

Transparency in the valuation process

The call for transparency in the financial markets is not new. But recent market turmoil and the regulators' response has escalated the call for improved transparency as well as the standardisation of financial information.

Regulators are actively responding to the market turmoil and continue to increase their demands for transparency and risk management. Following on from Basel II, MiFID, Reg NMS, IAS 39 and UCITS III, new regulations, standards and directives are being proposed that will result in new compliance processes and procedures to implement and follow. This year, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have both released proposals and comments to help clarify the continued importance of fair value measurement. The primary principles that underlie both FAS 157 (Fair Value Measurements) and the IASB Fair Value Measurement exposure draft are transparency and the use of an exit price.

Interactive Data is a strong supporter of initiatives to increase post-trade transaction transparency across the bond markets globally and supports both the IASB and FASB in their goals to provide additional clarity regarding fair value measurements and to increase the convergence of accounting standards. Firms with global scale will be in a strong position to benefit from the proposed global convergence of accounting standards on fair value measurement. Interactive Data has responded* to both the FASB and IASB with regard to FSP FAS 157-e and FSP FAS 157-4, and plans to respond to the IASB exposure draft Fair Value Measurement before the 28 September deadline.

The valuation process is clearly at an important juncture...

Transparency and standards are fundamental to the valuation process. Financial institutions are determined to better understand the components of the valuation process, including the underlying market data, model selection and calibration strategies. To accomplish this, clients want to drill down and review these inputs.

Using valuations from an independent third party can help reduce counterparty quote risk and can strongly support the independent price verification (IPV) function, providing another perspective on the valuation of a firm's financial instruments. As a result of the market turmoil and regulatory and accounting developments, independent valuations of complex instruments, as well as evaluations of fixed income securities, are in increasing demand.

Complex instruments such as OTC derivatives and structured products – and indeed most fixed income instruments – currently lack the price discovery mechanism that exchanges offer, and it is quite common for there to be limited trading in the secondary market following original issuance. Yet firms still need to understand the current economic value of these instruments. Consequently, an independent valuation should represent an objective, good faith opinion as to what a buyer in the marketplace would pay for a financial instrument in a current sale between two willing parties, i.e. a non-distressed sale, based on market information available at the time.

It is important that the methodology used to value the instrument is in line with the current market convention, and the valuation approach should be consistent with how a buyer or seller in the marketplace would also value this deal or similar deals. FAS 157 requires reporting entities to categorise the valuation of financial instruments by levels, based on the extent of observable (level 1 or 2), or unobservable (level 3), inputs. A similar notion of level 1, 2 and 3 inputs is proposed in the IASB Fair Value Measurement exposure draft. To assist financial institutions with their fair value obligations it is crucial that supplemental information regarding the valuation be available in order to provide increased transparency into the valuation process. This can include disclosure of the underlying market data inputs used and the methodology employed.

Interactive Data has long offered informational resources about its methodologies, the types of inputs it considers, and specific inputs for select securities to help its clients with their fair value hierarchy determinations. Recent additional informational resources, including a daily market commentary that reflects activity in the US fixed income markets as of midday, are designed to help clients better understand Interactive Data's evaluations and the impact that daily market conditions may have on these evaluations. Clients can submit and track evaluation inputs requests online – and currently review key assumptive data used in the evaluation process for structured securities, including collateralized mortgage obligations (CMOs), asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS) – via Interactive Data's 360ViewSM service. Through an exclusive agreement with Prism Valuation, Interactive Data also offers a valuations service for complex OTC derivatives and structured products, including transparency and discrepancy reports. Such support will continue to develop in response to changes in regulation and evolving industry practice.

With current market conditions, it is imperative that the core philosophies relating to portfolio valuation hold steady. Sound valuation procedures can enhance a firm's risk management operations, better preparing and positioning the business for the economic and regulatory uncertainty that lies ahead.

Interactive Data is a leading independent provider of daily evaluations for fixed income securities, as well as valuations for a broad range of alternative investments, including single name credit default swaps (CDS), CDS index trades, interest rate swaps and bank loan prices. Interactive Data also provides valuations of complex OTC derivatives and structured products through an exclusive agreement with Prism Valuation.

* Interactive Data's responses to the FASB and IASB can be seen at the following link:
<http://www.interactivedata.com/rd/fas157> .

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