Multi-firm review of how asset management firms value so-called 'hard to value' assets - video transcript

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Why does the valuation of 'hard to value' assets present unique risks?

NM: Valuation is a particular area where conflicts can arise. In particular, conflicts can arise if there is an incentive to inflate the marked value of the asset above and beyond what it should be because remuneration policies, for example, might be tied to growth in assets under management.

So, it is an area that concerns us and it is an area that we therefore looked at last year [2017] through a supervision project.

Valuation of liquid assets is relatively straightforward. There's liquid assets, for example, listed equities, there's a consensus price that's transparent on a market that's driven by supply and demand pressure.

But where an asset is less liquid, for example it might be a high yield bond, it's more difficult. So you need to apply judgement and you need to adopt a methodology that gives you an answer about what the true value of that asset is.

Therein lies the potential difficulty because where you bring in subjective judgement it may be that other incentives deviate away from an objective valuation process.

What do our rules say?

NM: Our rules require firms to ensure proper independent valuation.

This means ensuring impartiality as well as due skill, care and diligence.

The authorised fund manager should document the basis of valuation including any fair value pricing policy.

And, where appropriate, the basis of any methodology and ensure that the procedures are applied consistently and fairly.

Where an Alternative Investment Fund Manager (AIFM) does the valuation itself, there needs to be functional independence from the portfolio management.

The AIFM also needs to ensure that remuneration policies and other measures mitigate conflicts adequately.

Also that they prevent improper influence on employees involved in valuation.

If an AIFM uses an external valuer, it must be independent from:

- the AIF
- the AIFM
- anyone with close links to either

What was the scope of the review?

NM: We looked at unquoted equities, fixed income instruments and private equities.

We excluded real estate because we’ve done a separate project on that. The details of that project are available on the website.

In terms of range of firms, we looked at all different types of investment strategies and all different shapes and sizes of firms including private equity, alternative managers and traditional managers.

In some cases, we also looked at the role of the Depositaries and authorised corporate directors.

What do good firm arrangements look like?

NM: We want to see genuine valuation expertise. In the front line, in the first line of defence, among the portfolio managers of course but also crucially we want to see that expertise replicated in the second line of defence for systems and controls ensuring that the second line has sufficient expertise to be able to independently challenge the portfolio managers.

That’s really crucial. We want to see robust evidence of independent challenge from the second line in the day to day operations of firms as they’re making valuation assessments.

And, indeed, in some cases where a materiality threshold is breached, for example, it may well be appropriate to bring in additional independence through an external third party.

IOSCO has some helpful guidance on this. So, if firms are interested I would encourage them to look at the IOSCO website.

Where can systems and controls improve?

NM: We think the role of the valuation committee is absolutely critical. Where we saw good practice we always saw really good valuation committees.

The role of the valuation committee is to provide genuine, robust, effective challenge to the portfolio managers. That absolutely means that it needs to be composed of individuals with the requisite levels of expertise and gravitas to be able to effectively challenge portfolio managers.

We want to see valuation committees taking responsibility and accountability for the valuation processes, and it needs to be an ongoing process.

It may well be that valuation committees can learn from the practice of audit firms, for example.

There’s lots of scope for improvement here. Sometimes valuation committees lacked the appropriate expertise, we found. Sometimes it was a tick box compliance exercise. Sometimes insufficient challenge was provided.

We want to see genuine, robust, effective challenge across valuation committees.

What about the oversight provided by the Depositary?

NM: The depositaries play a really important oversight role we think. Our evidence suggests that they seem to take a narrow view of their own role and we think our rules are clear that their obligations go beyond that view.

For example, we want to ensure that they are checking that a valuation process exists but also that it's robust and effective in a meaningful way and not just a tick box affair.

What do we want firms to do?

NM: I want to see three key things:

One is expertise. In the first line of course but also in the second line. Not enough expertise in the second line of defence is one of the key findings of our review.

I want to see independence throughout the process. Independence from portfolio managers so that their valuations are being effectively challenged on an ongoing basis through the valuation committee and through an external third party where necessary.

And finally, I want to see these policies being adhered to meaningfully every day. Day in, day out. I want firms to be able to evidence that when we ask them to provide it.

It's about your duty to your investors. It's important that you treat their money as effectively as you would treat your own. It's really important that you recognise that you have a duty to provide them with a fair valuation of their assets.