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The AMF publishes the findings of its SPOT inspections on the valuation of complex financial instruments

As part of its short thematic inspections of the practices of asset management companies, the AMF examined how the valuation of complex financial instruments is organised within five companies and the second-level controls they have implemented. In a summary document, the AMF offers an insight into the good and poor practices encountered with a view to providing better support for market participants.

In force since July 2014, the Directive on Alternative Investment Fund Managers (AIFM) sets out obligations whose objective is to ensure that the various assets of a fund are properly valued. These requirements relate to the objective nature of this valuation, the justification and traceability of the methods used, and the valuations obtained. After a first series of SPOT inspections on the valuation systems of private equity firms (summary published in December 2018), the AMF examined the practices of five alternative investment fund managers in valuing complex financial instruments over the period 2017-2019.

Over this period, the portfolio of the management companies inspected had exposure to various complex financial instruments, including dividend futures, total return swaps (TRS), credit default swaps (CDS) and options on CDSs or contingent convertible bonds.

How the valuation is organised

Over the period studied, all five management companies inspected did have a risk management function that was independent of their portfolio management functions and which is generally in charge of the valuation. The AMF noted that assigning this valuation's responsibility to a specific person is a good practice.

Policies and procedures

With one exception, their policies and procedures clearly define the obligations, roles and responsibilities of all those involved in the valuation process. However, none of the management companies had clearly separated what falls under the valuation policy from what falls under the procedures.

Furthermore, in most cases, the description of the price sources used is not sufficiently detailed for various reasons (complex instruments that may belong to several categories of financial instruments listed, no indication regarding the order of priority of the price sources, or insufficient detail on price sources). In general, the process of reviewing the valuation of instruments, which may be performed using a model, another price source or additional controls, for example, is not described in sufficient detail. The AMF noted a good practice consisting in summarizing in a table sources of reference prices and their order of priority for each type of complex financial instrument used.

Valuation models

All entities did have valuation models used for valuation or review of valuation realised from other sources. The summary shows that the valuation models used by most asset management companies are not documented well enough and may include inappropriate modelling assumptions. Those used for review purposes have not always been formally validated by someone who is not involved in building them. In one case, those used for valuation purposes (and not just for review) were not approved by senior management prior to their implementation.

Actual process for valuing and reviewing the valuation

In most cases, the valuation process actually used is not totally consistent with the one described in the policies and procedures, either because the specified reference price sources were not used or because the actual process for reviewing the valuation are different from the one described. Regarding the review, the AMF noted that the frequency of use of the model was not always adapted to the nature of insufficiently liquid or unlisted securities. The AMF noted, within one institution, the good practice consisting in the systematic

integration of transaction prices in the control of the appropriateness market prices and the model results.

Second-level control system

The internal control plans of the companies inspected clearly refer to audits of the processes for valuing and reviewing the valuation of complex financial instruments held by the funds they manage. However, the AMF noted the absence of such controls in 2018 at one institution and, in some cases, controls that covered only some of the instruments.

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