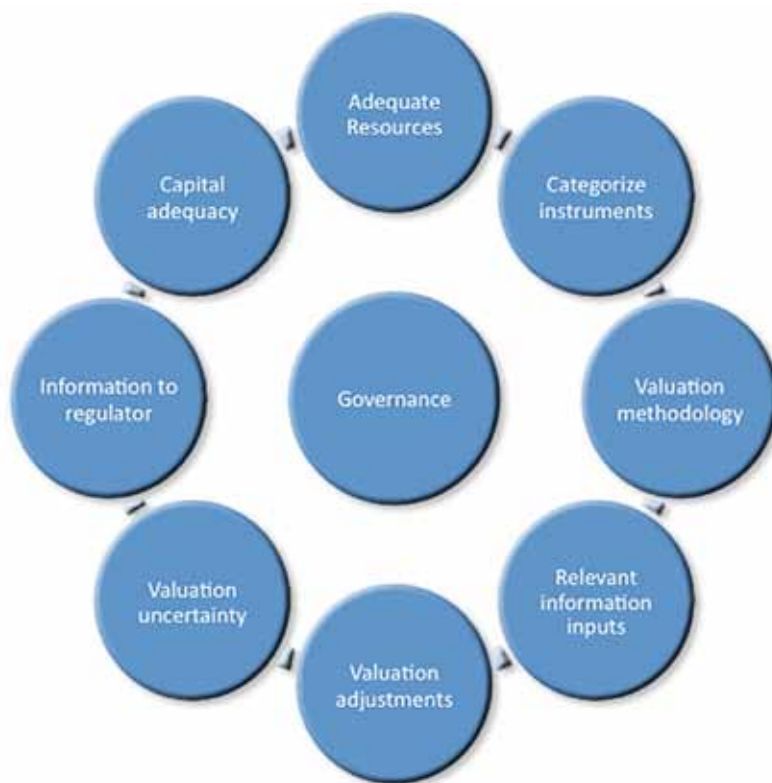


## FUNDAMENTALS OF THE VALUATION PROCESS

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General experience in the last year has shown that valuation processes of financial institutions were not robust enough to withstand stressed market conditions.

In April 2009, the Basel Committee on Banking Supervision issued its paper on "Supervisory guidance for assessing banks' financial instrument fair value practices", which sets out 10 principles regarding the valuation processes of banks. A summary of these principles is given hereafter.



### PRINCIPLES

#### Governance

- 1. Include the valuation process within the overall governance and controls framework.**

It builds the foundation for a structured valuation process, covering topics such as independence, monitoring, and proper escalation of issues.

- 2. Prepare for capacity to establish and verify valuations, including during periods of stress.**

This is particularly important during stressed market conditions, as it requires a higher level of involvement of valuation specialists in producing valuations and a higher level of involvement of the board in assessing, challenging and approving the valuations produced.

The use of valuation specialists does not relieve the board or senior management of their responsibilities over the valuations process.

- 3. Categorise financial instruments in a consistent manner for accounting, regulatory and management purposes.**

Policies should determine how instruments are categorised and any transfer of instruments from one category to another should be properly documented and approved.

#### Risk Management and Reporting

- 4. Have a sound process for the design and validation of valuation methodologies**

This includes the following:

- Independence of model validation.
- Rigorous validation of models, including assumptions, sensitivity analyses, benchmarking.
- Controls to identify model weaknesses.
- Testing of models during audit processes.

#### 5. Maximise the use of relevant inputs and important information to get to a reliable fair value estimate

Take account of certain factors when assessing reliability of information, such as stale prices, forced sale situations, number of independent price sources available.

#### 6. Have a rigorous process for determining valuation adjustments

The identification of valuation adjustments, their review and approval should form part of an overall solid framework, incorporating segregation of duties, management review, and escalation to the board and/or relevant committee.

#### 7. Explicitly assess valuation uncertainty within the valuation and risk management processes

Quantitative and qualitative assessments of uncertainty should accompany all internal reports containing internal valuation information and risk information.

#### 8. Promote transparency in external reporting

External reporting should have sufficient, relevant and reliable information on valuation methodologies used and explanations of valuation inputs and key assumptions used to arrive at fair value

### Supervisory Assessment

#### 9. Banks may have to provide supplemental information about their valuation and governance processes

In assessing whether the bank's valuation process is sound and working effectively, supervisors may request additional information, such as internal valuation reports provided to the board, and assessments by internal or external auditors.

#### 10. Supervisors should incorporate their evaluation of the valuation practices in assessing capital adequacy

Banks that have weak valuation processes will have additional capital requirements, such as under Pillar 2 in order to cover additional risks which are not being managed adequately.

### NEXT STEPS

During the period of market turmoil, a number of banks and other financial entities have gone through or are going through a learning curve regarding their valuation and risk management processes.

The next steps are to use the experience and knowledge gained in the past year to benchmark the valuation process, where appropriate, to the principles given above and to take corrective action where necessary.



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