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Pricing

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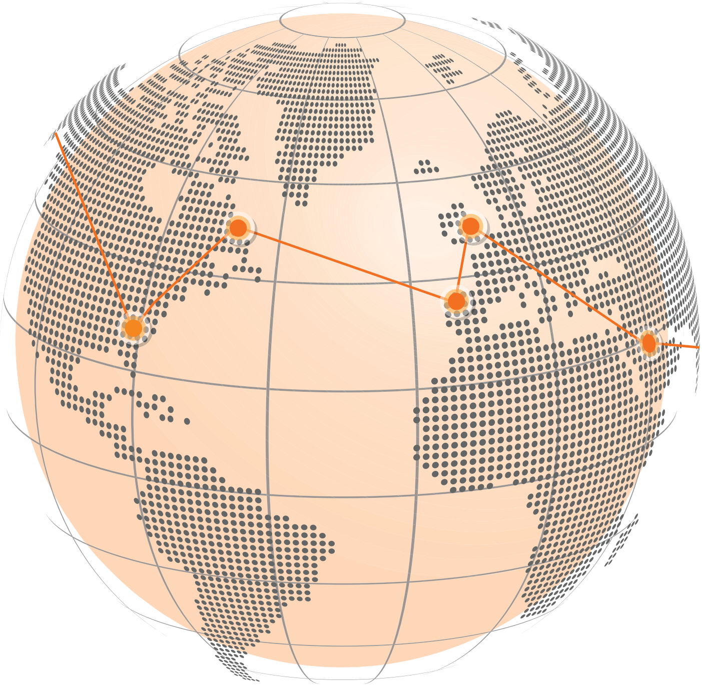


Editor's Letter

Ready For Transparency?

The questions this report raises about transparency in pricing include whether transparency improvements are driven more by regulation and standard definitions or by the demands of those consuming the pricing information.

Respondents in the Virtual Roundtable tend to call AIFMD (the Alternative Investment Fund Managers Directive in the European Union) and IFRS 13 (International Financial Reporting Standards) the major drivers for more transparency.

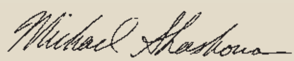
Earlier this year, IFRS accounting and valuation guidelines drove managers to pull together their reporting to meet January deadlines, as AIM Software's Michael Walford-Grant observes. "Now that this is out of the way, we're seeing a focus on … an automated process for pricing funds consistently across the firm to meet the requirements of AIFMD," he says.

AIFMD has also led to the advents of third-party external valuation services, notes HSBC's Chris Johnson, which in turn led many service providers to review their processes. Practically, for AIFMD compliance and increased transparency, fund managers now have to compile reports specifying risk calculations and exposure levels, says Thomson Reuters' Jayme Fagas.

In addition, end-user firms need clarity about IFRS 13, a definition of fair value pricing, Walford-Grant relates. This has pushed suppliers of valuations and prices to be clearer about their sourcing.

The demands for transparency coming from regulators and policy-makers, as Fagas identifies, have driven industry participants to focus on increasing it. Since that policy driver is there, and so strong, we don't know if there would be the same focus on transparency without it, but the trend has arrived, ready or not.

Yours sincerely,



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- Understanding the regulatory drivers including transparency, capital requirements, systemic risk oversight and surveillance
- Bridging the gap between the regulatory drivers and business drivers: Balancing cost vs. regulatory compliance
- Is there sufficient cross-over between regulations to warrant a central regulatory data warehouse and reporting solution?
- In what ways can firms collaborate to reduce the overheads associated with the common data needed for regulatory reporting, and do the regulators need to help with this?

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Interactive Data Expands Excel Content

In late March, Interactive Data began making more content and asset classes available via the Microsoft Excel add-in for its Continuous Fixed Income Evaluated Pricing service, which provides real-time evaluated prices for fixed income securities, according to company officials.

The Excel add-in now contains all of the assets currently available via the continuous evaluated pricing service—except for US money market securities, which Interactive Data will add to the service shortly—and in Europe covers all end-of-day evaluations, with the exception of convertibles and asset-backed securities.

"We have added European securities to the Excel add-in delivery capability of our Continuous Fixed Income Evaluated Pricing Service, with US money markets due to be released in the next few weeks," said Mark Wilson, fixed income commercial manager at Interactive Data. "This delivers fixed income evaluated prices directly into Excel, enabling users to get deeper insight into pre-trade prices, perform price discovery and keep on top of data key to their trading and investment decisions.

Joanne Faulkner

DelphX Plans Expansion, Data on Quandl

Bond trading venue operator DelphX plans to expand its Mav=n (Market-Adjusted Value per congruent Nexus) pricing service, to provide users with fair-value prices for SEC Rule 144A private placements, asset-backed and mortgage-backed securities, and municipal bonds.

The pricing service currently provides fair-value prices for 25,000 corporate bonds by analyzing historical trade data going back to 2002. Over 2015, DelphX plans to expand the service to 144A asset private placements, and asset-backed and mortgage-backed securities. The vendor also plans to add coverage of municipal bonds, but due to the complexity and size of the municipal bond market, these prices are unlikely to be available until 2016, says DelphX founder, president and chief executive Larry Fondren.

Separately, DelphX is adding its Mav=n end-of-day corporate bond prices to Toronto-based economic and financial search engine Quandl's financial and economic online database.

Faye Kilburn

Numerix Integrates with Cameron Tec for Structured Product RFQ System

Numerix has integrated its pricing and risk calculation engine with the FIX technology provided by Cameron Tec Group, to create a system for quickly responding to requests for quotes (RFQs) for over-the-counter structured products.

The process of managing RFQs from a client is often "slow and laborious," according to Jim Jockle, Numerix's New York-based chief marketing officer, and often involves a quant using Excel to do calculations.

"Our platform scrapes those emails from clients for terms and conditions, dynamically builds multi-factor models for those product types then returns those quotes back to the traders for approval to send out to their client," explains Jockle.

Numerix's calculation engine can now be used to translate a message from a client and price the products, before the price is converted into a Quote FIX message by Cameron Tec and returned to the client. Numerix decided to work with Cameron Tec in response to a requirement from a large bank in Singapore that wanted a more efficient way of handling the large number of RFQs it was receiving for bespoke structured products.

Nicholas Hamilton

Interactive Data Upgrades Apex Platform

Data services provider Interactive Data has upgraded Apex, its pricing and reference data platform, to add data access flexibility, ease consumption of data and improve total cost of ownership.

"The industry has been pushing for reduced costs and decreased complexity related to licensed data," says Hubert Holmes, managing director of reference data at Interactive Data. "Apex combines enhanced content coverage and completeness, with a rich data model and a suite of delivery capabilities."

Charles River Adds Thomson Reuters Data

Boston-based Charles River Development has added Thomson Reuters pricing and reference data to its Managed Data Service.

The investment management solutions provider has already added daily constituent-level benchmark data from Russell, FTSE and Standard & Poor's to the service, which is integrated into the company's Investment Management Solution and also is a part of the software-as-a-service version of its offerings.

Virtual Roundtable

Pricing: Fair and Present Transparency

Inside Reference Data gathers leading data management professionals to discuss the efforts being made towards transparent pricing, and the impact of AIFMD and IFRS 13

How do you view the progress that has or has not been made with increasing transparency in pricing?

Michael Walford-Grant, country manager for the UK and Ireland, AIM Software: Where trades occur on exchanges and trading facilities, price reporting continues to be adequate and feeds into downstream vendor systems. There are some developments in pre-trade pricing and discovery, alongside trade prices for some asset classes and from some vendors. The traditional valuation and model providers are doing a good job around thinly traded assets such as fixed-income and structured finance.

A notable change is the reduction in inventory holdings by large dealers and their reluctance to provide quotes. This has curtailed a traditionally important source of price discovery. The analytics firms are providing tools to enable illiquid and bespoke derivative instrument pricing. There are still gaps and challenges around private equity, project finance and esoteric/intangible assets.

The challenges for AIM's clients, from hedge funds to administrators, mainly reside in cost-effective aggregation and cross-referencing of many feeds and data sources. Once these are consolidated in-house, the process of ensuring the valuation functions are carried out in a transparent, consistent way across the firm for all portfolios and holdings is significantly improved.

Chris Johnson, head of product management for market data services, HSBC: Much progress has been made towards meeting the requirements for transparency that are explicit in new regulations such as AIFMD, Solvency II and MAS (Singapore) as well as investor reporting (e.g. NAV Transparency, OPERA). We are also seeing wider regulatory emphasis on asset valuation. The regulatory expectation is that asset owners should be able to explain how their assets are valued, the sources of the price sources and degree of certainty about it. Asset owners require management information from suppliers to support this with policies in place on which to base their governance.

Jayme Fagas, global head of valuations and transparency, pricing and reference data services, Thomson Reuters: Policymakers have put transparency at the center of the post-crisis regulatory agenda. The flurry of recent and upcoming regulations pose enormous challenges for all sectors of the global financial services industry. The cost and time implications of meeting the enhanced risk management and reporting obligations are significant and unavoidable.

Without a doubt, industry participants have focused an extensive effort on ensuring increased transparency around not only their pricing but the methodologies and data inputs supporting their valuations. This is progress and it illustrates the industry's proactive response to the evolving regulatory universe. Transparency is fundamental. In an attempt to comply with the breadth and complexity of rules that have been introduced, the importance of timely, accurate and transparent pricing and reference data has been acknowledged.

Advanced Information Management

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What impact have transparency efforts made? Are you seeing more visibility and quality? Have other benefits emerged?

Walford-Grant: As well as the efforts to clarify transparency of process and governance, clients are beginning to focus on source selection, where they need to handle exceptions and how they can get greater transparency into the forensic analysis of a valuation.

Johnson: Transparent reporting of asset valuations requires the identity of the price source and this has led to extra granularity within client reporting. This demonstrates where independent market prices have been used from recognized suppliers and, equally, from sources that are more specialized, even esoteric, in nature. Increased visibility and quality provides benefits such as a reduction in price challenges from clients. Data vendors have invested heavily in developing their bond evaluation services and there is now a wide range of options available for asset owners (at a price) to analyze pricing depth and certainty.

Fagas: The call for greater transparency of the data, sources and processes used in pricing has had a significant impact. The first real impact is also ironically the longest lasting – greater transparency requirements bringing to the attention of participating institutions the need to fully understand and identify the pricing and reference data services they use. In particular, it has demanded an accountability measure of organizations to understand how they should use pricing and reference data in addition to the origin of the content within that data. To this end, transparency efforts have resulted in increased visibility for regulators.

Beyond heightening the awareness of industry participants about the need to make their valuation methods visible, with a clear connection between the data inputs and price outputs, transparency efforts have unavoidably generated more work. For example, sourcing and mapping the correct data to populate the quantitative report template (QRT), and providing an audit trail of that data, involves enormous effort. The risk of error or omission is high, which may result in regulators demanding more *ad hoc* reporting or supplementary capital requirements where the firm's disclosures are deemed unsatisfactory.

Jayme Fagas,
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What impact has the AIFMD independent valuations mandate had?

Walford-Grant: Alternative investment fund managers need to show valuation processes and governance are in place to mitigate and remove conflicts of interest. The valuation function for an alternative investment fund needs to be carried out by an independent valuer. This function can be carried out by the fund manager or an external agent. General practice has been for alternative investment fund managers to take on the independent valuation function for the majority of assets. External valuers do not want to accept the perceived liabilities. The fund manager's objective is to produce unbiased, transparent and sound valuations with due care and skill, which adhere to IFRS accounting levels and valuation best practice guidelines.

We see alternative investment fund managers focusing on the risk of bias in alternative investment funds, such as unquoted and illiquid asset valuation, and complex and hard-to-value assets where subjectivity and judgement is needed. Many managers have focused on pulling initial reporting details together to meet the January reporting deadlines.

Now that this is out of the way, we're seeing a focus on cost-effective implementation of an automated process for pricing funds consistently across the firm to meet the requirements of AIFMD.

We partner with Voltaire Advisors and rely on their expertise in pricing and valuation risk to better understand how these requirements evolve and can be met.

Johnson: The requirement for independent valuations has ensured robust control procedures around model approvals are implemented for valuations in-house and by third parties. Bond evaluation services have sought accreditation for this reason. The emergence of third-party external valuers, as mandated by AIFMD, led to an in-depth review of valuation processes at many providers. The most significant impact is on smaller investment firms without the scale to support segregation of duties for independent valuation. AIFMD has highlighted the importance of valuation services using high-quality prices, along with valuation expertise.

Fagas: The scope of AIFMD is broad. Covering the management, administration and marketing of alternative investment funds, it is ultimately designed to improve investor protection by imposing new depositary standards and enhanced transparency through new investor disclosure rules and mandatory reporting to competent authorities.

Fund managers and advisors must submit regular reports detailing investment positions using accurate, verifiable data. Targeting the need for transparency across the hedge fund and private equity space, the AIFMD requires fund managers to compile their reports specifying risk calculations and exposure levels.

The challenge facing alternative investment firms is to populate their regulatory reports with a detailed array of accurate, up-to-date information under tight filing deadlines. All systems across the enterprise need to use the same data consistently to mitigate the risk of inaccuracies and omissions. At the heart of the process is ready access to high-quality, verifiable source data. Robust pricing and valuation data that adheres to fair value disclosure stipulations is crucial, as it feeds many of the downstream calculations regulators use to conduct risk assessments. Only by using high-quality, transparent evaluated prices for relevant instruments can the firm accurately determine its aggregate positions and exposures.

Has the IFRS 13 fair value pricing definition changed the way valuations are made?

Walford-Grant: End-users require clarity on IFRS levels. As a consequence, valuation and price suppliers are becoming clearer about the sources of prices and inputs used to create valuations. Many vendors supply descriptions of the price, such as indicative price/pre-trade, trade price and valuation, as well as the number of inputs or sources available, to enable the end-user to make leveling decisions.

Systemic changes to the fixed-income markets are pushing traditional price providers, like sell-side banks, to reduce inventory. This is making valuation vendors more transparent around the trade and price data associated with the valuation of thinly traded assets.

We enabled seamless integration of multiple-feed sources for clients and allow business rules to set flexible hierarchies, customizable for each portfolio.

Johnson: The three IFRS13 levels for insurers have been joined recently by similar regimes such as FRS102 SORPs and Solvency II valuation types. These promote the use of quoted market prices wherever available and only expect modelled prices where necessary. There are notable variations within the definitions requiring multiple classifications to support underlying disclosures for the same asset. The key regulatory priority is to identify assets with significant opacity. The definition of what constitutes active and inactive markets is unclear, making it difficult to classify accurately using consistent logic across all price sources.

Fagas: The IFRS 13 fair-value pricing definition has changed the way valuations are calculated. From its introduction on January 1, 2013, IFRS 13 has redefined how investment funds must measure and disclose the fair value of assets and liabilities. Fund accounting and administration functions are particularly affected as henceforth they have needed to ensure data is captured, processed and reported in the right way to meet the standard.

Providing regulators with transparency into the underlying data inputs and calculation methods used to formulate the prices, and evaluate the risk weightings associated with the assets, is especially vital to addressing IFRS 13. It is useful to note the fair value standard also underpins many other accounting standards changes, such as IFRS 9, indicating its scope in changing the processes used

Chris Johnson, HSBC

to determine how valuations are made.

Meeting the fair value requirement is relatively straightforward where entities invest in securities traded on-exchange or in active markets since an exit price is available. The process is more challenging when investing in complex and/or illiquid assets. The institution must then use a valuation technique to establish the transaction price on measurement date. IFRS 13 also enhances reporting entities' disclosure responsibilities by mandating they lay bare the valuation techniques and inputs used to arrive at their reported fair value measurements. The priority for investors therefore is to access the full sweep of market and evaluated pricing data they need in an effective and cost-efficient way, ideally from a single source.

How is the dynamic between pricing vendor and end-user changing with all these changes to transparency and regulatory compliance? Is it becoming more interactive or collaborative?

Walford-Grant: End-user fund administrators, asset managers and IPV functions are looking for greater efficiencies in aggregating multiple sources of data and pricing. Much of the focus around pricing or valuation transparency involves handling and forensic analysis of exceptions. This requires greater understanding of underlying data, models and processes, and typically involves reverting to the source.

Full transparency is most important for our clients. This includes being able to respond to enquiries from auditors and clients on which price was used for the NAV on a given date, the source of the price, which selection rule and controls were applied, who took decisions or made changes in case of human intervention, and more. This transparency improves our clients' pricing and data governance through a better overview and tools. The dialogue between our clients and their vendors becomes more interactive.

Johnson: Valuation transparency requirements are paving the way for direct links between asset owners and providers of the underlying prices. Asset owners must provide line-of-sight for the source of each valuation, which needs to be supported by their outsourcing intermediaries. Asset owners are building up their investment divisions to help demonstrate to regulators they understand their assets, the valuation sources and uncertainty. The increased costs to meet these regulations are in some cases absorbed by intermediaries, but the "aggressively commercial" approaches adopted by some vendors, along with licensing restrictions, mean higher costs will reach end investors.

Q&A

Valuation Velocity

Transparency of price sourcing is improving incrementally, as more external valuation sources may be used, observes Daniel Johnson, director of valuation at Wells Fargo Global Fund Services


Daniel Johnson

Has there been enough improvement in transparency to make a difference in data quality?

We have seen a small improvement in transparency as it relates to pricing data. For most of our asset management clients, these appear to be enough to satisfy them that the prices they receive from data vendors are sufficient to meet their current needs. But there are some challenges when clients perform deep dives to look behind the headline price.

How is the industry doing on compliance with the AIFMD independent valuations mandate?

The asset management industry seems to be coping well with the AIFMD requirements around valuation. There was some confusion initially about who would be the external valuer for each fund, as very few parties were willing to take on the liabilities associated with the role. Now it has been established that the external valuer does not need to be a third party independent of the fund manager, and that a fund can have more than one external valuer of its assets, the initial concerns have been allayed. The recent Quarterly Consultation Paper published by the UK Financial Conduct Authority (FCA) has been helpful in answering a lot of items.

Is compliance with AIFMD and IFRS 13 regulation leading to changes in service providers' pricing and valuation offerings?

The service providers have seen increased demand for enhanced pricing data since FAS 157—now ASC 820—was introduced several years ago. IFRS 13 helped bring the need for enhanced price data to a new audience of fund managers operating under IFRS. Whether or not the managers are willing to pay more for the enhanced data is another question. AIFMD's biggest impact is educating fund managers about the importance of a fully independent valuation function and what that means for portfolio managers' involvement and the need for independent pricing.

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