

Valuation control in turbulent times: Challenges to the operating model

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 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 financial institutions to better control and provide further analysis in respect of the appropriateness of their valuations.²



Building blocks of valuation control

We have seen organizations revisit the building blocks for valuation control functions to analyze 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.

The overall strategy and set up of the wider organization (organizational drivers) need to be assessed in order to determine the appropriate operating model for the valuation control function. For example an investment management organization 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 organizations that can work effectively when properly adapted to the wider organizational framework.

The key aspects of the operating framework – the governance model, infrastructure, human capital strategy, and actual processes and controls –

need to be reviewed 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. Regardless of the size of your company, the considerations presented below are relevant and should be closely evaluated.

Governance

- Is there sufficient oversight by senior management to assess significant and highly judgmental valuation matters?
- Is there a clear valuation control strategy with a supporting target operating model?
- Are 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 clearly documented and understood?
- If there are handover points with other departments throughout the valuation process, have they been clearly documented?
- What are the characteristics of the culture and does the operating model promote the desired cultural behaviours?

- If outsourcing/off-shoring arrangements exist for valuations, have they performed satisfactorily during recent market conditions?

Irrespective of how the function is set up, the oversight by and reporting to senior management is a critical component of valuation control. Depending on the size of the organization, controls and processes may 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 judgmental valuations. In addition, they also need to obtain summarized information around the quality of their processes and the complexity of their valuations.

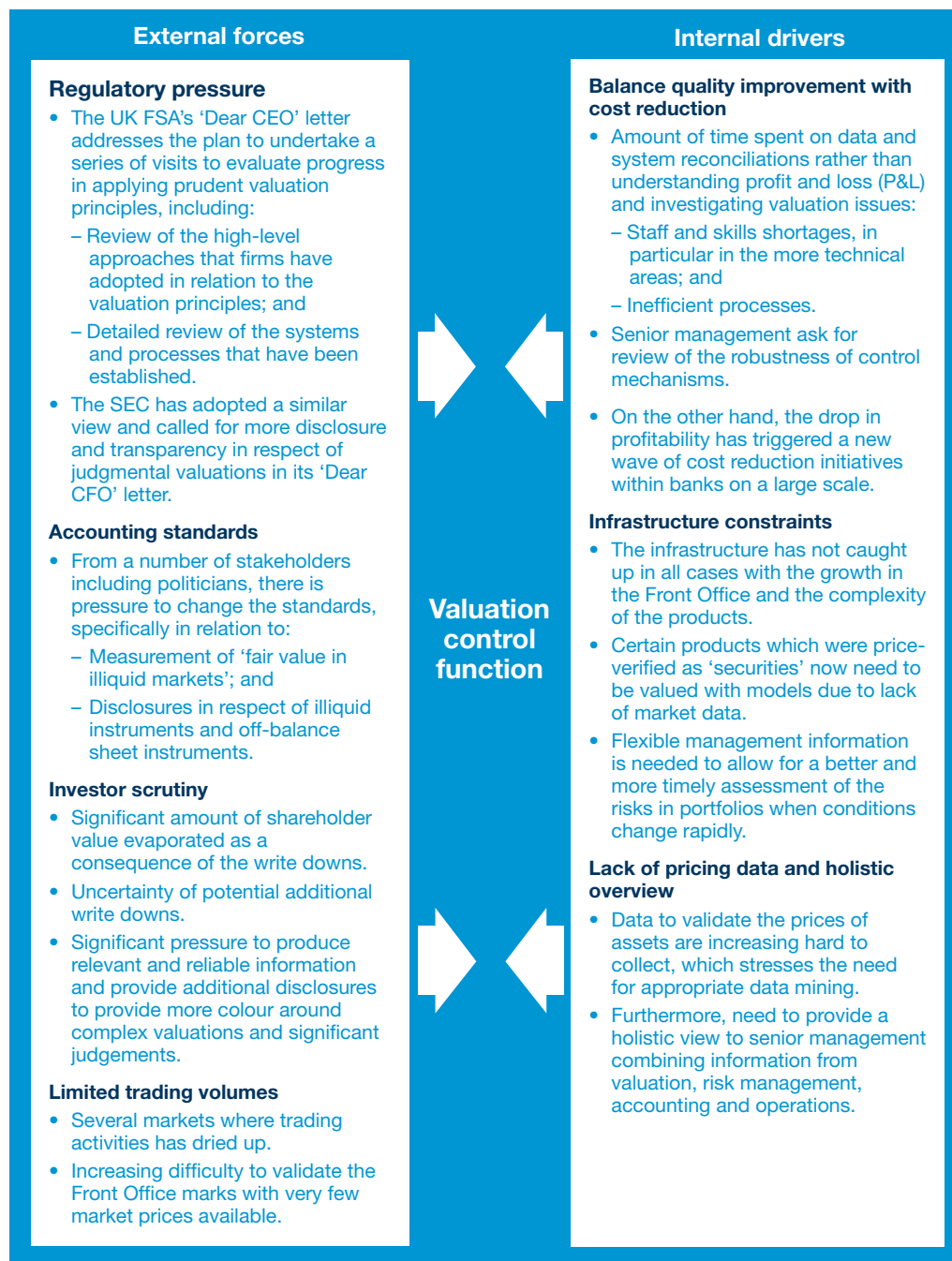
The overall culture of the organization and that within a valuation control function has been a key factor in driving a successful control environment. We have seen that within banks with an effective risk management structure, front office,

back office and controlling functions have an equal say and can challenge each other appropriately. 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:

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? If necessary, 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?

Figure 1 Summary of external and internal pressures



Independent verification of the financial instrument valuations has become much more difficult due to the current market conditions. There has been an increasing reliance on model based valuations and management judgment in the past year, making the transparency and control around those processes an important component of effective valuation control. Specifically, model review and calibration to market data for complex derivatives, where available, has been a focus of many organizations 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 sources and 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 judgmental valuations.

Human capital

- Do individuals performing independent valuations have sufficient product knowledge and quantitative expertise to challenge the business on valuation issues, especially in areas where more judgment is required?

- Are there acceptable staff turnover levels within the independent valuation function? Are current levels of resources sufficient to complete valuations in a timely manner in light of the increased complexity?

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 organizations 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).

Evidence shows that 49% of financial services companies have already cut back on their IT spend in response to the global economic slowdown.³ We believe,

however, that these short-term cost reductions can prevent organizations 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.

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.

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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).

³ 'Slowdown sees groups cut IT spending', Financial Times – 09.09.08.



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