HARNESSING DATA FOR BETTER VALUATIONS
November 2009
Introduction & Methodology
A-Team Group, a publishing and research company specialising in financial information technology, was commissioned by enterprise data management specialist GoldenSource to conduct research into the challenges of managing pricing and valuations data.

Throughout the course of October 2009, A-Team Group researchers interviewed 20 senior-level specialists closely aligned to market data or valuations (see Chart 1). Several spanned multiple responsibilities including oversight of client data, product information, and trading risk.

The interview sample was spread across asset managers (52%), Tier-1 and Tier-2 banks (32%), broker/dealers (11%) and custodians (5%) (see Chart 2).

Geographically, participants were dispersed across the United Kingdom (47%), Europe (21%), and the United States (32%) (see Chart 3). Over half of the respondents had global responsibility within their organizations (see Chart 4).

How to Make Sure Your Valuations are Not Off the Mark
It’s been well documented that a number of high profile failures and frauds have been related in some way to the mis-pricing of assets, and in the current environment this has generated increased scrutiny from regulators, accountants and industry bodies alike. We’ve seen significant changes in the rules governing the valuation of assets. And the result is that pricing policies and valuations processing are now at the forefront of operational risk.
This has made the already complicated task of valuing assets even harder. There are more stringent internal pricing policies that need to be adhered to, and a greater onus on financial institutions to show that they have used suitable methods to reach their price.

In nearly every case, regulations require that institutions accept ultimate responsibility for all prices delivered and used in valuations thus necessitating some form of internal valuations service or function.

Such valuations functions at the firms represented in our survey range from a basic comparison of third-party valuations data feeds, to very sophisticated modelling techniques. We found that while some firms outsource the management of asset valuations, the majority of financial institutions have custom in-house solutions to manage this. One market data manager suggested “in this case, it is cheaper to have our staff evaluate those few instruments than to pay the fee demanded by the sole data provider”.

Even those firms outsourcing asset valuations cannot always find acceptable sources for the more complex or harder-to-price securities and so still must value these securities themselves.

But whatever quality or level of sophistication of pricing models, without the highest quality data being fed into these models, the end result will be a valuation that is off the mark.

The largest Tier 1 financial institutions or sophisticated mid-sized institutions, that are major consumers of market data as a matter of course, often have well-developed pricing operations. These organizations, which may trade their own books as well as manage client holdings, have a stronger assurance they understand the underlying data and are confident they provide a higher quality price. Through internal refinement of policies and tightening of tolerances, these service units proudly deliver their best estimate and are prepared to help downstream users understand their conviction.

But it still requires significant data management and workflow processes to make the operation as smooth as possible, and many acknowledge that there are challenges in the ongoing management and refinement of their internal data management operations. Whether connected to existing reference data systems or market data platforms, issues around data quality and quality processing stand out.

Mid-size to smaller firms that do not have extensive data operations are finding it a real challenge to manage the sourcing of data and associated workflow in order to generate accurate valuations for which they must take ultimate responsibility.

With the increasing complexity of valuations data, and the associated rules governing valuations methods, financial institutions need to really address their data management processes to ensure that they do not become subject to fines for noncompliance to regulations, or worse, too high a risk exposure due to mis-priced assets, which as we’ve seen can cause devastating results.

Multiple Sources for Multiple Challenges

There are many different sources and methods for asset valuations, from trade prices and dealer quotes to composite pricing, evaluations and complex mathematical models. But, of course, there is no single definitive price for any particular asset that can be used for all valuations for all purposes. Instead there exists an array of data – collected internally, from counterparties, or from third-party providers – that needs to be integrated and compared, with parameters set to match various pricing policies, exceptions managed, and then fed into various relevant applications for end consumption.

The number of different providers required within a department can vary – larger, multi-national sources satisfy most needs of smaller institutions, but upwards of a dozen overlapping data providers are needed for larger demands. Where data points are available for a reasonable cost, all respondents prefer to have multiple sources to compare. For any given instrument, more than ¾ of the survey participants indicated ‘around 3’ sources were needed to set a price (see Chart 5).
Operators that set their own prices based on multiple sources of information generally agree the process is complex and difficult (see Chart 6). Many feel that ‘tedious’ or ‘consuming’ best describes the experience as they are under pressure to get the price ‘correct’. The most conscious are client facing managers that generate reports to external clients; finding an error in implementation of pricing policy means a costly – in resources and reputation – generation and distribution of revised statements. A head of asset services stated quite succinctly, “the only way we can handle the complex fusing of data from multiple sources is the strong capabilities of our financial engineering people”.

Even with ‘full’ automation (see Chart 7) there are still exceptions and non-traditional assets that require manual evaluation, validation through internal models, and a strong constitution for holding one’s position. All of the firms participating in this survey used some form of automation although 43% admitted that their processes are more manual than they would like.

Computer systems can be used effectively to check limits, to compare current volatility and liquidity against historical values, and even to gauge the effect of news and analyses on financial instruments – much like an algorithmic trading engine. However, rarely traded issues, private vehicles between two counterparties, and quality control all necessitate routine human intervention.

A major issue with pricing and valuations services boils down to one of customer service and transparency. Providers – whether internal or external – need to be supportive in price challenges and open about their methods and practices used to determine a price. In the case of equities traded on open markets this is less significant. But for fixed income, derivative, and more complex financial instruments transparency is foundational to a comprehensive picture.

Meanwhile, asset servicing organizations have their own issues in dealing with their clients and partners. Reconciliation with counterparties is a major concern – and a major headache – as it can be difficult to agree on a price or valuation generated by independent organizations. Even with the same core data, differing models and inconsistent application of pricing policies creates discrepancies that must be addressed.
A Structured Approach

In an ideal world, meeting strict pricing policies would be facilitated by access to a holistic view of the enterprise’s data, with clear transparency into the calculations of those sources to enable pricing teams to feel confident about each valuation. But the reality is far from this.

Of our survey participants, 78% were aware of a formal Enterprise Data Management (EDM) strategy and 86% of those firms with such a program include Pricing and Valuations in the overall plan (see Chart 8 and Chart 9 respectively). Those firms where pricing and valuations were not part of existing EDM activities suggested that, perhaps, it would be part of a later phase of those plans, or that they would continue with their existing operations to leverage sunk costs.

Those firms that do not have an EDM strategy are currently overwhelmed by the changes in internal structure – and in some cases imminent mergers – as a result of the cultural shift that has taken place because of the credit crunch and economic downturn.

Many organizations are holding off integrating full workflow orchestration and migrating legacy systems into new infrastructure until expense pressures ease. The current appetite for buy vs. build – participants in this survey equally for and against – is heavily skewed by limitations on budget and restrictions on utilizing external resources in lieu of internal staff.

Managing Complex Pricing Policies

Pricing policies – the governing rules by which a firm sets its prices and ultimately its valuations – are key drivers dictated by the business. In all organizations with internal pricing services represented in this study, policies are set and approved by a committee – often a dozen strong – of senior management before systems can be adjusted to affect those changes. Most respondents speak of a ‘policy manual’ or other tome that the business updates and distributes, or makes available via an internal website, describing in detail the policies that are in force. A few firms place the safekeeping of these policies with a single individual – and some without a written, consolidated document.

In conservative firms or horizon focused asset managers, these policies may be reviewed quarterly or semi-annually. Heads of trading desks, risk and compliance officers, and even CFO’s collaborate to ensure the right information is used to set the authoritative price. The process of setting the policy is as intensive as ensuring it is enforced on a daily basis.

But for market-makers and high-throughput firms, constant review throughout the day is essential to staying abreast of their changing exposure profile. Even though overall pricing policy – which may identify which data sources are used under which conditions – is established by a committee, the individual trading desks set their prices based on current conditions and observed changes to trends. Internal pricing desks, charged with external sourcing and confirmation, are constantly reacting to exceptions from out-of-range trading. Intra-day adjustments are a hard reality for these specialists.
Business Processing for Complex Rules

Setting policies is one thing; implementing them is another. Without a technical solution to manage the increasingly complex rules governing pricing, it can be very difficult for institutions to adhere to internal policy or jurisdictional mandates. In an operational environment sensitive to avoidable risk and undue focus from regulators, the implications of failure can be severe.

Although any system can be stressed by new types of instruments or assets representing a particular industry sub-sector, those utilising proprietary solutions are particular affected because ultimate flexibility was not in their original requirements specifications.

Indeed, more than one operations manager admitted that not all pricing policies could be implemented immediately because the underlying systems were not capable of handling certain complex rules based on new parameters. For these organizations, a generic rules engine capable of complex decisions based on any available data would streamline their operations.

In this study, 79% of respondents (see Chart 10) use some form of business process automation (BPA) component to facilitate application of rules to incoming data for pricing and valuations purposes. A significant 60% of those firms (see Chart 11) use a home-grown solution that doesn’t provide full functionality and configurability by a business user.

All participants utilising custom-built exception processing were sceptical about the ability for these systems to adjust to increasingly complex pricing policies in the foreseeable future while providing background data for decision justification. In many cases, quickly rolling out new product offerings to clients is hampered by these underlying rules engines. They see this trend continuing – but are not clear how it will resolve itself given the perceived cost of changing existing systems over to flexible platforms.

The Cost of Doing Business

The overarching themes of respondents’ view of the world are continual scrutiny and justification in a time where extreme price containment measures have already been put into place. No longer are investment houses content to blindly trust their partners and service organizations especially when so many have folded under their own burdens. No more can one simply rely on information provided by a third party – risk avoidance and regulatory compliance demand the data be validated and the company’s position be documented and revisited frequently. Sunk costs and continual scrutiny are common elements that level the playing field in a game where the correct blend of policies, data, and processing systems gives a player the winning combination.

And getting the right price isn’t cheap either. Data and licensing costs aside, 46% of survey participants spend (see Chart 12) between $1 million and $10 million for technology used for pricing and valuations. Half of the participants...
(see Chart 13) felt that the increased awareness of the value of quality pricing, and just inflation alone, will require this spending level to increase. Meanwhile, the other half are feeling the crunch to further reduce their expenditures and continue to find ways to be more efficient. For some, this simply means cutting staff and finding cheaper (and fewer) data sources to service their requirements. For others, this means replacing dysfunctional internal systems with something new.

The service costs above are in addition to the 10-20 full time staff necessary to manage the operations and utilise those services (see Chart 14). Most respondents utilising fewer than 25 staff members felt that they were right-sized for the current economic environment with sufficient dynamic headroom for some abnormal trading days. In this study, large organizations (the >25 category in the chart) actually have 50 to several hundreds of staff dedicated to their global pricing and valuations efforts.
Harnessing Data for Better Valuations

About GoldenSource

GoldenSource provides an integrated enterprise data management (EDM) platform for the securities and investment management industry. Our software and expertise help our customers benefit from better management, storage, and distribution of their data company-wide. A consolidated, centralized data foundation layer for securities and other products, clients, and counterparties combined with positions, balances, and transactions enables firms to show a real time aggregated view of risk and exposure. GoldenSource products are mature, proven solutions to support cost-effective growth strategies and stringent regulatory demands.

GoldenSource EDM supports all the critical business functions of a proven enterprise data management platform. This includes data acquisition, cleansing, normalization, validation, enrichment, and distribution. We deliver the unique ability to link product and entity information with real time transactions and positions. This granularity of information helps our clients to better manage exposures and liquidity, control risks, and maximize opportunities. Trading, risk management and compliance, settlement, portfolio accounting and other front, middle and back office functions all benefit from improved data management.

GoldenSource has its global headquarters in New York with EMEA headquarters in London and development offices in Linz, Austria and Mumbai, India.

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About Interactive Data

Interactive Data Corporation (NYSE: IDC) is a leading global provider of financial market data, analytics and related solutions to financial institutions, active traders and individual investors. The Company’s businesses supply real-time market data, time-sensitive pricing, evaluations and reference data for millions of securities traded around the world, including hard-to-value instruments. Many of the world’s best-known financial service and software companies subscribe to the Company’s services in support of their trading, analysis, portfolio management and valuation activities. Interactive Data, headquartered in Bedford, Mass., has approximately 2,400 employees in offices located throughout North America, Europe, Asia and Australia.

Interactive Data’s Pricing and Reference Data business provides global securities pricing, evaluations and reference data designed to support financial institutions’ and investment funds’ pricing activities, securities operations, research and portfolio management. Interactive Data collects, edits, maintains and delivers data on more than 6 million securities, including daily evaluations for approximately 2.8 million fixed income and international equity issues. Interactive Data specializes in ‘hard-to-get’ information and evaluates many ‘hard-to-value’ instruments.

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A-TEAM GROUP

About A-Team

A-Team Group, founded in 2001, is a publishing, research and events group that provides the global community of IT and data professionals in financial markets with the business intelligence they need to excel in their roles.

We’re widely known for our focused series of publications, research and events across mission-critical functions including high-performance trading infrastructure, low-latency market data and connectivity, enterprise data management, reference data, market structure, risk and regulation and more.

A-Team Group’s publishing division publishes a range of online and in print news services including Risk & Regulation IT, Reference Data Review, Market Data Insight, Electronic Trading and Low-Latency.com and A-Team IQ magazine. Find out more at www.a-teamgroup.com/publishing.

A-Team Group’s research division collates data, performs analysis and delivers results for internal product development and marketing, as well as publishing in-depth reports for external use, examples of which include:

- Business Entity Identifiers: The Crucial Foundation for Accurate Risk Management
- OTC Valuations - Pricing Assets in the Post Credit Crunch World
- Buy-side Firms Take a Hard Look at Data Practices: Derivatives Push the Data Management Envelope
- Are Contributed Bond Prices the Hidden Gem in Fixed Income?
- Faster Than a Speeding Bullet… Low-Latency Architectures and Building Blocks for Tomorrow’s Trading Applications
- Buyer Persona - The Influence Behind Data Management Decisions, and more...

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