No quick fix for fiduciaries on asset valuations

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The collapse in prices associated with a number of esoteric assets during the global financial crisis has led regulators, investors and other parties to examine new ways to calculate asset values and potentially reduce dependence on a few major dealers. However, it is not yet clear whether investors are ready to pay for something they have long assumed part of the service. Joti Mangat reports

Asian exposure to assets that suffered massive liquidity and pricing shocks after the bankruptcy of Lehman Brothers in September 2008 remains significant, although on a scale smaller than in the US and Europe. Both institutional and private wealth investors are still sitting on inventories of esoteric and illiquid assets spanning structured notes, structured finance and distressed debt. Moreover, while financial institutions may have received regulatory and accounting relief during the market dislocation, they now present troubling unknowns to finance and investment officers, concerns that were once more brought to the fore as markets became spooked due to concerns about some European sovereign debt in May and June this year.

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"Senior managers are aware they have legacy assets, and they realise the cost of funding and capital charges is only going up. With no independent access to price information, even a simple asset can become complex," says James Mudie, managing director and co-founder of Billarook, a Singapore-based company offering valuation advisory services to financial institutions. "The ability of institutions to source the relevant information can be limited by size or geographical footprint."

While liquidity has returned to most markets, an information vacuum at the more complex end of the product spectrum continues to challenge the ability of some fund managers, administrators and custodians to provide reliable portfolio valuations and meet redemption schedules. It is a problem that has caught the attention of some regulators. Mamoru Yanase, a director in the supervisory policy of Japan's Financial Services Agency (JFSA) in Tokyo, for example, is concerned that some of the country's smaller regional banks and credit co-operatives remain at risk and points to the heavy reliance on non-domestic counterparties among fiduciaries as the root problem. "Japanese fund managers and administrators generally rely on the originators of these securities - who are typically based outside Japan - for valuations," says Yanase. "The fact that many Japanese financial institutions do not have capability to value these products by themselves is a source of concern for us. We are encouraging them to be more careful with the information provided by originators and to develop their own abilities."

Asian regulators have also started talking about the capacity of trustees and accounting firms to provide an effective solution for valuing illiquid assets. The JFSA, for example, recognises the reliance of Japanese auditors on information from dealers as 'general practice', and is looking at ways to improve the situation. In Singapore, the auditing industry has taken advantage of regulatory support to adopt a more publicly critical tone. According to Ernest Kan, president of the Institute of Certified Public Accountants of Singapore, bank valuations and the models that support these valuations pose a systemic risk to derivatives markets. "From an auditor's perspective it may be difficult to understand the methodology used and banks may also not disclose the assumptions used in the portfolio valuation. Hence, the auditor may only be given the price information without any assumptions, which makes it difficult to audit the price information," he says. The Monetary Authority of Singapore is looking at new proposals to improve the independence of asset valuations (see box).

The result is that a new market is emerging for intellectual capital required to gain traction with quantitative problems associated with esoteric assets. In addition, funds and other third-party providers are peddling their quantitative skills to asset holders that appear to be frustrated with prices provided by a small group of major dealers. "Plenty of former structured products people are setting up their own derivatives revaluation platforms and there is value in that," says a senior derivatives sales executive at a US dealer in Singapore, who spoke on condition of anonymity. "This research into derivatives pricing inputs aids transparency and that can only help."

The matter is not just related to pricing for 'marks' needed to meet accounting requirements and the disposal of assets. Dealers were also accused of mismarking positions at the height of the financial crisis, for example, shifting collateral values down on collaterised debt obligations (CDOs) in the early stages of crisis to raise liquidity from hedge funds, followed by then raising margin haircuts across the board, according to an over-the-counter derivatives salesperson. "The whole thing snowballed from there," he says. "For the other investor classes, they were seeing collateral values plummet with no fundamental rationale."

"In times of crisis the desire to mark at levels that ensure you get the maximum levels of collateral can conflict with the true market price," adds Satyajit Das, Sydney-based author of Guns, Traders and Money: Knowns and Unknowns in the Dazzling World of Derivatives, and a former derivatives trader on both the sell and buy side. "Clients have been noticing that the marks and the margin calls don't exactly tie-up."

Leading derivatives dealers declined to comment for this article. However, Kevin Borrett, London-based managing director in Markit's portfolio valuations business, says the company saw a sharp increase in price challenges from users of the Markit service, which were attempting to understand the variations between counterparty prices, internally assessed prices and third-party prices. "During the worst, all three were substantially divergent. We heard about a lot of price challenges, and heard about many institutions that were deeply unhappy with their vendors and the lack of ability to challenge a price," he says.

Some market participants are now pushing for outsourced valuations to avoid further entanglement. Borrett says the number of Asian banks using Markit's services has increased, particularly among Australian institutions and other large regional commercial banks with a relatively smaller footprint in OTC derivatives and structured credit business. "Legacy inventory can be a particular risk for banks too, especially if they have since ceased market-making activities. Without the internal price-making capability, they have a new need for independent pricing to risk-manage those assets," he says.

Searching for solutions

Buy-side institutions are now demanding better prices from counterparties on a global basis, often cutting the worst offending vendors from their dealer panels. Proactive institutions, meanwhile, are adding quantitative resources to improve their internal pricing capabilities. "Demand from Asian buy-side institutions for our products has accelerated in markets where there was once strong reliance on counterparty providers," Borrett says. He adds that the Asian private wealth market, which has been a notable distributor of structured notes and structured products, is a current business focus in Japan and Taiwan.

Alongside other derivatives analytics specialists such as SuperDerivatives, GlobeOp, Fincad and Numerix, traditional financial data providers Bloomberg and Thomson Reuters are rushing to exploit the growing appetite for third-party services. With a premium on quantitative financial expertise and cross-market functionality, the rapid expansion of this data vendor marketplace could favour large-scale operations that can meet the operational demands and counterparty risk concerns of larger clients.

While it has established itself as a leader in the emerging market for third-party information, and is the only provider with Statement on Auditing Standards No. 70 level-II certification, which confirms a company's ability to protect the security of client data and ensure the reliability of the service, there are also concerns about the independence of Markit's products and the reliability of its data. Critics state that the company is majority owned by 16 investment banks that contribute data directly from their books of record, resulting in concerns that contributors could manipulate data.

Borrett says Markit has responded to significant volumes of 'rouge', or outlier, data points by slimming down its contribution base and discarding up to 60% of the pricing data received when calculating its independent price. The company also removes contributors that demonstrate persistent outlier patterns. "We're snapping a couple of million data points a day from exchanges, IDBs [inter-dealer brokers], and a large universe of equity, rates, commodity and credit-oriented data sources and running that against dealer runs," he adds. "The infrastructure required to do the analysis and scrub this volume of data on an intra-day basis for real-time delivery to users in all time zones has to be very robust indeed."

New intermediaries

Meanwhile, a new class of provider is emerging from within the buy side, says Hong Kong-based Jamie Spence, a co-founder of Billarook. "Hedge funds and specialist asset managers that have an ongoing business in a particular asset or asset class, and a critical mass of contemporary resources and technology, are moving into the advisory services space," Spence says.

Why might a hedge fund, whose reason for existing is to profit from proprietary trading activities, be interested in offering an advisory-only service? One cynic's answer is that they may be looking for assets on the cheap and want to bypass dealers. But hedge funds, struggling with market uncertainty and financial re-regulation, may also see such a service as an ancillary revenue stream that utilises vacant capacity to provide a new source of fee income. Furthermore, connections to fresh sources of capital may enhance strategic attempts to diversify funding away from prime brokers.

Spence suggests that regulatory and fiduciary drivers are converging in Asia, with increasing numbers of financial officers looking at a new

approach to asset valuation. "Many buy-side institutions in Asia don't have the resources to do this work, or operate small teams that are dependent on investment banks for information," he says. "We've seen a fairly dramatic acceleration in the level of interest in our confidentiality framework from senior managers across the region."

The model relies on both sides of the deal to enforce a strict firewall between advisory and proprietary trading activities, which Spence says is achieved by structured confidentiality agreements between senior financial officers and service providers. "We work with senior executives independent of the business lines and trading desks to ensure that information gets onto the table on a bona fide basis," he say, adding that competitive bidding between potential advisors for valuation mandates forces bidders to focus on quality.

While Spence says Billarook continues to broker more service agreements, other information vendors suggest the reliance by some hedge funds on proprietary pricing models may limit their ability to provide the best solution. For OTC products, the Financial Accounting Standards Board (FASB) fair-value standard FAS 157 awards Level II status to valuations based on quoted prices; while values based on unobservable or modelled inputs are considered least reliable. In the case the of the Black-Scholes pricing model, for which volatility is a key input, the use of historical price movements to model volatility would appear to fit within Level III, while a valuation that uses primary volatility data for similar options instead stands a better chance of passing the observability test. "It's understandable that hedge funds are transitioning their business models to meet changing market dynamics. There is definitely a place for quantitative expertise and price models, but it's crucial to calibrate them with good data. I doubt that the smaller boutiques have direct access to the level of data necessary to do this properly," says Markit's Borrett.

Capital charge

Until prudential regulators decide whether they want to engage with the pricing problem, the market will look to self-regulation to improve information flow between banks and their clients, and support fair value accounting approaches. While rising asset values might make CFOs feel less compelled to incur new business costs moving forward, changes to capital regulations could mean that access to observable data and third-party valuations become mandatory for all participants. "The process of improving information flow will ultimately be driven by the cost of capital associated with holding esoteric and complex assets. To the extent that asset owners can provide independent information around these assets, they will become less costly to own. If there is only one price provider for an asset and that's the counterparty, the incentive will be to divest these assets," says Billarook's Mudie. Given the relatively strong capital positions of Asian financial institutions and their low exposure to the worst affected asset classes, this dynamic may be more telling in the US and Europe.

Despite heightened scrutiny, some dealers are confident they will remain central to the valuations industry as it enters its new phase given their significant resources. "Price challenges are not new and have been exacerbated by the recent volatility," says the senior derivatives salesman. "Auditors that want to have the final say on fair value tend to rely on basic spreadsheet models, but our models are validated by internal risk committees and the regulators of our business. The more complicated a product is, the harder it is for customers to revalue it themselves."

Singapore sets the tone

Asian regulators have begun to look at ways to bolster fiduciaries by improving their access to information. The Monetary Authority of Singapore earlier this year published a list of proposed amendments to the Code on Collective Investment Scheme including the Ucits III-like requirement that funds may only participate in financial derivatives that "are subject to reliable and verifiable valuation on a daily basis and can be sold, liquidated or closed by an offsetting transaction at any time at their fair value".

The proposals suggest a new definition of "reliable and verifiable valuation" for OTC derivatives, which must include a valuation made independently by the fund manager at fair value "and which is based on either on current market value or an appropriate valuation model checked at an appropriate frequency by an independent ‘third party'. The proposals are explicit that the managers valuation ‘should not be based solely on a valuation provided by the counterparty to the transaction".

Marking to liquidity

The awareness that liquidity can become the major determinant of value during severe market stress is driving new approaches to liquidity risk management at the individual portfolio level. According to Carlo Acerbi, a risk researcher with MSCI Barra, the information provider has developed a primary data-intensive methodology that allows investors to quantify liquidity risks for all asset classes. "Funds are committed to provide liquidity, and when facing redemptions they must respect risk limits. Mark-to-liquidity is a way to quantify consequent potential costs hidden in the net asset value of the fund." he says.

The methodology uses observable market data to create categories of explanatory variables for liquidity on an asset specific basis. "In general, for derivatives, this method provides a limited number of variables that can describe appropriately the liquidity of an asset category," he says.

Although he naturally prefers to use primary data to derive liquidity-adjusted values, this can be difficult to source in some of the asset classes that investors are most concerned about. "Investors are increasingly concerned about the liquidity of bond portfolios, but also futures and options, asset-backed securities, convertible bonds, and other asset classes," he says. "For some of these there is no historical data available, and yet, relevant information may still be available because specialist traders and market-makers do have timely and solid opinions on how expected transactions costs will perform in specific scenarios."

Asked if this leaves the liquidity value-at-risk concept exposed to the same constraints as investors seeking good price information from

counterparties, he says: "The disclosure of liquidity information is not as delicate an issue as the disclosure of price levels. Liquidity information is not something traders are jealous with."

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