HARVEST
Transparent Investment Valuations

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International Valuation Standards Council
1 King Street
London, EC2V 8AU, United Kingdom
Via email to: aaronsohn@ivsc.org

Re. IVSC Invitation to Comment – IVS Agenda Consultation 2017

Dear Members of the Council,

Thank you for the Invitation to Comment (IC) on the IVS Agenda Consultation 2017, issued on 15 May of this year. In our previous letter to the Council, written in response to the 2016 publication of the IVS 500 Exposure Draft, we indicated our support for the Council's project as stated on p. 3 of that Draft:

- to develop high quality valuation standards for financial reporting and regulatory purposes
- to ensure consistency and transparency in the valuation of financial instruments
- to enhance general governance of the same

In what follows, we again restrict our remarks to issues of securities valuation, which is our area of expertise. First, we offer a few remarks on pages 9-13 of the IC, concerning the formation of a dedicated Financial Assets board, which we support. Second, we provide a context for our concerns about how information about price and value presently circulates within the financial system, based on our experience as a securities valuation specialist. Here, we address several specific and continuing challenges related to securities valuation, drawing on our experience with fair-valuation before and after the financial crisis. Third, we address several questions raised in the IC that we think bear on best practices in the valuation of financial instruments, while recognizing that the Council's work as a whole and the current IC extends beyond that specific domain.

The Establishment of a Financial Assets Board

Pages 9-13 of the IC indicate that the formation of a dedicated Financial Assets Board is still under consideration pending a determination of market need. However, at the end of May, the IVSC issued a call for applications from potential members of such a Board, which suggests that it will eventually be established. Similarly, IVS 500 made mention of a Financial Instruments Task Force that would bring stakeholders together to improve valuation of financial instruments (p. 3). We hope that the Council will indeed establish such a Board or Task Force. In our experience, valuing, pricing, auditing, and accurately reporting on financial instruments continue to present significant but not irremediable problems.

Despite the various standards, regulations, laws, and training regimens that have been established in the U.S., particularly since the crisis, we continue to observe mispricings and variances, a general tendency to rely overmuch on a single pricing source, as well as persistent problems with fair-value levelling. Over time, some of these difficulties could be ameliorated through professional training and/or credentialing designed to help auditors and other users of financial reporting information more easily and accurately identify securities with valuation and/or structural risk features. Certain systemic issues will require a more intensive engagement with and collaboration among industry participants, service providers, specialists, and regulators to ensure that investors are adequately protected and systemic risks minimized. For example, the role of inputs in the construction of price/value is still not as generally well-understood as it should be, nor are the inputs presented as transparently as they should be, as we explain below.

We strongly support the creation of a Financial Assets Board that is equipped to address issues specific to the valuation and auditing of financial instruments, especially since they were central to the crisis of 2008. Further, we recommend that any future Board approach securities valuation in such a way that the individual structural features of the securities in question are taken into account, as many of the regulators and agencies in the U.S. have already done.

Regulation, Risk, and Information: The Construction and Transmission of Price and Value

Global standards for the valuation of financial instruments from the IVSC would be a welcome complement to work already completed or underway by the PCAOB, SEC, AICPA, FASB and GASB in the U.S., as well as to the international efforts of the IASB and the Basel accords. As a recent report by the SEC's Division of Economic and Risk Analysis (DERA) demonstrates, regulations put in place since the 2008 financial crisis have not correlated with reduced access to capital or reduced market liquidity,[1] as some industry participants have claimed.[2] In fact, trading volume continues to be robust, and new issuances of securities are far from entering a period of decline.

The role played by the ratings agencies within the crisis is now well-established. High ratings too often hid bad securities. That the consequent damage to financial institutions proved so enormous that government bailouts were required and that the concrete social costs borne by citizens were likewise profound are matters of fact, not opinion. What is perhaps not so obvious, but can nevertheless be easily demonstrated, is that the ratings agencies' informational failure in 2008 is a cautionary reminder of how important it is to attend to the (interconnected) flows of information and risk within the financial system. If higher-quality information is available but not used, then the continued use of low-quality or inaccurate information effectively becomes a matter of choice, one that we respectfully urge the Council to pre-empt.

We saw during the crisis that risk is in part a consequence of information and the ways that information gets acted upon. Even then, however, it was possible to figure out that the ratings information for mortgage-backed securities was suspect, prior to their eventual downgrading. Price and value are

[1] https://www.sec.gov/files/access-to-capital-and-market-liquidity-study-2017.pdf
[2] https://www.bloomberg.com/news/articles/2017-06-07/wall-street-says-rules-risk-next-crisis-trump-regulators-agree

dependent upon information, and it is imperative that good information gets passed through at appropriate points within the financial system as a whole.

For example, the information provided by pricing services is essential, since mutual fund securities must be priced every day; there is simply no other efficient, cost-effective way of valuing that kind of volume "by hand." Pricing services satisfy a legitimate systemic need. But there are other contexts in which the information offered by pricing services is unsatisfactory, especially in financial statements and audits, where it is materially consequent that the best available information is used. In such cases, accurate valuation requires more than back-filled and highly automated proprietary pricing services, as useful as the information they provide may otherwise be. Better, more transparent information is needed.

In the U.S., the fair-value hierarchy highlights two key informational standards: first, that valuation results from an understanding of all relevant inputs and, second, that financial instruments can often be highly complex and illiquid, in which case appropriate caution and professional skepticism are required when assigning values. In theory, these two parameters should work together to ensure that the highest possible quality of information gets taken up and transmitted within the system as a whole.

In practice, however, the situation is more complex, and the highest quality information does not always get used, even when it is easily available. Perhaps this is not entirely surprising, because value and price are determined and passed on within settings shaped by professional and institutional commitments, norms, and habits, as well as multiple and intersecting interests. Nonetheless, it is hard to see how an auditor can be expected to understand the inputs relevant for a given valuation when the data that auditor is working with does not provide them. We state the obvious here because we think it is relevant to a problem that continues to concern us: the fact that we are seeing significant mispricings and variances, overreliance on single pricing sources, and persistent problems with fair-value levelling. In other words, valuation problems analogous to those we saw in the 2008 crisis still persist.

IC Gap Analysis and Financial Instrument Valuation

On p. 7 of the IC, the Council lists several topics that are under medium-to-long-term consideration, including "automated valuation models and analytics" (#4), as well as "price vs. value" (#7). We will briefly address these two Gap Analysis issues here, reserving more detailed remarks and any recommendations for additional topics until after a determination is made about the ultimate status of the Financial Assets Board.

As we wrote in our comment on IVS 500, we recommend that the Council make a clear distinction between pricing and valuation with respect to financial instruments/assets, reserving "valuation" for the work of specialists (like Harvest) who perform independent analysis that ensures input transparency. Currently, the "price vs. value" issue is being addressed by the Council's Business Valuation Board and the Tangible Assets Board (p. 18); we strongly recommend that the anticipated Financial Assets Board also weigh in. The persistent problems we have observed in the U.S. context in getting fair value "right" point to the need for the kind of information that is only provided by specialists. Also, and related to topic #4, distinguishing "easy" and "hard" to value securities and determining appropriate fair-value levels cannot be done using the information provided by automated pricing services, as useful as they may otherwise be, because they provide no transparency with respect to inputs. Consequently, we also recommend that any future Financial Assets Board be included in the Council's work on issues of automated models and the use of data analytics, since both are highly relevant to the valuation and pricing of securities.

We thank the Council for its invitation to comment and for its time in reviewing our concerns. If the Council is interested in discussing any of our views in more detail, we are at its disposal: please contact Susan DuRoss at 312-823-7051.

With best regards,

Harvest Investments, Ltd.