

# Financial Assets Need Independent Scrutiny

When subprime mortgage borrowers began defaulting on their home loans in 2008, residential mortgage-backed securities generated returns on investment sharply below investor expectations. Cash flows realized during the investment holding period often failed to meet some of the most conservative estimates for the time.

The result was an unprecedented slowdown in the active trading of residential MBS and other bonds collateralized by mortgages or mortgage-backed securities. In the absence of active deals, the fair market value of portfolios containing distressed assets became elusive, making compliance with the Financial Accounting Standards Board's [Statement of Financial Accounting Standards No. 157](#), which concerns fair value measurements, challenging for portfolio managers at entities that must file reports with the Securities and Exchange Commission.

FAS 157, refined through staff positions and now known as [Accounting Standards Codification Topic 820](#), defines fair value to be "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date." The operative terms within this definition are "orderly transaction," marking a loud distinction from the distressed transactions that have dominated the secondary mortgage market since 2008.

Valuing illiquid assets to reflect their fair market worth is no longer as impracticable today as it was at the onset of the credit crunch. While some entities leverage internal models, others rely on broker/dealer marks. Still others rely on third party independent price providers for their valuations.

Today we are seeing most engage a combination of methods to demonstrate to regulators independence and transparency in pricing process.

Indispensable inputs include default rates, prepayment rates, and loss severities. To project cash flows to portfolio holdings with minimized dispersion from the true fair value, a robust database of loan level collateral files is necessary. In addition, the price evaluators must be attuned to real time "market color," the viewpoint based on multiple sources (e.g., market makers, sellers, buy-side firms) at any point in time.

Fair value measurements properly marked to internal models may satisfy audit and regulatory requirements. But for fair value measurements to promote investor confidence, merely acceptable model outputs will not suffice. Today, investors demand independent valuations of thinly traded securities to eliminate any appearance of conflicts of interest, which can arise where the compensation of portfolio managers or other instrumental parties is tied to portfolio performance.

Because an underwhelming valuation can compromise those parties' earnings, strong valuation governance and control procedures are necessary to defend accountability. Although independent valuations can be provided by separate in-house valuation teams, it is often supplemented by independent third party valuation services.

Third party services confer greater security because they generally do not have any financial interest in the valuations they provide. Their disjunction from the principal-agent scheme offers greater certainty to regulators and investors of funds.

Third party services offer transparency into the model methodology employed and inputs used to arrive at their valuations, a function of competition amongst the different providers to offer more to clients. The valuations can then be compared to those generated by proprietary models and defended during a regulatory audit.

Moreover, in 2012, independent third-party valuation services with access to a rich source of market color as well as independent models provide yet another degree of separation to improve the price point. Paired with the benefit of skilled judgment acquired through valuation experience, third party vendor evaluations offer a necessary alternative and supplement in-house independent valuations. (Full disclosure: my firm provides such valuations.)

The importance of independent valuations is not a modern revelation. A legislative mandate requiring independent scrutiny of mutual fund valuations was raised as a must for investors in the wake of the Great Depression, when fraud and unscrupulous practices led to the mis-valuation of mutual funds.

Called the [Investment Company Act of 1940](#), the law was passed by Congress to stop the value manipulation of mutual fund assets. Private equity funds, hedge funds, asset-backed securities and other investment options common today had not yet been introduced.

Section 1(b)(5) of the Act reads: "The national public interest and the interest of investors are adversely affected when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny."

Much like the Investment Company Act of 1940 restored the integrity of and confidence in the mutual fund industry, independent scrutiny of the valuation of financial assets is necessary to attract the private capital of investors to lift the markets in the wake of the credit crunch. With history as our guide, the restoration of the securitization markets, along with the revival of the housing market, depends on third party valuations.

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