

Group of Thirty – Best practices for valuation of financial instruments

The Group of 30 Steering Committee recommends that all major banks and investment banks evaluate their current practices against the best practices for valuation of financial instruments (governance, control, price verification and audit practices) and that the results of this review process should be reported to the Board of Directors or its Audit Committee.

Governance

1. **A clear and delineated governance structure should exist including provision for appropriate segregation of duties as well as documented procedures for the escalation of issues and exceptions to the board of directors and the audit committee.**

- The board of directors or the audit committee should approve a high level framework for accounting and valuation.
- The board of directors or the audit committee should review the governance structure regularly to ensure it remains appropriate especially if major acquisitions, disposals or business changes have occurred.
- All significant changes to accounting and valuation policies should be reported to the board of directors or the audit committee.
- Design of the detailed accounting/valuation methodologies should be the responsibility of a senior management group reporting to the CFO or its equivalent.
- The escalation process to senior management for various valuation oversight topics should encompass all high risk areas and be based on judgment and/or discrete financial thresholds but in all cases should be documented.
- Financial control and risk management must be independent of the risk taking businesses.

2. **A senior management grouping should have responsibility for the management and oversight of control and valuation policies and procedures. This group should report the results of its work directly to the board of directors or the audit committee.**

- Membership should include representation from market risk management, credit risk management, financial control/product control groups, senior business management, tax and legal.

- Day-to-day responsibility for oversight should be a combination of financial control and risk management.
- Information consistent with that produced by financial control and risk management for senior management should be provided periodically to the board of directors or the audit committee.
- Proper and complete documentation should be prepared and reviewed by senior management and, where relevant, the board of directors or the audit committee for all processes involved in the determination and verification of fair values.

3. **Initial responsibility for the determination of fair value should reside with the risk taking business. Ultimate responsibility for determining the fair values incorporated into financial statements must be outside of, and fully independent of, the risk taking functions.**

- Risk takers, under the supervision of senior risk-taking management are responsible for providing prices/market values for all financial instruments held at fair value.
- Financial control (the function responsible for the preparation of the financial statements) is responsible for reviewing (in conjunction with other control functions such as risk management) the fair values and ensuring adherence to the institution's policies and relevant accounting standards.
- Ultimate responsibility for the determination of the value included in the financial statements should be in financial control.
- Documentation should be prepared for policies and processes related to independent price verification.

4. **Senior management should ensure that there are adequate resources, with the appropriate experience, training and reward to ensure that control and independent price verification functions are performed to the highest standards.**



Control

5. **Risk limits (for both market and credit) should be established, approved and monitored within a framework and overall risk appetite approved by the board of directors or the audit committee.**
 - A risk management committee should establish more detailed limits in consultation with business heads and senior management.
 - A range of risk measures should be used as well as reasonableness tests.
 - For market risk, value-at-risk, stress testing and scenario analysis should be used.
 - Credit risk should be measured based upon current mark-to-market as well as on the basis of future potential exposure.
 - Other measures, such as notional limits and present value of a basis point should be used, particularly for items not measured on a fair value basis.
6. **For financial assets and liabilities measured at fair value, organizations should disclose information in their financial statements that is consistent with the way they measure and manage risk. Any significant differences between the day-to-day measurement and management of risk and GAAP should be well documented and approved by senior management and appropriate board-level committees. The same practice should be sought for other financial assets and liabilities to the extent that risk oversight and management reporting is not based on GAAP principles. This recommendation is not intended to limit the use of risk management information based on non-GAAP principles (e.g. value-at-risk etc).**
7. **There should be a procedure for the approval of new transaction types and markets (New Product Approval) and related controls and risk management approaches. This is a critical element of the control framework.**
 - The initial identification of risk, control and valuation issues for new transaction types and markets should be the responsibility of the risk taking businesses.
 - The ultimate responsibility for New Product Approval, including the risk measurement, control and valuation procedures for such new projects, should reside with a senior management grouping including representation from all relevant control and infrastructure groups (e.g. compliance, legal, internal audit (in an independent advisory role), financial control, risk management, tax, operations, technology, etc).
8. **An appropriately qualified and experienced independent price verification (IPV) group should be responsible for the fair values used in the financial statements.**
 - The IPV group should be part of financial control.
 - The members of the IPV group should be appropriately experienced (e.g. product controllers, risk managers, valuation experts, qualified accountants, etc.) and should have significant “on the job” experience as well as specialist training.
 - Risk takers, under the supervision of senior risk taking management, are responsible for providing prices/market values for all financial instruments held at fair value.
 - Financial control (the function responsible for the preparation of the financial statements) is responsible for reviewing (in conjunction with other control functions) the fair values and ensuring adherence to the institution’s policies and relevant accounting standards.
 - IPV groups should work closely with risk management, product control groups and those involved in the new product approval process (see above).
 - The IPV group should seek input from risk taking units.
 - Where fair value is a critical component of reported results IPV groups should have access to dedicated quantitative professionals within financial control or risk management to deal with complex price verification issues.
9. **There should be a group dedicated to model verification, independent of risk taking activities, employing highly experienced and qualified quantitative professionals.**
 - Especially where fair value is a critical component of reported results, considerable man-hours should be dedicated to model verification by appropriately qualified staff.
 - This Model Verification Group should be within financial control or market risk management.
10. **Valuation models or changes to a valuation model must be reviewed and approved by the Model Verification Group. Details of model approvals and changes thereto should be recorded in an inventory.**
 - A report should be prepared covering significant assumptions and model limitations. This report should be used to focus the independent price verification processes, as well as being the basis for limits setting and valuation adjustments.



- Trading on models that have not been fully validated, or reviewed, should be subject to specific and rigorous limitations and senior management approval.
- The inventory should include each model's review status, date of last review, limitations on its use and a scheduled re-review date.
- Institutions should have a formal process for ensuring models remain up to date.

11. There should be procedures for the timely review of highly structured/complex trades independent of the persons responsible for their design and execution.

- Such transactions should include unusually large trades or those with a significant profit at inception and/or transactions that raise questions about tax, accounting or suitability policies.
- This review should be undertaken by a similar group to that for the New Product Approval, often with more involvement of technical people such as those in the Model Verification Group.

12. For institutions using hedge accounting, the documentation, valuation and control requirements should be managed centrally by financial control.

Price verification procedures

13. Institutions should undertake a rigorous process, at least monthly, to determine fair values. The results should be reported to senior management. Where fair value is a critical component of reported results, senior management should report the price verification results to the board of directors or the audit committee.

- Prices and valuation parameters for liquid markets should be independently verified using external market data such as stock exchanges and other external sources of prices.
- Remaining parameters should be verified by way of broker quotes and consensus-pricing sources supported by market data and technical analysis to ensure that all inventory positions are verified for reasonableness.
- These prices/inputs should all be requested and received directly by the IPV group.
- The reports to senior management, board or audit committee should identify the 'quality' of prices used to determine fair value for each type of asset or liability.

- Other ad-hoc procedures including collateral reconciliations to position value, a review of similar recent transactions and early termination analysis should be undertaken.
- Consideration should be given to undertaking unscheduled, mid-month, detailed price verification. At a minimum this unscheduled verification should be performed if the result of other work identifies a potential difficulty and must be completed by people independent of the transaction execution.

14. An independent group should be responsible for approving and monitoring valuation adjustments for consistency and appropriateness. The group's findings and any changes to the method of determining such adjustments should be reported to senior management. A report of price verification differences and valuation adjustments should be distributed throughout senior management and, where fair value is a critical component of reported results, to the board of directors and the audit committee.

- Valuation adjustments for credit, bid/offer, liquidity and model uncertainty should be made on a consistent and systematic basis. Adjustments for servicing or administration are considered inappropriate by certain accounting frameworks and financial institutions.
- Valuation adjustments for early termination, customer unwind, funding and hedging should be considered, as appropriate, to determine fair value.
- Market and credit risk management groups should provide assistance in the determination of valuation adjustments.
- Valuation adjustments must be rigorously reviewed by the independent group to ensure that appropriate fair values are being adopted in accordance with accepted GAAP.

15. In addition to a rigorous monthly IPV process there should be a process for the review and explanation of daily profit and loss (and for non-traded financial assets/liabilities the relevant periodic profit and loss), which should be reported to senior management on a daily basis.

- This process should involve an analysis of results by reference to movements in market prices and indices, transactions, independent risk analysis and other information.
- For non-traded financial assets and liabilities the independent pricing process should be subject to similar procedures on whatever periodic basis is used to prepare profit and loss accounts and reported on a timely basis to senior management.



Audit

- 16. Internal audit departments should review at least annually the independent price verification procedures and control processes.**
- Review of the IPV process should include the policies and procedures as well as the treatment and escalation of exceptions.
 - Internal audit staff involved in such work should be experienced and attend both internal and external training similar to that received by the IPV group.
 - The head of internal audit should report the results of their testing to the audit committee regularly (and where fair value is significant to reported performance, frequently) on the scope and results of price verification.
- 17. External audit should devote considerable resources to reviewing price verification processes and performing valuations of transactions, especially in those institutions where fair value is a critical component of reported results.**

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The best practice statements are taken from the Group of Thirty report *Enhancing Public Confidence in Financial Reporting*. For further information, please visit the Group of Thirty website www.group30.org

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