

Meeting Multiple Demands for Transparency in the Valuation of OTC Derivatives

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*Auditors, regulators, risk managers and investors all demand greater transparency in the valuation of OTC derivatives and complex instruments. **Anthony Belcher, director, European Fixed Income at Interactive Data**, explains how valuation processes are evolving to meet these new transparency requirements.*

Q. Auditors, regulators, risk managers and investors are all demanding more transparency in the procedures for valuing complex instruments, such as OTC derivatives. What does transparency mean for all these parties?

Firstly, and from a top-level view, industry participants are trying to understand the risk inherent in OTC derivative instruments. They are therefore looking for more information on the assumptions and the inputs made in the model-based valuation process in order to help improve their understanding of the risk exposure.

From an auditor's point of view, transparency is required around the evidence used to support a valuation. This information is needed so that auditors can understand how the valuation fits into regulatory principles in place, as well as to meet the new demands for evidence required by new accounting standards.

More specifically, auditors need to be able to compare information that is presented to them by companies against the information provided by other internal and external sources. Auditors also need to demonstrate that the information was stress tested and use the data from those tests for their own review of the valuation.

Regulators are currently more concerned about understanding liquidity. They want to understand the risk-weighted appetite for these types of complex instruments, which given their structure and trading patterns, will be at the less liquid end of the spectrum. Regulators have put in place many more stress testing scenarios as a result of the credit crisis and the introduction of new testing requirements is expected to continue. For instance, the UK Financial Services Authority's liquidity requirements require a new degree of stress testing.

Like the regulators, risk managers want to better understand the valuation process so that they can assess the liquidity of the firms' holdings and the potential impact on the viability of the business.

Risk managers are unsurprisingly also focused on stress testing – and specifically the execution of both forward and back stress-testing scenarios – so they can better understand their risk exposure.

As a result, there is definitely an increase in demand by financial institutions for software to support both types of stress tests.

Finally, investors want to be able to see that there are controls and processes in place around the management of these types of complex instruments. They want to see evidence in reports from the chief financial officer, but are also interested in information that will help them better assess the risks and ensure there is proper diversification in place.

The introduction of new accounting standards will also increase the amount of transparency that investors will see by expanding the depth of information around the types and the different levels of instruments included in reports.

Q. How can the use of models and calibration methods be more transparent?

The market is moving towards using standard model types for the valuation of different instruments; this should help financial institutions better understand which valuation processes are most suitable for specific types of instruments.

Financial institutions also want to clearly see the market data used to calibrate these models and the sensitivity analysis included in the process. The Prism Valuation service for OTC derivatives, available through Interactive Data, offers a transparency report for OTC derivatives valuations that allows clients to see what models are used, what market data was used to calibrate those models, and how the valuations could fluctuate.

Q. How will the introduction of new accounting standards affect the transparency of valuations?

Changes in accounting standards are a major driving force behind improvements in the transparency of the valuation of OTC derivatives and complex instruments.

The Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC) Topic 820, *Fair Value Measurements and Disclosures* (formerly FAS 157) promotes transparency by requiring valuations to be categorised into a three-level hierarchy. Levels one and two include valuations based on observable market data. Typically, complex OTC derivatives would fall under level three – i.e. valuations based on unobservable inputs reflecting the reporting entity's own assumptions, for example through the use of models. The International Accounting Standards Board (IASB) has also proposed standards which largely correspond to FASB's Topic 820.

In addition, the categorisation of instruments under new accounting standards will help clarify which valuation procedures should be used in valuing different instruments, for example under either a fair value or amortised cost approach. Under International Financial Reporting Standards (IFRS), all derivatives are to be valued using a fair value approach. A draft proposal from FASB similarly extending fair value is expected later this year.

IASB and FASB are having regular discussions to promote the convergence of accounting standards. One item on the agenda of the IASB/FASB joint meetings has been sensitivity analysis for level three assets. This analysis is designed to improve the understanding of the different assumptions that were made in the valuation process. Sensitivity analysis is already present in IFRS 7, *Financial Instruments: Disclosures*; however, FASB pulled similar language out of a recent Accounting Standards Update (ASU) to Topic 820. Minutes of the March joint

meetings suggest realignment between FASB and IASB on this topic, perhaps resulting in more consistent standards globally. In order to help clients meet this requirement, a discrepancy report comparing the differences between a client's valuation and valuations from Prism Valuation is available as part of the OTC derivatives valuation services from Interactive Data.

I think that adjusting procedures to comply with new fair value requirements is one of the important changes for firms in the derivative space. Previously, it would have depended on where the instrument was held (in the trading book or the banking book) as to what the valuation approach would have been. But that has now changed because both books will at least have to disclose what the fair value is for these assets (IFRS 7). Firms, such as insurance companies and pension funds, will now have to review processes to ensure they can provide the fair value of an instrument.

Q. What are the newly emerging best practices in the pricing of complex instruments? What is now standard practice post credit crisis?

Stress testing, scenario analysis and sensitivity analysis have also emerged through the credit crisis as tasks that need to be completed on a more regular basis and with a more aggressive degree of rigour. I imagine that firms will need to make large IT investments, whether internally developed or off-the-shelf packages, so that they can support these new risk procedures.

In the more mainstream valuation areas, such as for vanilla fixed income bonds, we also continue to see a move away from the practice of relying upon a price provided by a counterparty. Many firms are no longer comfortable relying upon one source, especially where there is a conflict of interest, and are therefore looking for multiple sources of valuations. Ultimately, the valuation committee wants to demonstrate to the board of trustees that it has established an independent valuation process.

The use of multiple sources of valuations is already common practice both in the US and the UK, while the rest of Europe is now moving towards establishing multiple sourcing as a best practice on a broader basis.

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