REFINITIV EXPERT TALK

PRESSURES MOUNT FOR "FAIR VALUE" PRICING ON ILLIQUID, COMPLEX SECURITIES

Regulators increasingly demand transparency, independence in valuations

Acknowledgments

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The U.S. Securities and Exchange Commission (SEC) has joined the growing list of global regulators cranking up the pressure on how financial services firms price investment securities and how those values are determined. Rule 2-a5 under the Investment Company Act of 1940, which the SEC officially adopted in December of 2020, is just the latest step in a decade-long effort to address valuation practices not only for registered investment companies, but across the spectrum of the financial services industry.

From investor protection initiatives, such as Rule 2-a5 and Europe's revised Markets in Financial Instruments Directive (MiFID II), to more stringent capital requirements for banks, including the Fundamental Review of the Trading Book (FRTB) guidelines, regulators are zeroing in on "fair value" pricing. These tightening regulations are increasing demand for third-party vendors to provide fair – and defendable – prices for every asset in an institution's portfolio.

For the many investment securities, fair value is easy to determine, according to Joseph Hayek, Compliance & Controls Officer for Refinitiv Evaluated Pricing Service in New York. Highly liquid, exchange-traded stocks, such as Apple and Amazon, generate reams of market data every day. On the fixed income side, even if they aren't as actively traded, public bond offerings still generate enough information to build a solid pricing foundation. For one thing, publicly traded bonds require a debt rating from a qualified rating service, and investors have access to both the corporate financial statements and to the terms and conditions baked into each bond offering.

"The more liquid side of the business is easier to price than the less liquid side because there is ample trading information, a lot of bid-offer information and comparable securities with market color," Hayek says. "Valuations anomalies are at their most acute when it comes to less liquid, hard-to-value or private assets.

"That's where the regulators are increasingly focused. In fact, Dodd-Frank and the European Market Infrastructure Regulation (EMIR) are devoting a great deal of attention to illiquid and complex instruments, with a particular focus on derivatives and structured products," Hayek notes. Highly transparent valuations are required to meet these stringent requirements, particularly for increasingly popular securities, such as private placement debt, church bonds and structured notes.

Finding clarity in complex, opaque markets

Private placements offer unique cash flow features

Historically low interest rates have helped fuel a surge in debt private placements in recent years. According to a 2020 report from MetLife, the U.S. private placement market generated an estimated $100 billion in transactions in 2019, nearly double the reported transactions in 2015.

Long a haven for institutional investors looking for higher rates than can generally be found in the public fixed income markets, private placements tend to match higher yields with better downside protection. That's been a particularly attractive combination for the insurance industry, which has to match long-term assets to liabilities within tight tolerance parameters.

In today's persistently low interest rate environment, though, more institutional investors have begun moving into the market, driving up demand for price evaluations.

Church Bonds

On the other end of the spectrum are church bonds, which are exclusively retail products with decidedly local markets. While they have many similar characteristics to private corporate bonds, church bonds tend to be significantly smaller and cater to a much narrower audience – usually just the congregation itself. They are typically used to fund capital campaigns, such as a new building or restoration of an existing structure, and investors are guided more by their desire to support their church than by portfolio performance.

Much like their private equity brethren, though, church bonds present unique challenges to buyers and borrowers, alike. With these inherently opaque products, valuers are often flying blind. Borrowers don't need to get a public credit rating on their debt. They don't need to open their books to third parties, and the terms and conditions underlying the bond agreements are private.

Then there's the issue of liquidity. There are limited secondary markets for private placements or church bonds. Investors have to hold their bonds to maturity or find their own buyers, which can be time-consuming and expensive. Also, without a secondary market, there's no observable data to support price values.

Church bonds have added complexities. First, most bonds are backed by the value of the church's real estate holdings, which can be impacted by a broad range of local, regional and national economic factors. Second, churches are as unique as their congregations, so there is no broader sector information to help support pricing.

Another challenge is that the repayment of church bonds is directly dependent on congregation donations, and church membership and attendance have dropped dramatically over the last two decades. As private, nonprofit entities, there are no comprehensive data sources covering church closings, bankruptcies or bond offerings.

Creating structure around structured note pricing

Structured notes add another layer of complications to pricing this relatively illiquid security. While on the surface they look like more traditional bank-issued bonds, the bond itself has an embedded derivative that determines the cash flow and total return.

For example, some of the more popular structured notes are tied to major market indices, such as the S&P 500 or the Dow Jones Industrial Average (DJIA). The performance of the bond is based on the performance of the underlying asset, and the underwriters use options to capture that performance within the structured note.

With interest rates stubbornly hanging on to historic lows, structured notes have become increasingly popular with retail investors looking for higher returns from their fixed income portfolios. The investment industry has responded.

Historically, investors have largely depended on the underwriters themselves to establish the "fair value" of their offerings, but increasingly, regulators and compliance departments are demanding price confirmations from objective third parties.

Building evaluated pricing models

With limited market data to support these complex and highly illiquid investments, evaluated pricing models depend on a variety of inputs, notes Moti Konak, Director of Fixed Income and Derivatives Valuations at Refinitiv. "The challenge centers on the underlying assumptions and inputs capital markets firms – or their pricing/valuations service providers – use to value each asset and the robustness of those assumptions to regulatory and end-investor scrutiny," Konak explains.

With structured notes, pricing evaluators need to not only price the bond based on the creditworthiness of the issuer, they need to understand how to accurately predict the future value of the embedded derivative. A key hurdle in this market is that every structured note is a unique instrument that can hold an almost infinite number of variables – from the underlying asset to the length of maturity to the terms and conditions that will ultimately determine both the risk and potential reward of each note.

Pricing evaluators have to comb through the fine print of every offering and establish the value – or cost – of each variable. That requires access to an extensive library of derivative pricing models and the expertise to understand which model to use for each note.

With private bond placements, large issuers – think General Electric or IBM – typically issue several different types of bonds. If the issuer also has public debt, those ratings can be used to support private placement values. Without a public market price comparison, though, investors are dependent on their own internal credit rating. Sector analysis can also be used to support values.

Unfortunately, none of these inputs are generally available for church bonds. Each church bond has to be evaluated as a new issue, and values are often built on more subjective inputs, such as how well pastors are received by their congregations and their ability to fundraise.

Evaluating evaluators

With all of these variables and unknowns, there is no such thing as a "perfect" price in these illiquid markets. That's why firms need to find a valuation/pricing partner with deep insight and extensive expertise into every sector they cover. Here are the key characteristics firms should consider when searching for an evaluated pricing vendor that they can trust:

- Valuation methodology
  Does the vendor apply a methodology that is consistent with market standards? Look for a partner that directly sources comparable market prices daily from a wide network of market-making participants.
- Coverage
  Is the vendor a global operation with access to core and local markets? A wide network of data sources allows coverage at global scale, for liquid and illiquid markets.

- Independence
  Does the vendor originate, issue or trade securities, or have any other vested interest in the prices set? Independence is critical to delivering defendable evaluation pricing.
- Transparency and reporting requirement
  Does the vendor provide transparency into the methodologies, models and inputs underpinning its valuations process? The extent to which this information and content is incorporated into your leveling procedures is critical to meeting regulatory and disclosure reporting requirements.
- Access to expertise
  Will you have direct access to the professional evaluators when you have a question about a valuation? Some vendors have specialists available to field calls and provide immediate feedback, while others do not.

Not all providers are created equal. The quality of the evaluations is directly related to the scope of the data available and the network of internal resources, external data partners and the market makers providing input. With increasing regulatory scrutiny over how banks, investment companies and other financial service institutions manage their portfolios, it's more important than ever to have a trusted partner evaluating these assets for you.

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