REFINITIV EXPERT TALK

FAIR VALUE: ACCURATE, TRANSPARENT PRICING DELIVERS A COMPETITIVE ADVANTAGE

Investment firms tasked with managing client portfolios frequently face a range of challenges when striving to establish fair value for securities, particularly illiquid, distressed or otherwise hard-to-value instruments. Where trading activity and market color are all but absent, ensuring seamless access to accurate fair value prices can deliver a distinct competitive advantage.

REFINITIV®

DATA IS JUST THE BEGINNING®

Establishing fair value

Where securities are exchange traded and prices readily observable, such as in the world of equities, establishing the true or fair value of an individual security is usually straightforward. Other financial instruments, however, can prove more complex to value, especially those where trading is not as frequent, less liquid or even distressed.

One such example is securities in the fixed-income universe, which comprises a far larger number of instruments than the equities market. Moreover, the majority of these instruments are traded over the counter and often with low frequency and thinner trading volumes. This presents firms with some significant challenges when valuing client portfolios.

Not only do firms need to accurately value each and every security, but in terms of global regulation, the methods and underlying assumptions used in the valuation process also need to conform to certain standards.

In 2013, the International Accounting Standards Board (IASB) implemented the International Financial Reporting Standard (IFRS) 13, which "defines fair value, sets out a framework for measuring fair value and requires disclosures about fair value measurements."[1]

Designed to help firms navigate these challenges, as well as to improve levels of transparency within the pricing process, IFRS 13 delivers useful guidelines, but simultaneously places greater reporting and disclosure obligations on firms. Similar legislation exists in the U.S., in the form of the Accounting Standards Codification (ASC) 820.

IFRS 13 describes three different valuation approaches. These approaches take into account the vastly differing amounts of information available to valuers.

Underlying methodologies

Refinitiv's Abdellah Adhana, Manager, Fixed Income and Derivatives Valuations, comments, "When valuing client portfolios, firms need seamless access to accurate fair value prices based on sound underlying methodologies and assumptions. There is increasing awareness of the need to understand the underlying data, including which benchmarks were used and which risk methods were applied. Such enhanced scrutiny and greater levels of transparency are beneficial to the market as a whole because this new approach triggers debate among market participants."

Adhana explains the three leading methodologies for deriving fair value:

1. Mark-to-market approach

The mark-to-market basis of pricing financial instruments is used in liquid markets, generally characterized by robust trading activity and market color. In such markets, there is plentiful data that can be used to confirm fair value.

2. Mark-to-model/use of comparables

In the absence of sufficient liquidity and market color, instruments become harder to value, but comparable values can be calculated based on market observations. Different sets of comparables can be used, but the bigger a comparable sample becomes, the more generic the result. The challenge becomes one of identifying the most appropriate comparable from which to derive fair value.

3. Fundamental approach

Where no direct or comparable information is available at all, one applies a fundamental approach. The approach relies on the use of company financials, credit metrics or other analytics to estimate recovery value. Evaluated pricing is especially useful in highly illiquid markets.

1 https://www.ifrs.org/issued-standards/list-of-standards/ifrs-13-fair-value-measurement/

Refinitiv® Evaluated Pricing Service (REPS)

Refinitiv delivers independent, transparent and accurate evaluated pricing that spans more than 2.6 million fixed-income securities, derivatives and bank loans.

Joseph Hayek, Compliance & Controls Officer, Evaluated Pricing Operations comments, “Because the securities we price are not originated, issued or traded by us, we are completely agnostic and deliver pricing based on unbiased, best available information at any given time. We draw on vast quantities of relevant data, including color aggregators and dealer contributions on the Refinitiv® Eikon terminal in order to derive fair value prices, which are the best prices a seller can achieve in an orderly, non-distressed market.”

Offering global coverage and prices that are available at multiple times every day, REPS delivers complete transparency, with customers afforded full access to the underlying conditions and methodologies used to establish an evaluated price.

Assessments consider a range of inputs, including dealer quotes and trade prices; inherent risk and assumptions relating to, for example, credit or liquidity risk; and the prices of comparable instruments by the same issuer, or issuers in a similar industry sector.

Refinitiv’s goal is to be as transparent as possible in all areas in order to give clients peace of mind that prices used are able to stand up to regulatory scrutiny.

Moreover, Refinitiv’s methodologies are consistent with both market and fair value standards and comply with the guidelines outlined by ASC 820 and IFRS 13.

Choosing a pricing partner

When choosing a pricing provider, there are many factors that should be taken into consideration.

Accuracy and transparency relating to both the underlying assumptions and methodologies employed are arguably the two most important attributes that should be considered, but other factors, including reputation; the breadth and depth of coverage offered; global reach; and the quality of communication with clients are all important.

Hayek believes that strong connections within the investment community are vital, but also points to the importance of deep domain expertise, commenting that Refinitiv’s evaluators possess invaluable skill sets and that clients enjoy direct access to valuation teams.

Refinitiv, as a global operation, is able to access substantial data sources on a global scale and our breadth and depth of coverage is supported by the vast volume of data available via our proprietary Eikon platform and Reuters news. We hire skilled evaluators across global markets, and are therefore able to meet global clients’ pricing needs across the U.S., Europe, Asia and emerging markets.

We also prioritize our client communication, enabling direct client access to our team of evaluators and permitting clients to submit challenges through our price challenge and transparency portal on the Refinitiv® Datascope Select platform.

Hayek further emphasizes the importance of striking the right balance between automation and human interaction. The Refinitiv model strives for a high level of automation of the pricing process to boost efficiency, but retains the valuable dimension of human intelligence to monitor and check information.

The importance of compliance and controls should not be underestimated. In order to ensure accuracy and consistency, it is imperative to have robust controls in place – Refinitiv staff review a range of quality controls every day, looking for securities breaking tolerances in the event of a downgrade or credit deterioration on the back of breaking market news.

We go through an annual audit and our teams must conform to a series of controls. We also have a general operational risk program including three lines of defense that reviews incidents, control breaches and so on to ensure continued improvement of our service.

Investment firms should review such controls when choosing a pricing partner, since they operate in a highly regulated environment and must undertake reasonable efforts to ensure that their pricing partner of choice is employing the best possible methodologies.

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Competitive advantage

The ability to accurately price even the most challenging or illiquid assets can create a significant competitive advantage for individual pricing services. Those firms able to consistently offer transparent valuations, based on robust methodologies and sound underlying, up-to-date assumptions – in both stable and volatile markets – are likely to find themselves ahead of the curve.

A final point to note is that an SEC rule relating to fair value and proposed for 2021 (proposed rule 2a-5) will focus on a fair value framework and related compliance matters.

The rule would significantly expand compliance obligations that address fair valuations by investment firms.

Hayek comments, “This is the first time that the SEC has proposed the introduction of a regulation where pricing services are a primary focus that require a level of oversight by investment firms in a bid to ensure that the processes, data and skills utilized in deriving fair value are of a certain standard.”

Not only do we envisage a future regulatory environment where pricing services will need to withstand scrutiny, but the right pricing partner can help investment firms to navigate the regulatory landscape with accuracy, ensure essential transparency, and price even hard-to-value assets with speed and efficiency.

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