Independent Asset Valuation: Accounting or Accountability?

Fund managers across the globe are taking definitive measures aimed at enhancing their corporate structures so as to ensure that governance is capable of withstanding investor and regulator scrutiny. Management accountability has expanded noticeably in the wake of last year's financial market crisis, and we are now witnessing the emergence of independent governance boards and impartial valuation committees whose goal is to ensure greater transparency, disclosure and risk management oversight. Increasingly, fund managers are expanding into new investment strategies which employ hard-to-value assets which typically fall under extreme regulatory oversight. Independent asset valuation ensures greater strategic flexibility and ensures that fund managers are able to comply with regulatory demand for clearly defined, fully documented, demonstrably robust pricing procedures.

Delivering investment performance remains the principal goal of fund managers worldwide. Yet increased regulatory intrusion and the emergence of standard-setting bodies are placing remarkable challenges on operational personnel with most firms employing in-house compliance, risk management, treasury and technology officers. For example, fund managers participating in the Term Asset-Backed Securities Loan Facility (TALF) must contend with numerous operational and logistical issues, including: collateral eligibility, borrower qualification, sponsor certification, funding periods, position limits, obligation assignments, voting/consent rights and hedging constraints, to name but a few. Although TALF is a unique program with extraordinary operational requirements, the challenges and costs of implementing an effective framework to comply with such rigors can be daunting, to say the least. To complicate matters, investors are much more likely to raise substantial questions if these functions are performed entirely in-house or by a single outsourced counterparty. Fund managers must therefore employ a balanced and unprejudiced system where responsibilities are segregated and impartial counterparties are tasked with varying levels of oversight and compliance.

Accounting Complexity - Multiple Valuations & Operational Implications

Managers are presently struggling to comply with the set of best practices outlined by the President's Working Group (PWG), Hedge Fund Standards Board (HFSB) and International Organization of Securities Commissions (IOSCO) as disclosure and valuation demands tend to be costly and potentially compromising. Furthermore, the lack of a single, unified set of industry leading practice standards has slowed the rate of adoption with most managers opting to implement only a handful of proposed requirements.

We contend that the most challenging standards for adoption are those dealing with valuation. For example, FAS 157 Fair Value and FAS 115/EITF 99-20 Impairment Analysis, including preparation of supporting documentation for methodology framework and modeling assumptions, must be based on disciplined application of input hierarchy. These issues are further complicated by dysfunctional trading conditions in the wake of last year's financial market instability, and open the door to a number of control issues when attempting to justify observable price data.

The most relevant valuation issues revolve around FAS 115-1 ("The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments") and EITF 99-20 ("Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets"). In effect, recognition of impairment losses requires more than just a drop in the security's price. While an individual price decline may be material, it can also be reflective of temporary liquidity constraints for an individual security or market sector. In April 2009, FASB issued FAS 157-4 which reaffirms the objective of fair value measurement while purposefully allowing for multiple asset values where the volume and level of activity in a security has significantly decreased. From an operational standpoint, having multiple asset values for the same security can result in numerous logistical issues, including:

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calculation of principal/interest, tax treatment, input discrepancies and resolution of pricing disputes, to name but a few. Thus, selecting observable data for valuation purposes requires principles-based pricing methodology which must be well documented and supported by an independent third-party pricing agent. Moreover, pre-examination reviews in preparation for audit, accounting and regulatory examination should be performed in order to validate assumptions. Such reviews will ensure that the expectations of management, investors and auditors are satisfied.

Accountability Issues - Independence is Incontrovertible

Increasingly, fund administrators are being called upon to fill the void of independent asset valuation. While independent valuation committees are a positive first step, the formal constitution of such committees largely calls their expertise and independence into question. After all, if firms are creating valuation committees where members bring few relevant insights or capabilities, little to no value is created. On the other hand, most prime brokers and custodial banks are well equipped for asset valuation. That said, these agents are often conflicted and so unable to serve in a truly independent role - prime brokers are primarily concerned with credit risk and collateral management issues whereas custodial banks must ensure safekeeping of client assets. In the end, asset valuation is a function of both pricing methodology AND source credibility.

Looking ahead, valuation issues are likely to remain a central issue for the fund management industry. Although emerging standards provide some guidance, key questions regarding accountability and implementation remain unanswered. Given the generally distressed state of global financial markets, investors demand greater transparency of pricing methodology and increased segregation of responsibility across the fund's numerous service providers. Managers are thus advised to prepare for the complexities associated with delivering independent asset valuation less they fail in their obligation to the fund and its underlying shareholders.

Swiss Fund Services is uniquely suited to fill the emerging valuation gap.

Call us now at +1 441 278 7615 for more information.

Yours Sincerely,

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