

IVSC Project on Methods of Valuation for OTC Instruments

OVERVIEW

The International Valuation Standards Council (IVSC) is an independent, not-for-profit, private sector organisation that has a remit to serve the public interest. The IVSC's objective is to build confidence and public trust in the valuation process by creating a framework for the delivery of credible valuation opinions by suitably trained valuation professionals acting in an ethical manner.

The IVSC achieves this objective by:

- (a) creating and maintaining the International Valuation Standards (IVS);
- (b) issuing technical guidance for professional valuers; and
- (c) promoting the development of the valuation profession and ethical practices globally.

In view of concerns expressed by governments, financial regulators and others over both diversity and a lack of comprehension of how financial instruments were valued, in 2009 the IVSC formed a Financial Instruments Expert Advisory Group (FIEAG) to assist it in identifying valuation problems in the financial markets and projects that could be undertaken to help rebuild confidence in the valuations of financial products, particularly for over the counter (OTC) instruments.

The FIEAG contributed to the production of a new high level International Valuation Standard for financial instruments (IVS 250) that following due process has now been published¹ as one of a completely revised suite of standards. The FIEAG identified two further projects that have been accepted by the IVSC for inclusion in its Work Plan. One of these is to produce a Technical Information Paper on methods of valuation used for valuing OTC instruments.

This paper describes the background to the project and sets out matters that the Board believes need to be considered.

The IVSC wishes to form a **working group** to help progress the project. This will ideally include individuals with different perspectives on the valuation of financial instruments, for example:

- experience in valuing OTC instruments either on sell side, buy side or as an independent consultant;
- users of valuations (including preparers and auditors of financial statements that include valuations of financial instruments),

Because of the anticipated regulatory interest in the project the IVSC is also considering the formation of a **review panel** of experts from financial sector regulators. This panel would have input into the scope of the project and an opportunity to provide feedback on a draft proposals before they were made public. However, in order to allow the participants in the working group to explore ideas and discuss matters freely, members of the regulatory community would not take part in the working group sessions.

Nominations for membership of the working group or review panel are invited. An application form and further details can be obtained from the IVSC Technical Director, Chris Thorne by email to cthorne@ivsc.org.

¹ IVS 2011 – available from www.ivsc.org

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Project Objective

The financial crisis of 2007-08 resulted in much criticism of the valuation of financial instruments. Some of this was directed at the use of fair value measurements in accounting for financial instruments rather than the valuations themselves. However, it was also clear that the rapid growth in both the complexity of products over the previous decade and in the methods developed to value these products had created a situation where senior management, independent directors, investors and regulators did not have sufficient understanding of the products or the valuations.

It has also become apparent that some of the accounting requirements for measuring instruments would have benefited from being informed at the time of their creation by an established source of recognised valuation best practice. In the absence of this many consider that there are mismatches between the way in which the accounting fair value of an instrument has to be determined and the way in which it would be valued by market participants.

The role of the IVSC includes identifying and promoting principles of best valuation practice for all classes of asset and liability. While these principles will be of benefit to valuation practitioners, they are also intended to help those who use and rely on valuations understand the process and the result. Defining and publishing best practice brings transparency that in turn builds understanding and then confidence.

The objective of the IVSC project is to produce a high level guide as to the accepted best principles of best practice for valuing OTC Financial Instruments. It is not intended to produce a training manual or to otherwise teach people how to use complex mathematical formulae or models. Although some commonly used methods may be referred to, this will be in the context of a generic discussion of the principles underlying the model; critiques of individual models will not form part of the brief. The objective is to identify and define the fundamental principles that should underpin valuation activity in the sector, not to produce an academic study.

The target readership for the guidance will be:

- quantitative analysts and other specialists involved in the creation and valuation of OTC products;
- those who commission, require or rely on valuations of OTC products such as senior management, risk controllers, auditors, regulators and fund managers.

Project Scope

The IVSC Standards Board has identified the following issues that it considers should be addressed by the project, although the working group is encouraged to make recommendations to amend or extend this list.

- Asset classification and relevance of asset class to methods adopted. It is recognised that there are many ways of classifying different types of instrument, but it is suggested that the factors that will influence the way in which instruments are classified include the nature of the instrument, the purpose for which the valuation is required and the method of valuation required.
- Overview of principal methods and models. This should not provide a detailed examination or critique of any model but should discuss model types in a generic context by reference to the objectives of the model and fundamental principles on which it is built.
- Valuation models for dealing with different asset types (eg equity, fixed income, structured credit, asset backed securities) and option types (European, US, Bermudan, Asian, Digital, Path Dependent etc)
- Principles for model calibration and input selection. The purpose is to describe calibration methods and input choices that are acceptable for different models and asset types, rather than to limit the scope of possibilities.
- Principles for model solving. The aim of this section is not provide detailed algorithms for model solving but to provide a high level overview of the most relevant methods and key principles.

It is envisaged that the style of the guidance will be mainly narrative with a minimal number of mathematical examples.

Special attention needs to be paid to the technical depth of the document. As indicated in the project objectives, the output of the project should not be an academic paper or a training manual, but a reasonably high level exposition of the key principles aimed at helping informed and educated readers understand what is accepted as best practice in valuing different types of instrument. However, given the subject matter it cannot avoid some technical content if it is not to be too superficial to be useful.

The working group is requested to firstly review the scope outlined above and feedback any recommendations for a significant change to the IVSC Standards Board. If the scope is agreed the second stage will be to develop a skeleton paper to indicate the overall structure and contents that are proposed. This will be shown to the proposed review panel and the Board. Once agreed the working group will then be asked to develop a detailed document that, subject to Board approval will be released for public comment as an Exposure Draft.