Finding value

Representatives of Markit, accounting firms and the buy- and sell-side met at The Yale Club, New York, on 12 May to assess the story so far on **Financial Accounting Standard 157**. The key issues that emerged ranged from the definition of exit price to where Level 2 ends and Level 3 begins. Below is a small selection of what was discussed

Attendees quoted in this article:

Michael Abbate, senior manager, Ernst & Young
Neeraj Chopra, global head of valuations and control, Lehman Brothers
Sally Fassler, cfo, Sankaty Advisors
Jeff Gooch, roundtable chair and evp, head of trade processing and portfolio valuations, Markit
Kevin Gould, evp, head of data and analytics, Markit
Nigel Hyde, md, head of Totem, Markit
Kevin Kispert, partner, Ernst & Young
Marcus Komm, global head of valuation review, Morgan Stanley
David Lukach, partner, PricewaterhouseCoopers
Andy Nendick, md, Totem, Markit
Michael Smith, head of valuation control, Deutsche Bank
Alexey Surkov, partner, Deloitte & Touche
Andrew Viens, vp of operations, Sankaty Advisors

Jeff Gooch, roundtable chair and evp, head of trade processing and portfolio valuations, Markit

Jeff Gooch: Let's start with one of the major technical talking points. It seems to me that there is a lot of discussion around exit price – we've certainly had a lot of questions from funds about what constitutes an exit price for the sake of FAS 157. Is it mid, is it bid, is it offer or is it one of a bunch of other definitions? What do people around the table think?

Neeraj Chopra: Well, for us it's bid – that's the exit price. I think it is for most people as well. But the problem comes when you have to define whether that price relates to a normal marketplace or if it's a distressed one.

Sally Fassler: There's a very real difficulty in coming to a conclusive opinion on what to use and whether it's a distressed sale, liquidation, forced sale and so on – all those kinds of terms and defined sales that you're not necessarily supposed to use for a FAS 157 exit price. Opinions vary, so we've done an analysis on certain of the assets that we invest in to see what the range would be if we were to go out to banks and ask for a bid. When you get a 15-point range where do you go? You can't take the mid of that; I mean, it's 15 points. I think it's less about defining what you're going to use as a bid and more about trying to navigate when you don't have transactable bids.

Marcus Komm: I think the regulation is quite prescriptive about having to use these types of data points in the absence of others, but it has an increase in Level 3 inventory as a direct consequence. The strictness of the rule that says you've got to be at exit and leverage available data is actually introducing a lot more issues with assumptions as to how to exactly use these to measure what the exit is. So, by default, you're increasing the subjectivity in your valuations.

Jeff Gooch: Well, that's something I've heard from a few people: saying mid is theoretically a derived price, but if you go to bid then it is very liquidity- and circumstance-dependent in terms of what's available at the time.

Nigel Hyde: But in 157 it talks about theoretical exit price. It's not talking about a forced sale. There's where you can get out of the position right now and there's actually what you think will be a reasonable price to get out of that position in reasonably ordered markets.

Sally Fassler: While I'd like the latter to be the answer, I'm not sure that's the case. I know if I'm having an audit as of the 31st of December, I have to value as of the 31st of December and FAS 157 says come up with your theoretical exit price as of the 31st of December. But I know I'm not selling it; I'm doing my audit two months later and haven't sold it.

Marcus Komm, global head of valuation review, Morgan Stanley

Kevin Kispert: And to that point, I think the issue of intent is an important one. Does the reporting entity's intent really matter under FAS 157? I think most people understand that intent is somewhat irrelevant. Whether you actually plan to sell the asset or not, the question is, if you were going to sell it, taking into consideration liquidity issues and other market dynamics, what do you believe is the price you would get for the asset as of the measurement date?

Also, I do agree that that one of the biggest questions we're hearing in the marketplace right now relates to whether every sale in a distressed or dislocated market represents a distressed sale? I believe the general view among the accounting firms is that not every transaction that occurs in an illiquid market constitutes a fire sale. You have to consider these transaction prices in determining your fair value measurement. That doesn't necessarily mean that price represents the fair value of the instrument being measured; an adjustment may be warranted in certain circumstances. But you can't simply choose to ignore this observable data.

Regarding the discussion around mid versus bid-ask prices. There is a practicability exception in FAS 157 that allows entities to record positions at the mid. Many of the people around this table probably don't utilise that expedient, given how they run their business, but FAS 157 does enable this to be an accounting policy decision to be applied consistently.

Jeff Gooch: Consistency certainly seems be an issue. I hear from a range of people that the same positions are being treated differently by different firms. We've now got to a situation where a trade for a bank that did 50 similar trades on the same day could be Level 2, but exactly the same trade from a fund which has only done one transaction like that this year could be Level 3. Now is that an intended consequence or just an unfortunate consequence of the rules?

Sally Fassler, cfo, Sankaty Advisors

David Lukach: It is an unfortunate consequence, but it is probably a reality because each market participant must look at the world from their point of view. In the bank's case, it probably has several data points to look at, whereas companies outside of the dealer community probably have less transparency into the market.

Kevin Kispert: Under FAS 157, we now have a framework to guide the determination of fair value measurements. This has served to highlight certain diversity in practice that existed – for example, different asset classes were being marked in very different ways. I think one positive outcome is that, historically, people thought about fair value in a number of different ways, and the framework is requiring people to think about fair value in a more consistent manner. Whether or not the framework is a good fit for every asset class measured at fair value is a separate question, but a fair one.

Jeff Gooch: I think the interesting consequence of it is that if you're going to start relying on actually observable trades, how do all market participants access those observable trades? For some products that could be quite difficult, because only certain points on the curve trade. The other points don't – there's not a lot of half-year maturity at certain points, for example.

Talking to a few of the firms represented around this table and elsewhere, the consensus view appears to be if an instrument definitely trades that's fine. Equally, if you've got some trades on the five-year bond and you've got some trades on a seven-year bond,

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it's perfectly acceptable to interpolate between those to the six-year bond that hasn't traded recently and put a price in for the six-year maturity. However, if you've got the five-year bond and the seven-year bond and you've got a 10-year that hasn't traded, it's probably not good to extrapolate out to the 10-year.

David Lukach: I don't know if I agree with all of your adjectives, but, yes, I agree with your concepts. A mean-reversion type of relationship may provide a useful data point. The analysis of the data can be complicated, and the standard does not preclude you from extrapolating or otherwise estimating data or values.

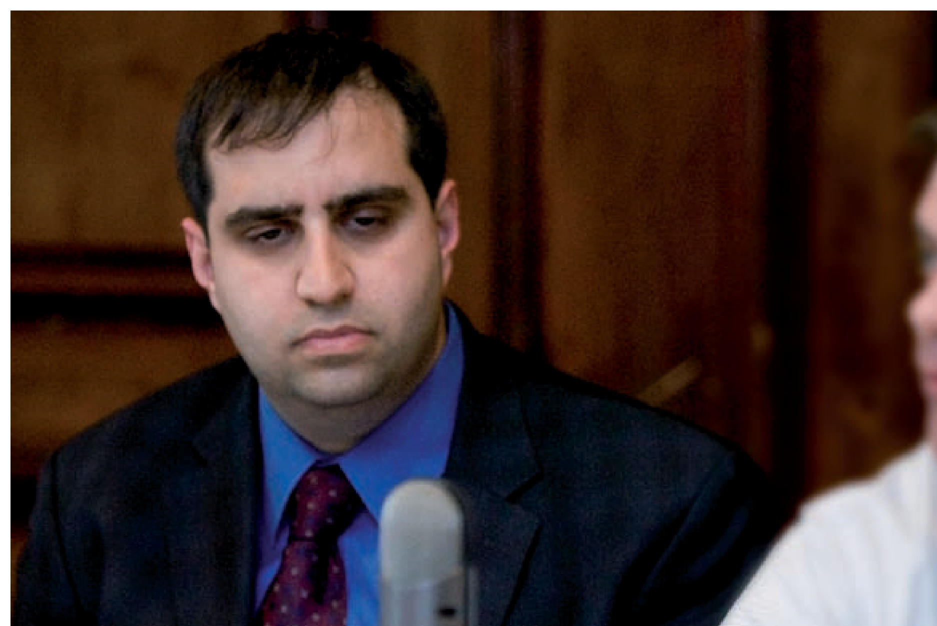
The extrapolation process, however, may cause you to land in a different pricing level. And whether it's Level 2 or Level 3, for example, would depend to what degree you extrapolate – which is an improvement over the previous standard that basically precluded any extrapolation.

I think most people would say they are comfortable with interpolation and with extrapolation for many products. It just depends on what products you have. The standard requires observability in some way, either direct or indirect, to the maturity of the instrument you are trying to value to get to Level 2.

David Lukach, partner, PricewaterhouseCoopers

Other than that, it's relatively silent. So how can you estimate values? There's probably different ways to use available data to estimate value; it all depends on what information is out there and whether you can access it.

Kevin Gould: That's a really interesting question. If you consider some of the asset classes for which we create consensus pricing, I often wonder how people are using that data. Is it reasonable to look at a complete asset class and to become comfortable because one considers the data to generally satisfy level 2 criteria? Or alternatively, within an asset class, let's think about corporate CDS for instance, is there a view along the lines 'we'll take 30 per cent or 40 per cent of this asset class where we're confident it's all Level 2, and the other 60 per cent or 70 per cent we actually think is Level 3?'.


Michael Abbate, senior manager, Ernst & Young

Michael Abbate: Yes, there are certain asset classes – those in the subprime area, for example – where you may put the whole asset class in Level 3 because they see no activity. And there are certain asset classes like CMBS products where you might work on an instrument-by-instrument basis and walk through and see where you have activity and where you don't.

Kevin Gould: So, if you get somebody saying they've got a consensus curve, is that a Level 2 price? Say you've got eight institutions using a curve to mark their books – we know that they're doing due diligence themselves around that and we know that they're looking around where they're trading and quoting and have traded in the instrument themselves – and then they send us their respective curves and we create a composite of that; is that a Level 2? Could we use that data to prove valuation on a trade, or do we separately have to now go and validate that against trade data out there in the Street?

Marcus Komm: I think yes but there's actually a lot of discussion around what's really an observable market price – especially around cases where data is available but a product is illiquid, how do you know?

Michael Smith: It should be viewed as a data point – by itself, it's not necessarily the answer. But if you have other supporting transactions that are consistent with the external valuation services, you have a much stronger case toward using it.

Kevin Kispert: I would agree. And related to this, one of the issues we've been discussing recently regarding corroboration is how to prove whether something is a good proxy for something else. For example, if an entity is valuing a 30-year yen swap, would this be considered a Level 2 instrument solely because the entity correlates three-month yen interest rates to three-month US Libor? You can apply statistical techniques to almost anything, but that doesn't mean the analysis is predictively valid.

Kevin Kispert, partner, Ernst & Young

Another point about consensus pricing is that, depending on the instrument, there may certainly be other corroborating data produced that enables you to get to a Level 2 classification. I think some of the more interesting discussions relate to those products where most of the firms that provide the consensus pricing information are all taking positions in the same direction within the market. In the case of such one-way markets, the view I've heard expressed by many is that consensus pricing is an important data point, but in and of itself doesn't get you to a Level 2 measurement.

Kevin Gould, evp, head of data and analytics, Markit

Nigel Hyde: Sure, if we're talking about a one-way market in highly complex products – that may be one thing. But not all one-way markets are for complex products – dollar bermudan options, for example. Now are we saying dollar bermudans is a one-way market, therefore it has to all be Level 3?

Kevin Kispert: If there are observable inputs you can use to value the product, so to previous point, the product is not overly complex even though from a dealer prospective it primarily trades one-way, then the observability of the inputs would result in a Level 2 measurement.

Another area where there's been some interesting discussion relates to management bias and whether, if the use of a third-party pricing source is

Michael Smith, head of valuation control, Deutsche Bank

deemed to take away potential management bias in the measurement, does this fact, in and of itself, automatically result in a Level 2 measurement?

In my personal view, no, not necessarily. For example, let's say you have a third party (such as a broker) that determined the value of an instrument using unobservable inputs and a proprietary model, so to them it's a Level 3 instrument.

Does the fact that this third party puts their Level 3 value on a piece of paper and hands it to you (the reporting entity) automatically make this a Level 2 instrument to you? If the third party is willing to stand behind this price for execution and it represents a firm bid, maybe. But if not, then I would argue it's probably not a Level 2 instrument despite the absence of potential management bias in the quote.

Kevin Gould: In aggregate what seems to be implied here is that, a consensus price on its own has, without any further corroboration, to therefore be Level 3. That means that for the vast majority of OTC derivative trades, it doesn't matter what pricing source you're going to use, if it's a Level 3. Even if you've got multiple inputs coming from books of record from the Street, you're saying actually we still think that there's some doubt about it.

And that therefore implies that it's a Level 3, which I think is not the intent of the rules. Because we've got a high degree of confidence around most of those prices, it's more a question of working out how we take what we have and push that forward and get confidence around its use.

Marcus Komm: I think the real notion of Level 3 has become watered down a lot as people have taken the view that, if in doubt, be conservative, because they don't want to make a mistake. What does that result in? I presume the initial intention behind creating Level 3 was to indicate that this is the real tough stuff, the real toxic stuff, the real issues of concern. Does Level 3 represent that at this point? Probably not. Probably right now Level 3 represents everything that's just not super straightforward but not necessarily extremely risky.

Andrew Viens: Right. There is a difference between the true fair value assets and toxic stuff that sits in Level 3 because there really is no liquidity around it; the stuff that I'm forced to put there because the rule says I have to put it there. The comparability across the investor base is the real issue, whether you're sitting at one of the banks or you're sitting in one of the funds. I feel the issue is caused when I go through the diligence and I add some more colour and I explain away my Level 3 and can justify a move to Level 2 and somebody else doesn't take the same approach.How does an investor or anyone else looking at the financial statement make an apples-to-apples comparison?

Andrew Viens, vp of operations, Sankaty Advisors

Jeff Gooch: What do people think is the perception of having a Level 3 disclosure in your balance sheet? Do you think it matters to an institution at the moment and do these things actually fundamentally change analysts' opinions?

Michael Smith: It's still kind of early days. The standard was contemplated and the rules drawn up, and then the whole credit crisis happened in the market. So I think people are taking a step back and saying: 'I'm not sure I expected all of this; it's going to take me some time to understand how it will be judged'.

Kevin Kispert: I think the extensive focus on the balance sheet is interesting. A key objective of the Level 3 disclosures was to provide more transparency into the amount of unrealised gains and losses an entity has reported related to its more highly subjective fair value measurements. So it seems as if the income statement impact should be getting more focus. This raises the point regarding certain issues surrounding the Level 3 roll forward that are being discussed, such as questions about at what amount to show transfers in and out of Level 3 and the diversity in views out there.

Kevin Gould: That's an interesting theme. We could ask the investment banks around the room whether they think that today there's a reasonable degree of commonality around what they're calling Level 3 assets? Or do you think that's quite dispersed, but it's likely to coalesce and you're going to get significantly common views around what should and shouldn't be?

Neeraj Chopra: I think it's pretty aligned, I would say by and large.

Marcus Komm: I agree; I would say it's becoming aligned right now; there is a process of convergence going on right now. There are definitely two opposing forces: there's the commercial interest on keeping Level 3 low, but there's certainly also the obligation of prudency to the investors and shareholders to consider. Right now, the latter I think is having the upper hand, which is saying if in doubt move to Level 3. And I think that's what we'll see – where people say: 'Market corroborated? Ah, I'm not really sure; move it over.'

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Jeff Gooch: There's a whole bunch of questions we get asked in this space. But another one is how arduous is it, from a mechanical perspective, to actually do Level 3 disclosure in terms of all the kind of notes and data collection that needs to go with that?

David Lukach: I think if you asked me a year ago, it was much harder than it is right now as companies have improved their processes. But the reporting requirements are detailed and remain difficult for most entities, especially in a dynamic market.

Marcus Komm: I think certainly you can get to high levels of accuracy, but the operational aspect of it does lead to approximations. You have no choice, because to truly do this on a security-by-security basis in all cases is just impossible. There are the sort of approximations that every bank must make that are within reason – and, again, that is where 'how to' guidance

Nigel Hyde, md, head of Totem, Markit

Andy Nendick, md, Totem, Markit

will help a lot too, i.e. more specific guidance regarding the sort of approximations we can make in certain cases: for example, when can one aggregate, when can one not aggregate and so on.

Nigel Hyde: A couple of times you have mentioned guidance. Do you mean actual guidance from the auditors, or guidance from the rest of the Street about what they're doing?

Marcus Komm: It sort of goes hand in hand, right? For example, when the white paper came out, I think all banks somewhat felt that they needed to be adhering to it. Nobody wanted to be left out and have to say, 'I read it but I didn't do anything'. So I think that's the type of guidance I'm talking about – or even guidance in the standard itself, which would be more explicit and mandatory.

Michael Smith: I think you can't underestimate the operational efforts being made. There may be a security-by-security type of review that has to take place for the inventory that sits on the cusp. That's still an enormous amount of effort even if you have it perfectly automated, because of the judgement involved

Jeff Gooch: I had a question from a fund the other day about their US corporate bond portfolio. They had got all the pricing from another vendor but were saying that they were unclear about their 157 position. I suggested that corporate bonds were generally fine when correctly monitored, so I was fairly sure that 95 per cent of their portfolio would pass Level 2 without any kind of stretch.

But the fund's view was that they had to audit every single one of those bonds, in terms of what that vendor had done to give them the price, because the vendor might have done extrapolations or other things. While most bonds have some very liquid points, which is all fine, there may be some dodgy ones in there. And were they now expected to create an audit pack to give to their auditors for every last one of their bond portfolio?

Alexey Surkov: For large liquid issues there are ways to not have to do that much work – for example, there are other ways of observing trades. It's about getting behind the market quote and understanding where the data is coming from.

Kevin Gould: I can tell you that there are only 5,000 to 6,000 corporate bonds that trade a week.

Kevin Kispert: Matrix pricing has always been an approach used to value fixed-income securities and it is still an acceptable approach under the standard. But we've seen people undertaking more work than they have historically, and part of that stems from the need to classify the instruments in the fair value hierarchy and part from current market conditions. We've seen companies bifurcate their portfolio and figure out the 5 per cent or 10 per cent of positions or asset classes (for example) that might be more questionable in terms of observable data and focus on these positions.

Neeraj Chopra, global head of valuations and control, Lehman Brothers

Kevin Gould: From my own perspective, I'd put a lot more confidence around, for instance, 1,000 CDS curves and PVs coming out of any of those 1,000 at any maturity, versus evaluated pricing that is created for any bond on the same 1,000 credits, and it doesn't matter what tenors are being used. So it's interesting to see what is accepted, because it's been a practice that people have been familiar with over many, many years and therefore they've got comfortable with it – versus an OTC derivative when maybe there isn't that level of comfort yet in the marketplace.

Marcus Komm: One aspect of OTC derivatives that everybody seems like they're comfortable with is if all the inputs to the OTC derivative are market based – then I don't think there are a lot of questions about where that ends up. There is more of a question when either there's an input where the determination of whether it's market based or not is not straightforward, or there is some issue about the bid-ask spread, as we discussed earlier in one-way markets. I don't think there's concern about just relatively generic OTC derivatives. From reading the disclosures, it looked like a lot of these are in Level 2 – the vast majority are, I would say.

Kevin Gould: It's all about viewpoint I guess – no one disagrees that CDS quotes for IBM, for example, are more liquid than any given IBM bond, out of

Alexey Surkov, partner, Deloitte & Touche

the 200 that probably exist out there. However, with CDS, as liquid as that market is, if you're not in the market as a broker dealer, it's more difficult to see the trades.

Take the example of the IBM bonds – as everyone probably knows, the most recent issue of IBM is what trades and there's therefore a liquidity premium associated with that bond. All the other IBM bonds are going to trade wide to that bond, but who knows how wide that basis is on a given day? Do we have a tail wagging the dog issue here? In truth the market, the Street, everybody's got more confidence around the CDS prices than they do about any one of those IBM bonds, and yet the accounting standard seems to be running the other way.

Neeraj Chopra: Well, you've got your single-name CDS; what level did that fall in to?

Kevin Gould: I think generally it would be Level 2 but perhaps not always. It does seem however that everyone is comfortable with the bond prices being level 2.

Jeff Gooch: Okay. I'm conscious of time, so one last question. In summary – is 157 a step forward or a step backwards?

Kevin Kispert: I would say that overall it's a step in the right direction. And I think it has definitely helped to enforce discipline.

Marcus Komm: I think a lot of that's due to the timing, right? It's just, with what happened in the market and with large Level 3 balances involved in the disclosures, people were obviously more nervous about it. If those market events hadn't happened and there had been smaller balances involved, it might have been easier to focus more on consistency between the market players. That said, overall I think people are now more comfortable with the standard and more accepting of it. And convergence gets you a step closer to the standard achieving what it originally set out to do.

Andy Nendick: I think it will be interesting to see what the International Accounting Standards Board does regarding fair value. They seem to be adopting a wait-and-see approach. ■