

Valuation control in turbulent times: Challenges to the operating model

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The current market conditions have shone a bright light on financial instrument valuations and raised some critical questions for executive management.

- Do they feel comfortable signing off on the overall valuation in the financial statements?
- Do they get the right information around complex valuations?
- Do they understand the significant judgemental assumptions and the valuation complexities involved?

In this article we discuss the key areas for financial institutions to focus on as part of their review of the appropriateness and effectiveness of their valuation control processes.

Introduction

The credit crisis and its impact on the wider economy have introduced significant volatility and uncertainty in the financial markets. Under these circumstances it has been apparent that the valuation control processes at certain financial institutions are facing substantial challenges, as has been illustrated by some high-profile public admissions

about mismarking of trading positions in the past year. With the continuing illiquidity in certain markets, this phenomenon is likely to continue and will create significant challenges for the reporting season in respect of attributing the appropriate valuations to illiquid financial instruments in the financial statements.

In this article, we will focus on the key challenges around valuation governance and control as a consequence of the recent market developments and the more important considerations in responding to them. Our observations are mainly focused on investment banks. However, we have seen similar principles being introduced and applied at other financial institutions, such as investment management and insurance companies, in order to enhance their valuation governance and control processes in response to the current market conditions.

Specifically, we believe that organisations need to review their operating model in respect of valuation control functions to ensure that they are able to effectively respond to the current challenges. Particularly, oversight by and transparency

to senior management around the complexities and judgements taken in respect of valuations.

In the eye of the storm

Valuation control functions are regarded as a key element of the governance structure of financial institutions, with independent verification of asset prices among their core responsibilities.¹ The current markets and lack of trading information have made this independent assessment challenging. In addition, the regulators and investors are putting more pressure on the banks to better control and provide further analysis in respect of the appropriateness of their valuations.² This is explored in further detail in figure 1 overleaf.

Building blocks of valuation control

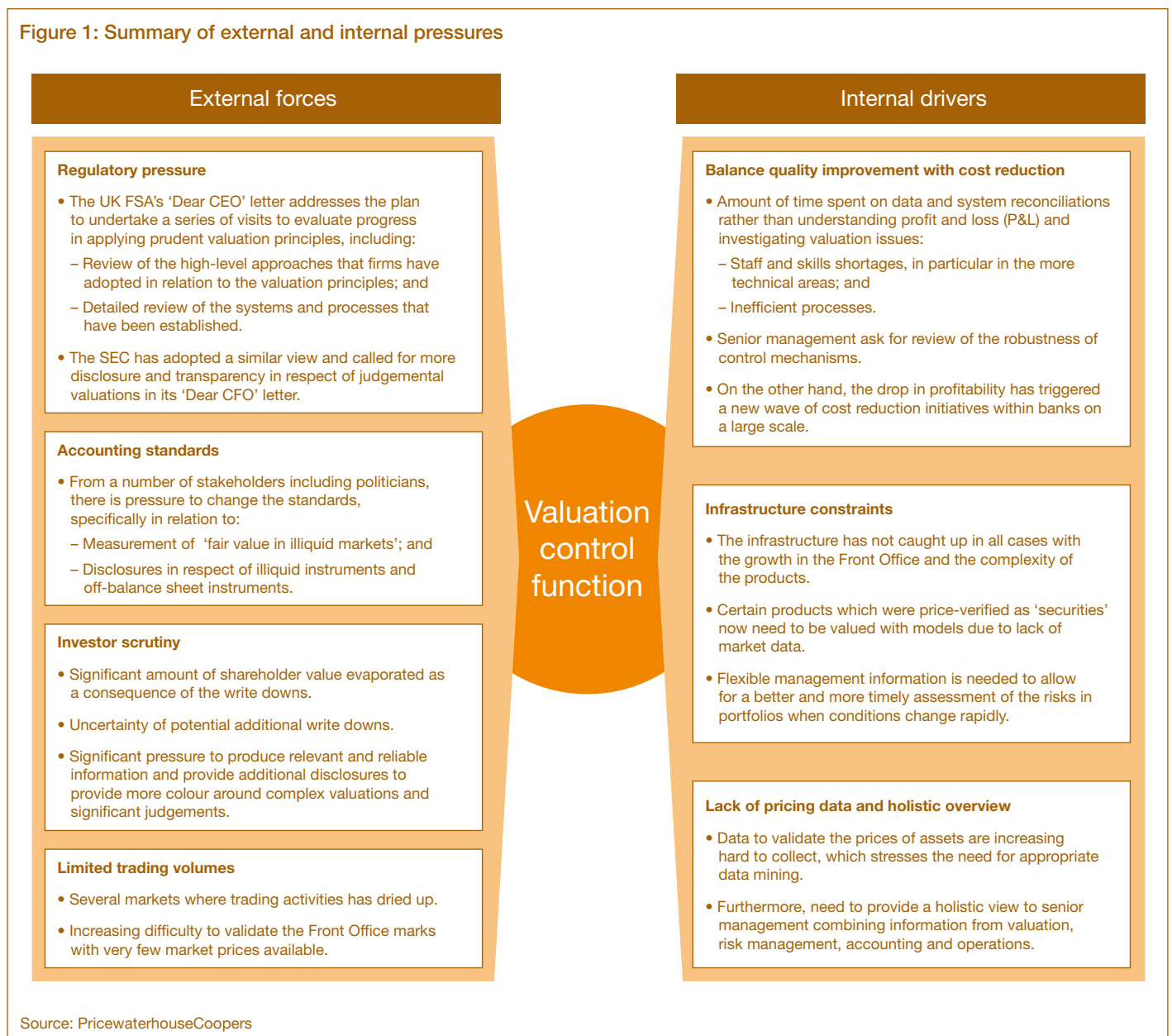
We have seen organisations go back to the building blocks for valuation control functions as shown in figure 2 on page 27, to analyse and improve the effectiveness of their core activities and to rebuild the confidence of the main stakeholders. This includes a review of the alignment of their operating model to current market conditions and a changing regulatory environment.

¹ Independent price verification is the process of determining the fair values incorporated into financial statements independent of the risk-taking functions (e.g. front office).

² See for example the FSA's 'Dear CEO' letter of 13 August 2008, and the SEC's 'Dear CFO' letter of March 2008 on management's discussion and analysis disclosure regarding the application of SFAS 157 (Fair Value Measurements).

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Figure 1: Summary of external and internal pressures





In our experience, the strategy and set up of the wider organisation ('organisational drivers') need to be considered to devise the appropriate operating model for the valuation control function. For example, an investment management organisation with less complex products typically has a leaner infrastructure and may have outsourced some or all valuation control processes to third party service providers and administrators. Hence, the role of the valuation control function and the skills and competencies required would be very different from an investment bank that is driven by innovation and has numerous complex products and instruments to price and value. Therefore, there are different models for valuation control functions applied by organisations that can work effectively when properly adapted to the wider organisational framework.

The key aspects of the operating framework need to be reviewed (i.e. the governance model, the infrastructure, human capital strategy and the actual processes and controls) in light of the current market turbulence and an assessment needs to be made of how these challenges impact the current operating model of the valuation control function. We shall consider each of these aspects in more detail.

Governance and organisational structure

- Is there sufficient oversight by senior management to assess the significant and highly judgemental valuation matters?

- Is there a clear valuation control strategy with a supporting target operating model?

- Are globally consistent policies in place to address the core activities and have they been updated for recent market circumstances?

- Are the roles and responsibilities of the function, including handover points with other departments, clearly documented and understood?

- What are the characteristics of the culture and does the operating model promote the desired cultural behaviours?

- Have outsourcing/off-shoring arrangements performed satisfactorily during recent market conditions?

Governance

Irrespective of how the function is set up, the oversight by and reporting to senior management is a critical component of valuation control. Controls and processes

can be split between several different units within the same function or sometimes between several different functions across different regions, which makes it difficult to obtain a comprehensive overview and to gain appropriate insight into issues identified. The key is to distil the critical processes and controls to ensure senior management obtains correct, relevant and timely information to allow them to make appropriate decisions in respect of judgemental valuations. In addition, they also need to obtain summarised information around the quality of their processes and the complexity of their valuations.

The overall culture of the organisation and that within a valuation control function has been a key factor in driving a successful control environment. We have seen that within banks with an effective risk management structure, front office, back office and controlling functions have an equal say and can challenge each other appropriately. In such an environment different views on overall valuations are properly discussed and reconciled to ensure a robust view is reached on complex valuations. Based on our experience with leading firms who have strong cultures, we have identified the following key cultural attributes, which we believe contribute to an overall robust control environment:

Valuation control in turbulent times: Challenges to the operating model continued

- The desired culture is defined and integrated throughout the organisation: Leaders act as clear role models for other team members and personal objectives aligned with desired organisational culture and linked to rewards;
- Full transparency – rapid escalation of issues, quick to admit mistakes;
- Attention to detail – applies to all levels and all departments;
- Continuous improvement – emphasis on lessons learned from unexpected events (positive or negative);
- ‘Collegial tension’ – challenging others is the expected behaviour of ‘real partners’;
- Leaders of support and control functions have equal stature to front office personnel – no overrides; and
- Detailed policies and procedures, especially in the area of complex structured products, are supplemented by good judgment.

Organisational structure

There are a wide range of models for a valuation control function. In figure 2, we have included some of the key components of valuation control. In many investment

banks the model control function is part of a risk management function, whilst the other components typically fall in the responsibility of Product Control. However, as stated before, the specific set up of the function should be aligned to the organisation’s business model, product mix and the firm’s infrastructure.

Reliance on and interaction with other departments is important and in particular, finance and risk interaction has been identified as one critical factor in identifying and mitigating credit crunch losses. A relevant publication, ‘Senior Supervisors Group – Observations on Risk management practices during the recent market turbulence’³ performed a comparison of the practices at organisations that have not suffered significant write-offs versus those organisations that have had large losses. Some ‘best’ practice areas included were as follows:

- Senior oversight – Effective firm-wide risk identification and analysis, and better sharing of key risk management reports, both quantitative and qualitative. Senior management was involved in decision making.
- Comprehensive risk-monitoring capabilities – Informative and responsive risk measurement and

management reporting and practices. Use of different methods to look at risk to gather more information and different perspectives on the same exposures.

- Robust valuations – Consistent application of independent and rigorous valuation practices across the firm.

Organisations that have focused on creating an effective relationship between risk and finance, ensure there is frequent and effective interaction between key stakeholders on a day-to-day basis and appropriate governance through formal bodies such as the valuation committee, reserving committee, risk committee, business planning committee, etc.

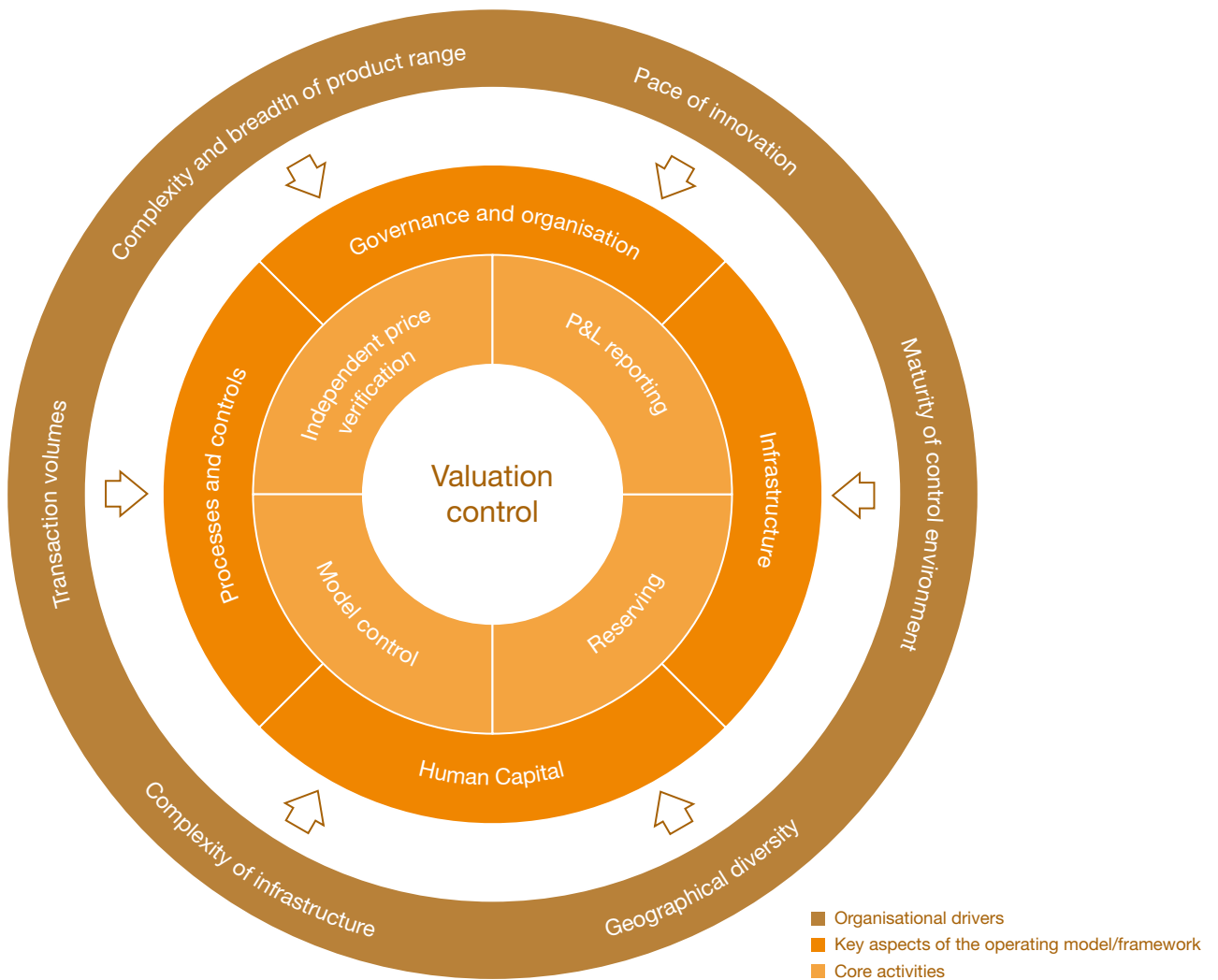
They have a clear definition of roles and responsibilities of all stakeholders, including detailed sign off and escalation procedures, and ensure appropriate hand-offs between stakeholders, e.g. in respect of the model control being performed by risk and the independent price verification by a product control function.

Additionally, they are able to combine risk and financial results reporting to ensure a more holistic view is provided in relation to business performance and the associated risks.

3 Senior Supervisors Group, ‘Observations on Risk Management Practices during the Recent Market Turbulence’ – 06.03.08.



Figure 2 – Drivers and key aspects of a valuation control operating model



Source: PricewaterhouseCoopers

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Processes and controls

- Do you obtain independent valuations for all your positions? Are they reliant on internally developed models? Do you have management information that presents you with the quality of the valuation control processes?

- Does your daily P&L reporting process adequately explain the drivers of the P&L, particularly for more complex areas of the business?

- Does management reporting highlight the areas with issues where decisions need to be made by senior management?

- How is that information shared, i.e. are other departments made aware of significant valuation issues/control breakdowns?

- How do you ensure that your processes and controls comply with changes in regulation and accounting?

Independent verification of the Front Office valuations has become much more difficult due to the current market conditions. There has been an increasing reliance on model based valuations and management judgement in the past year and this makes the transparency and

control around those processes an important component of effective valuation control. Specifically, model review and calibration to market data, where available, has been a focus of many organisations to ensure they can place reliance on model based valuations in the absence of quoted prices.

As noted above, it is important to report on the effectiveness of the control processes to senior management, e.g. the level of positions actually independently verified to external data and the quality of that data. Besides reporting to senior management, there also needs to be a forum for escalation and decision making at a senior level to appropriately evaluate complex and significantly judgemental valuations.

Human capital

- Does your valuation control function have sufficient product knowledge and quantitative expertise to challenge the business on valuation issues?

- Do you have enough senior resources to be able to challenge the front office appropriately, especially in areas where more judgement is required?

- Does your valuation control function have acceptable staff turnover levels?

The significant changes in the financial markets have increased the need for senior management to reassess whether they still have the right number of people with the right skills in the appropriate areas. The valuations have become more complex and as such a different skill set and level of experience may be needed to cope with the current issues. In recent years there has been a move in a number of organisations to create more quantitative skills within valuation control functions to be better equip them to deal with valuations of complex products in illiquid markets.

Current hiring freezes and redundancies are likely to compound the current challenges, the volume of work for valuation control functions is increasing as opposed to decreasing. High staff turnover and a significant proportion of temporary staff can also add significant problems. We have observed instances where this has led to significant issues due to inappropriate training, handovers and for poor understanding of processes and controls to be performed leading to a breakdown in control.



Infrastructure

- Is there a common data source for valuation processes?
- To what extent are processes automated and how is the use of spreadsheets controlled?
- Is the data used for the valuation process reliable?

Support functions can easily be behind in respect of infrastructure developments compared to the front office. For example, systems and processes are often unable to sufficiently deal with complex structured products, leading to the following issues:

- Complex system infrastructure and default use of spreadsheets;
- Largely manual processes and high workload;
- Lack of common data sources;
- Out of date or incomplete inventories and mapping of products and models; and
- Problems around handover points (information flow between stakeholders).

49% of financial services companies have already cut back on their IT spend in response to the global economic slowdown.⁴ We believe, however, that these short-term cost reductions can prevent organisations from making necessary strategic investments to improve the infrastructure. Looking at the symptoms above, productivity, efficiency and control gains are to be found. Senior management should consider the possibility that targeted strategic investments might generate savings (and revenues) exceeding that which could be saved through short-term cost cutting.

Conclusion

In these difficult times it is important for senior management to review the appropriateness of the valuation governance and control operating model to ensure that they are able to respond appropriately to the current challenges. As part of this we recommend focusing on the following key areas:

- Establishing governance and oversight over the determination of judgemental valuations and accounting application, especially quality control and transparent reporting to senior management on key judgements and valuation decisions;

- Creating a robust process around independent verification of valuations and assessment of the appropriateness and calibration of models to available market information;
- Ensuring the right culture is in place in organisations to allow for adequate challenge and 'bad messages' to support an equal balance between front offices and support functions;
- Investing in skills and technology to enhance the control framework around valuations and complex accounting issues; and
- Increasing interaction with other parts of the organisation, to ensure that a comprehensive, holistic and integrated view of risk, valuation and accounting issues is formed.

⁴ 'Slowdown sees groups cut IT spending', Financial Times – 09.09.08.