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The rise of OTC derivative third party valuation services

Portfolio managers love OTC derivatives; COOs love to hate them. At a recent Investit conference, we asked 35 investment management firms and third party administrators their key areas of spend for the next year. 89% of delegates said 'supporting OTC derivatives'. The investment management companies we speak to are particularly worried about the issues arising from the pricing and valuation of OTC derivatives. Most currently rely on counterparties for pricing and valuation. Remember, these are the individuals who sold the instrument to them in the first place. Verifiable valuations are essential – the FSA is keen to see OTC valuation processes automated. This means big business for those

companies that provide support services and technology and, unsurprisingly, a number of pricing and valuation service providers have appeared over the last couple of years. These systems provide a solid alternative source of valuations to counterparties. However, the take-up of these systems by buy-side firms is limited. In this article we examine the benefits of third party valuation systems - and highlight a few points of caution in using them.

The growth in third party valuation service providers

The use of OTC derivatives in investment management has grown significantly over the last few years. These instruments are unique contracts and can be very complex and the rise in their use has exposed the limited operational and technological support in investment management firms. Pricing (the time the OTC derivative transaction takes place) and valuation (the ongoing value of the OTC derivative) are causing particular problems. OTC derivatives require new types of market data and bring new challenges in sourcing, storing, managing, controlling and distributing data. Investment managers have limited experience in dealing with this data and so rely on sell-side counterparties to provide prices and ongoing valuations for OTC derivatives.

While the FSA has stated brokers should act in their clients' best interests, investment management firms' clients and investment consultants want to see at least one other source of valuation being used as verification. This has led to the growth in the use of third party outsource providers, who can take advantage of economies of scale, and the emergence of third party valuation services provided by market data firms, such as Markit, Tullett Prebon, Lombard Risk and Bloomberg.

What investment managers need

Investment managers do need an internal model and/or an external system that captures OTC trade data and historical market data, to conduct pricing and valuation. To ensure confidence in a value this system would use a variety of different valuation models to ensure confidence in a value. Building an in-house model is a difficult job - investment managers have very little experience in OTC derivatives compared with their sell-side counterparties. OTC derivatives make much larger demands on data capture, cleaning and management. And many managers lack the volume of historical data on which to base empirical valuation analysis. It is a convincing argument for buying a third party valuation system – or using an outsource provider.

Why use third party valuation service providers

Investment managers should consider using a third party valuation system or outsourcing the valuation process to a third party administrator, which will use a number of these systems. Third party valuation systems bring a number of benefits:

- Systems have large amounts of historical time series data. This supports marking-to-model valuation for OTC derivatives. It is not merely about collecting years of data; it is also the effort involved in cleaning, managing, summarising and distributing the data.

- Valuation models are stress-tested by a wide variety of circumstances and, particularly where long-dated maturities are involved, the results are more reliable as the assumptions in the models will have been adjusted appropriately.
- Service providers employ a number of skilled and experienced staff to build and operate their valuation models. Building up a resource base with the right skills (both technical and business) in the right market takes years.
- Service providers offer a systems and technical infrastructure that investment management firms would otherwise have to acquire. This can save hundreds of thousands of pounds.
- Using a provider will save time and money – a comprehensive valuation system or model does not have to be created in-house. This can be especially attractive for firms launching a new product that uses OTC derivatives.

A word of caution

Third party valuation service providers are not going to solve all investment managers' valuation issues. Managers shouldn't buy these systems blindly and need to be aware of potential concerns:

- Third party valuation service providers use proprietary valuation models. It is their product and what they sell. So, it is unlikely they will want to share them with managers. Consequently, how do managers know if they are accurate?
- Usually access to the underlying data is extremely limited. Again, much of the value in the service is derived through the use of clean reliable data covering specific markets.
- Integration is expensive. Most providers will require an interface to be built to an exact specification - an XML interface is likely to be required.
- Investment management firms and third party administrators need to check data security, as they would be sending potentially sensitive data on positions to service providers.
- Can the service provider give both breadth and depth in all markets? Most providers specialise in specific markets in which they have been active for many years and have therefore built up the data sets, which feed the models. Newer markets, such as energy and pollution, require time-series data before being able to mark-to-model. This data can be difficult to source.
- Investment managers should understand the economics of their OTC business, before searching for the right system. Where is the OTC business going in terms of volume, capability and diversity? The typical range of 'costs per position per instrument per month' offered by providers range between \$10 and \$100. Subscription models are becoming more creative and modular.

While it is tempting to only pass the service providers the difficult instruments to value, it is likely that these will be the most expensive on a 'per position' basis. Managers should consider a volume discount and bundling in the 'hard' valuations.

Who guards the guards?

Using a third party valuation system is a great improvement for those investment managers who rely on counterparty valuations. It's more transparent and independent – something clients, investment consultants and the FSA will all appreciate. However, investment management companies should not rely on these systems in isolation. The lack of transparency in systems' valuation models makes it complicated to validate data. Third party valuation systems should be one input into the valuation process, albeit a very important one. Investment managers should check valuations from these systems against counterparty data - and have an appropriate level of in-house expertise to spot anomalies themselves. Good third party valuation service providers will expect challenges to their valuations from time to time.

About the author

S-J is a business analyst and project manager for both business and systems projects. Her business experience spans the investment process in the front office (portfolio management and trading) right through to middle and back office operations (risk, compliance, legal, settlements, valuation and accounting) for all asset types - including derivatives.

With over 12 years experience in financial services, in both transfer agency business as well as core investment management, S-J has managed a wide variety of global projects, covering operations, front office, middle office and client reporting. Her recent projects include implementing OTC derivative capability on legacy systems and establishing a Fixed Income operation in India.

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