of normal portfolio risk management, currency hedging may be used by AMP Capital. Currency profiles are established to ensure there is a clear understanding of the objectives, authorities and controls on such activity. It is acknowledged that hedging activity will primarily be by way of forward contracts, but options and other derivatives may also be used. In all cases, the same guiding principles for managing derivative risks specified in this DRS apply to managing currency risk.

## **8. External investment managers**

AMP Capital may fully or partly sub-delegate investment management of a fund or portfolio to external investment managers. The external investment managers are responsible for implementing investment strategy in accordance with the IMA between them and AMP Capital. As part of a fund's investment strategy, AMP Capital may also invest in collective investment schemes managed by external investment managers.

The external investment managers are responsible for ensuring that there are appropriate controls in place for derivative transactions and may prepare their own DRS where applicable.

AMP Capital performs the following control activities to ensure reasonable derivative risk management checks are in place within the operations of the external investment managers:

- external investment managers are only appointed after adequate due diligence is performed. The due diligence process includes a review of the external investment manager's risk management practices and controls, including their use and control of derivatives;
- the AMP Capital's Mandate Compliance team monitors and reports compliance and breaches to investment mandates (including derivative guidelines) established with external investment managers. During the establishment of mandates with external investment managers, AMP Capital considers the guiding principles of this DRS and the overall investment strategy of the fund;



- for investments in collective investment schemes, due diligence will also be conducted on the schemes prior to investment including reviewing the use and controls of derivatives where the scheme has authority to use derivatives; and
- ongoing monitoring of external investment managers which may include obtaining periodic compliance certifications from the managers. A diverse range of events may also trigger a periodic review of the external investment managers. Such triggers include, but are not limited to, risk issues, a material variation to a manager's business processes or personnel, significant performance issues and mandate breaches.

## 9. Personnel Management

AMP Capital recognises that due to the complexity and risk involved in dealing with derivatives, sufficient skills and knowledge are required to transact in derivative instruments.

AMP Capital ensures that staff with appropriate skills and professional expertise are responsible for managing portfolios that include the use of derivatives.

Management of personnel risk at AMP Capital includes the implementation of the following controls, along with people controls described under operational risk:

- staff expertise, qualifications, skill level and experience are taken into account before granting authorisation to the staff to trade in derivative instruments;
- all personnel responsible for the trading and administrative support of derivative securities are required to have appropriate educational qualifications and practical experience. These personnel will complete ongoing derivatives training, which may cover topics such as new instruments and the law pertaining to trading and market practices, as appropriate;
- the remuneration system for AMP Capital staff is driven through team scorecards that include both performance, cultural and risk based targets and measures. Individual bonus allocations specifically include assessment of risk behaviours and compliance both at the fund and organisational level; and
- there is separation of duties and staff reporting lines.

## 10. Assessment of controls

The management of the relevant business functions is responsible for implementing, reviewing and monitoring the controls outlined in this DRS to ensure the ongoing adequacy and effectiveness of these internal controls. Material breach of restrictions or breakdown of control procedures will be reported to senior management and the relevant governance committees via the AMP Capital's incident reporting process.

The AMP Capital Enterprise Risk Management team monitor ongoing compliance with this DRS via a regular process of compliance attestation by the business confirming that the controls and procedures described in the DRS have been adhered to. Any issues or exceptions are reported accordingly to the relevant governance committees.

In addition to above, internal and external auditors also regularly review the internal control environment including those relating to derivatives trade. The internal audit team is a separate and independent function from the AMP Capital Management team. The results of these audits are reported to the relevant governance committees and audit recommendations are monitored for implementation.

## 11. External audit

The DRS is subject to an annual external audit. The scope of the audit requires the auditors to assess and report on whether the major procedures described in this DRS have been followed and that any changes have been approved. The audit is to be conducted in accordance with Australian Auditing Standards.

## 12. Reporting

### **Internal Reporting to Board of Directors - Significant Exposures**

AMP Capital provides such reports to the Board (or their delegated sub-committees) to enable them to perform their responsibilities. Reporting with respect to compliance matters is performed with consideration to materiality and the nature of the compliance breach.

### **Reporting to Clients**

AMP Capital's Client Services team provides reporting to clients as agreed with the clients. This involves supplying a copy of this DRS together with any subsequent changes.

On an ongoing basis, AMP Capital provides regular and appropriate reporting on asset exposures including the impact of derivatives, as agreed with the client. AMP Capital also reports on matters when, in its professional judgement, there is a significant occurrence or event in relation to the use of derivatives.

It is recognised that daily movements in markets may create compliance breaches which are beyond the control of AMP Capital, and which the controls and systems are designed to identify and correct. Provided that such breaches are not material, corrected as soon as practicable and do not represent a fundamental breach in controls, such breaches will not be specifically identified or referred to in any reporting.

## 13. Date of approval

This DRS was approved by the Managing Director of AMP Capital on 15 March 2017.