Buy-Side Price Validation: Tackling the New Pricing Challenges

Asset managers have tackled pricing issues for years. But what they haven't faced – until now – is a minefield of thinly-traded markets and unprecedented regulatory scrutiny. While the subject of pricing isn't new, it has never been more explosive – and the old way of running processes is being put to the test.

This latest wave of pricing pressure on the buy-side is being driven by the likes of the International Financial Reporting Standards (IFRS) for accounting, which place tougher requirements on how complex derivatives are valued. Likewise, AIFMD, EMIR, Solvency II, and Dodd-Frank provisions are all putting transparency at the heart of the valuation process. This is very much on the regulatory radar, with comment letters from both the FCA and SEC in recent years, warning of the risks associated with outsourcing functions which are critical to regulated activities – which certainly includes valuations.

Indeed the problem of valuation has worsened recently in the bonds markets, following a period of shrinking liquidity. With new capital rules prompting investment banks to reduce or even quit trading in fixed income, traditional sources of pricing from bank inventory have dried up.

This is why asset managers are reviewing how they establish valuations, and the level of diligence they apply to third party sources. As such, price validation is firmly in the spotlight.

THE HIGH PRICE FOR ERRORS

Compliance, however, is only part of the story. Accurate valuations drive accurate net asset value (NAV) for funds. The consequences of getting these wrong are severe: mistakes affect purchase and redemption transactions and cause mis-statements of fund performance.

The operational effects are clearly problematic, but it is the reputational ramifications that are perhaps the most concerning and far-reaching. In the U.S, highly publicized mutual fund NAV errors have illustrated how considerable, and sometimes irreversible, reputational damage can be.

While many of these issues are not new, investor awareness of valuation issues exposed during the credit crisis has created a more urgent need for asset managers to look for accurate pricing. The problem is that coming up with an accurate valuation is no easy task.

INDEPENDENT ARBITRATION

This is why robust price validation is essential. It requires asset managers to access multiple evaluated price feeds from various external sources in order to analyze, compare and determine their own price. Price validation is also needed to ensure that any prices arriving through a data vendor, broker, or evaluated pricing supplier are reasonable and complete.

In the past, it may have been acceptable to rely on a single third-party source for pricing, but that's certainly not the case in today's compliance heavy landscape. Gathering data from just one vendor means there is no way of verifying the reliability of that source. Instead, the asset manager has to trust the feed completely, which carries a significant level of risk.

While some firms have built spreadsheets and manual processes to plug the gaps, these don't deliver the consistency and transparency regulators and investors demand. It is up to the asset manager to evaluate feeds independently, for both easy- and hard-to-value instruments. Above all, asset managers need to be able to defend and justify the prices they place on their asset holdings, with an appropriate audit trail to fall back on when questions get asked.

CASE STUDY: ILLIQUID BOND PRICING

For some fund managers, the solution to pricing illiquid bonds is to use a single provider for evaluated prices. This is increasingly seen by regulators as a major dependency and source of valuation risk. They would much prefer to see this risk mitigated by the use of multiple sources.

The pricing of fixed income investments has been subject to major strain over the last few years. During the financial crisis which blew up in 2008, some sources for bond pricing were found wanting.

For one, liquidity has dried up. Investment banks have reduced their involvement in fixed income trading under tough new capital rules. As a consequence, the use of broker quotes for illiquid bonds – previously a common approach – has become more difficult with the reduction in inventory.

At the same time, the fixed income instruments that managers invest in have become increasingly complex. This comes from the growing use of sophisticated hedging strategies and the desire to attract more institutional money through higher- yielding assets.

While the nature of the bond markets and investing has dramatically changed, valuation practices have remained relatively simplistic and often overly reliant on a single source.

This unhealthy attachment to a single source is coming under scrutiny by regulators for multiple reasons.

Fund managers often have to strike daily NAVs for instruments like municipal bonds that go untraded for days or even weeks – in other words, they have to mark-to-market without a market. Managers who rely on one source of pricing for this inevitably expose themselves to the strengths and weaknesses of the evaluated pricing service they choose. Poor data affects daily calculations, ranging across net asset values, performance, portfolio weightings, and exposures.

In addition, after several blow-ups involving esoteric valuation models, new regulations such as AIFMD, EMIR, Dodd-Frank and Solvency II are forcing more managers to be much more transparent about pricing. These managers are required to show precisely where they derived their models from, which

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CASE STUDY: ILLIQUID BOND PRICING *(CONTINUED)*

market data sets are being used as inputs, and whether assumptions regarding default risk, interest payments, and prices are grounded in reality.

Because of these risks and others such as concentration, regulators are pushing managers to end their dependency on limited sources for pricing data. They want managers to implement their own due diligence on their vendors through independent verification across sources.

For fund managers, healthier pricing practices include:

- Sourcing different prices from a variety of sources
- Collating, ranking and defining those prices in a central place where records can be audited easily – not in spreadsheets
- Applying business rules to detect issues before they occur and demonstrate responsibility in decision-making

Given the complexity of the market and the persistent scrutiny of regulators, smart fund managers are seeing that it's time to address these issues.

CASE STUDY: FX PRICING

From the EU extending sanctions on Russia to China devaluing the Yuan, there is no shortage of events affecting a fund manager's investment strategy. But in the midst of such volatility, the priority for any fund manager remains the same: deliver absolute returns in an increasingly competitive, intricate and highly regulated market.

It's no secret that one of the keys to achieving this is managing high levels of pricing risk across FX and certain fund managers will be aiming to alter their positions – at the same time as keeping a large exposure to their base currency. While fluctuations in currencies such as the USD and GBP are reasonably predictable, funds that manage a base currency of say the Russian Ruble (RUB) are exposed to greater uncertainty.

A highly volatile base currency can elicit an excessive amount of risk, which presents a serious challenge for a risk manager who must anticipate the future in order to hedge against exposure. While risk managers may have stress testing processes in place, this won't fully illustrate how their exposure is affected by increasing currency volumes. Formulating accurate prices as volumes rise in order to better understand exposure is critical to better managing this risk and a key challenge for firms to address.

With this in mind, certain fund managers have taken the approach of building spreadsheets and relying on manpower to analyse high volumes of data. Unfortunately, this strategy ultimately results in less accurate prices. Consequently, fund managers have begun to seek an alternative – one that not only allows a third party to cleanse data for more accurate prices, but also to manage the infrastructure. It's easy to see why, as with pressure to reduce bottom line costs; no fund manager wants to shoulder the burden alone.

CASE STUDY: FX PRICING *(CONTINUED)*

For fund managers with a volatile base currency, relying on people intervention is a risk – particularly in today's market.
However, for those that adopt the third party route, unpredictability could translate as opportunity. Selecting this approach should lay the platform for better fund performance which means higher revenues. In this risk- conscious world, having strong foundations is the first step on the road to delivering those all-important returns for investors.

CONCLUSION: REDEFINING THE RULES

In order to validate the consistency and defensibility of price sources, asset managers need an approach that seamlessly connects to third party sources and applies sophisticated, pre-defined rules to compare feeds. This would allow them to remove speculation and, instead, arbitrate multiple prices in an unbiased way.

The degree of sophistication of these rules can be crucial, particularly for intricate OTC instruments and very thinly-traded bonds. Every input and assumption for evaluated pricing models must be documented and tracked, and wherever possible several vendor feeds, evaluated pricing models, and broker quotes for the same instrument must be considered. The price which ultimately gets selected must be tagged with its underlying source as well as documentation regarding how it was chosen. As a result, regulatory demands for a transparent and defensible process will be met.

Once on top of compliance, there are business benefits to be gained. By adopting this approach to independent pricing and valuation, an asset manager can avoid operational and reputational costs associated with miscalculations. Therefore, customers and prospects will have increased confidence in their ability to manage risk. As a result, an asset manager's reputation is enhanced, and new revenue opportunities will start to emerge.

Crucially, in a multi-asset market and a climate of reducing costs, price validation approaches must be accessible, easy-to-implement and able to handle any asset type, including exotic instruments. Asset managers have already shown that they are increasingly drawn to managed services offering quick deployment, there is a segment of the market that still prefers the traditional in house deployment, price validation should be no exception. It is entirely possible to deliver the benefits of consistent, defensible and transparent pricing with minimal impact.

The upshot is that with a quick and reliable route to performing price validation, the advantages far outweigh the challenges involved. Asset managers can be confident that they are reporting defensible prices, resulting in sound fund performance results. Perhaps the most important outcome is more loyal customers and confident investors, leading to positive reputations. And in a volatile and risk-conscious market, that is a precious and sometimes elusive trait.

In the absence of a single source to validate prices against it is paramount that firms can apply multi sourcing and demonstrate consistency across pricing models underpinned with complete transparency and data lineage. This approach delivers greater confidence and better manages pricing risk to satisfy regulators and investors alike.

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