



Q&A: Pricing and Evaluations

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1. Where are innovations and improvements happening in pricing and evaluations? Is it in efficiency and speed, or other areas?

Clients always want pricing as fast as possible, and there is constant work on improving efficiency and delivery speed for operational purposes. However, we believe that the main innovations in pricing and valuation are taking place in the areas of valuation functionality and support. This is particularly noticeable in the levels of transparency valuation users increasingly need, and the associated requirement to ensure that valuations are fully justifiable. There is also a lot of work being done on improving the support process for price requests and challenges.

2. How are new regulatory requirements shaping the way pricing and valuations are conducted and provided?

Whilst these regulations vary in target and intent (risk, consumer protection, etc.), virtually all the valuations components are focused on the use of mark-to-market and/or objective and fair valuations for financial instruments. This places a much greater burden on user firms to source such prices from vendors, and also increases pressure on vendors to provide greater asset class coverage using a more robust methodology.

3. What are funds and firms looking for when choosing pricing and valuations providers? Is it only transparency, or are there other virtues they want, such as greater coverage?

Coverage is a perennial problem. Today there is increasing need for objective valuations across a much broader range of asset classes – including derivatives and structured products – which creates a serious business problem for users. Pricing vendors are under pressure to produce valuations for a larger universe of instruments, many of which are more complex and esoteric than the most common fixed income products.

Transparency (in the sense of users being able to fully understand how a valuation was produced) remains a key and growing requirement. However, we are increasingly seeing this aligned with a need for users to also be able to justify the use of a price source to various external parties – clients, risk teams, auditors and

regulators. We call this combination of transparency and justifiability ‘Defensibility’ and have built our new Evaluated Pricing Service around this concept.

4. For portfolio managers, how much of a factor is credibility of pricing sources? How can firms and providers address gaps in trust?

In the final analysis, valuation is a trust business. If the valuation of a financial instrument cannot be trusted, then the whole downstream edifice of the financial system is built on unsound foundations. This was revealed most dramatically during the recent credit crisis, where liquidity in many sectors collapsed as investors could not trust the value of their holdings.

Addressing the gap in trust in valuation falls back to the previously mentioned concept of Defensibility. If users can both understand exactly how a valuation was produced, and fully justify the methodology, inputs and assumption used in this process, then a strong level of trust can be placed in the robustness of the price. There are a number of ways in which this trust can be developed further – complete transparency is hugely important as is external review and validation of a vendors methodology and process.

5. Do forms of pricing such as evaluated pricing have greater credibility with users? Are other pricing and valuation specialties gaining traction with similar or other attributes?

Our view is that a fully transparent and validated Evaluated Pricing Service fully meets user requirements for a credible valuation source. However, it appears that some users are still deeply wedded to the concept of a ‘market price’ – either a trade or a quote from a dealer. Whilst it is true that, in liquid, normally functioning markets, market prices are perfectly valid, they begin to succumb to some credibility issues when these circumstances do not apply.

An appreciation of these issues and failings of many market prices, and what options are available to address them, is gradually beginning to emerge in some of the more sophisticated users, but this has some way to go. Regulation is likely to continue to take user firms down this path, but some will no doubt be led kicking and screaming!