How credit managers can improve reporting by better evaluating pricing providers

How credit managers can improve reporting by better evaluating pricing providers

By Govind Mohan, CFA
EY Americas FSO Assurance Senior Manager, Wealth & Asset Management

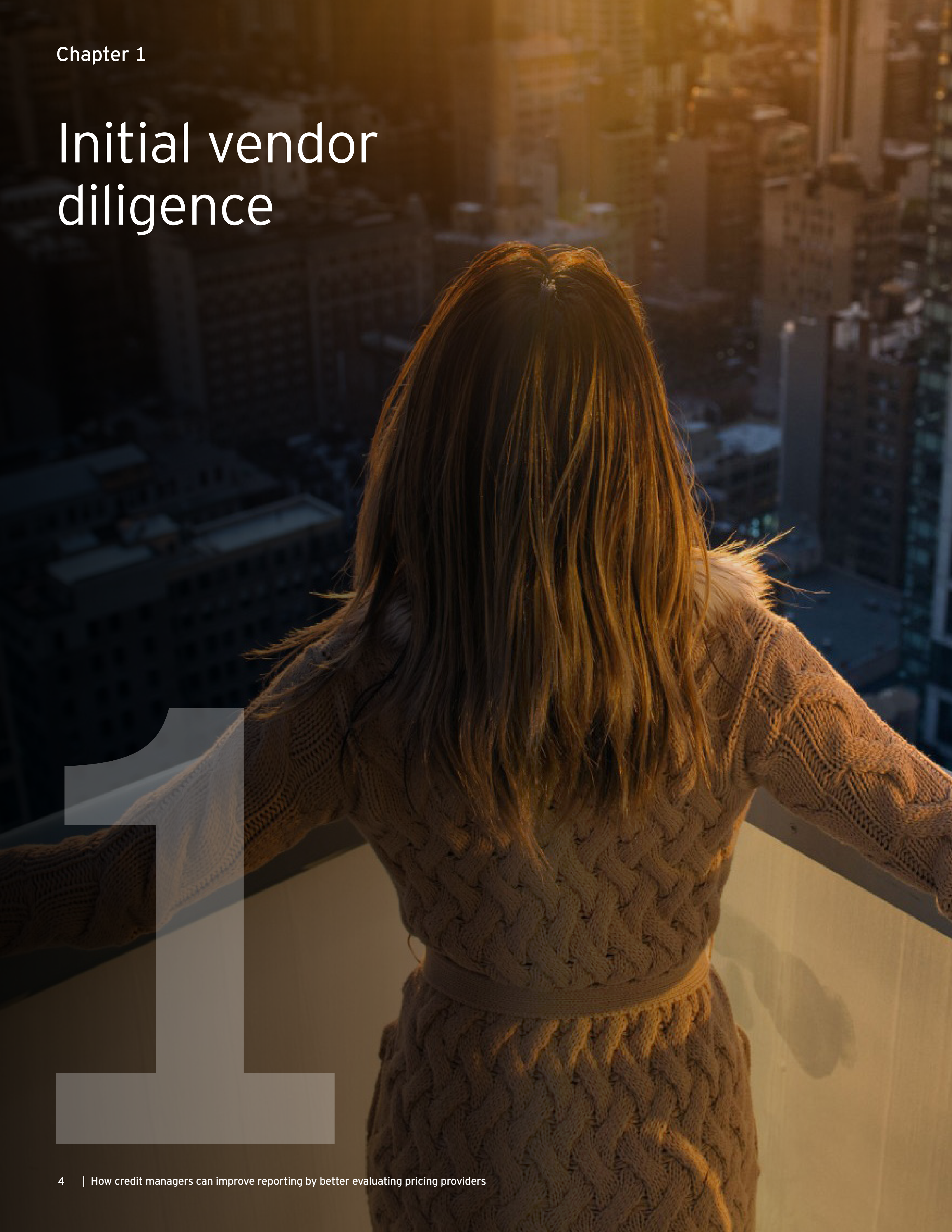
To protect from risk, credit managers must employ the right level of diligence at a reasonable cost.

In the first article in our credit series, we discussed key differences between return maximizing and capital preservation strategies and highlighted leading practices credit managers should consider when fulfilling their pricing responsibility to investors and regulators. In this article, we dive into one of those leading practices – performing efficient levels of due diligence on pricing vendors and brokers.

Credit managers continue to seek cost savings in their back and middle office because of fee compression and the rise of passive managers. The spotlight over the last few years has been on the cost of pricing. Considering the large volume of fixed income instruments traded by many managers, it is not hard to understand why the cost associated with this volume can be concerning.

Pricing vendors have responded to the challenge. The consistent message we hear from many of the largest managers is that the cost per security has dropped dramatically. This has resulted in a shift in pricing philosophy: managers now rely on "cheaper" vendor prices and reduce front office/pricing committee checks and corroborative broker checks.

Without the right level of diligence on these pricing vendors, credit managers can become overly reliant on the accuracy of the prices they receive. While vendors have become stronger at their craft, it remains the ultimate responsibility of credit managers to provide accurate reporting to their investors and regulators. As an incremental procedure to meeting with the vendor annually, we explore how managers can perform periodic analyses on these vendors. We also discuss how brokers should be subject to uniquely designed diligence procedures as well, and rotated out of use in the event of poor performance.



Chapter 1

Initial vendor diligence

Key factors for managers to consider

During the initial due diligence process of picking pricing vendors, it is important to consider three key factors:

1. Is the vendor reputable? Do other credit managers we know rely on and trust this vendor?
2. Does the vendor cover all the credit types the manager wants it to cover?
3. Can the vendor provide a direct feed into the accounting system, eliminating the need for manual reconciliations of data?

There are many diligence questions on standard questionnaires, but we believe the questions listed above are most critical. Reputation may correlate to brand recognition, but rather than focus on the glossiness of a vendor's marketing materials, it is simpler and more effective to call credit manager peers and ask them which vendor has delivered the most consistently accurate pricing results over the engagement period. It may not be the cheapest vendor.

Credit managers should also pay attention to the breadth of experience of the vendor. For instance, bank debt positions are covered by only a few vendors. Many vendors do not have extensive coverage abroad — pricing sovereign debt from developing or underdeveloped countries will require a vendor with a global reach. Most vendors cover senior corporate debt or mezzanine positions, but to decide on a primary or secondary vendor based on those common asset classes alone could be a mistake in the long run, despite what the vendor's business development teams may say.

To limit the risk of data loss and error-prone manual reconciliations, vendors offering automated data feeds into the manager's back and middle office systems should be ranked higher in the selection process. Various accounting systems can run automated reconciliations between primary, secondary and tertiary vendor feeds and produce reports on pricing errors and missing data that are hugely beneficial to the diligence process.

Chapter 2

Ongoing vendor diligence

2

"While vendor-developed cash flow models are proprietary and will likely not be shared, vendors who encourage qualitative discussions on model assumptions are likely more confident about their pricing accuracy.

Engaging best-in-class pricing vendors

Typically, credit managers maintain at least two pricing vendors – a primary vendor and a secondary vendor. A comparison of prices is performed between the primary and the secondary, and the primary is then used unless the comparison difference breaks a predetermined threshold, which would warrant the primary price to be validated by a third source (e.g., broker/market maker).

If a primary vendor price is routinely being replaced by that from a secondary vendor or a broker, the investment committee should determine whether that vendor can truly stand on its own as a primary. This may seem obvious, but applying this approach from a practical perspective can get challenging unless the right assessments are put in place, including:

- **Computing the average percentage difference, by asset class, between primary and secondary vendor prices throughout the reporting period.** It is important to look at these differences by asset class because managers of distressed positions must account for greater volatility in price. If the average price difference by asset class starts to expand, it may be appropriate to take a deeper dive into the securities causing the largest variances. Managers must first account for the fact that vendors offer differing combinations of bid, mid and ask prices and so consistency in comparison is key. Some of the variances may be caused by underlying issues at the company that issued the security. Other variances, especially when the prices driving those variances are compared with those from a market maker (e.g., a broker or deal team professional), could show deficiencies in a primary vendor's pricing methodology.
- **Analyzing the underlying pricing model for a selection of products.** Especially in the case of complex fixed-income positions, like collateralized loan obligations, it is prudent to ask your pricing provider to provide assumptions underlying their cash flow model, including prepayment and default rates. It is also important to validate via inquiry that the vendor did not receive prices for a specific security from another vendor or broker. In such instances, managers should go to the actual source of the price. While vendor-developed cash flow models are proprietary and will likely not be shared, vendors who encourage qualitative discussions on model assumptions are likely more confident about their pricing accuracy.
- **Evaluating the vendor's role in a price challenge framework.** If price variance thresholds are breached and prices need to be challenged with the primary vendor, managers should be aware of how quickly and accurately the vendor responds to this challenge request. A "gold standard" vendor will have robust and complete data supporting every security price (especially considering vendors typically charge a fee for price challenges), thus showing that they are ruthlessly efficient in bridging pricing gaps. Ultimately, it is management's mark that ends up on financial statements. If an internal valuation team does not exist, a manager should ask the vendor for metrics such as credit ratings, collateral and key financial ratios in order for management to "sign-off" on price challenges.
- **Calculating differences between period-end price and traded price (backtesting).** Perhaps the best diligence analysis a credit manager can perform is to compute the average price difference between the period-end vendor price for a security purchased or sold within that period, to the traded price of that security. Typically, credit managers will look for prices on similar securities traded within a week before or after the period-end. Although prices beyond that period may be too stale to use, managers could compare the implied yield of a position to that of a similar security, especially in the case of distressed positions or structured securities that may not trade as frequently. Primary vendors who consistently breach predetermined thresholds for backtesting differences will need to be re-evaluated for their position as a primary.

Broker diligence

3

"If a broker provides bid and ask quotes with small size, it may mean that demand exceeds supply, and so the broker can get better deals at smaller lots. However, small lots could also be an indication of a broker simply testing the market, which would indicate a quote that is unreliable.

Beware of quotes that provide a false sense of reliability

Historically, broker quotes were commonly obtained by credit managers, but usage of such quotes has declined. This is due in part to the rising popularity of using pricing vendors for the reasons noted in Chapter 2.

As their job is to trade credit positions, brokers have limited incentive to provide accurate prices to credit managers. To the extent that a market transaction is conducted at a reasonable size, brokers provide an excellent data point on the price of that traded position. Considering the best price is the one that market participants are willing to trade on, these broker quotes are especially powerful in this context. However, quotes become less reliable when brokers are simply asked at reporting periods for their estimated price on a security.

These days, broker quotes are typically collected in situations where the primary price is challenged by the deal team, or is outside the range when compared with a secondary price. Credit managers use these broker quotes to "break a tie" because brokers, considered as market makers, are quoting buy or sell prices to make a deal.

Credit managers should evaluate data received from brokers on a periodic basis. If a broker provides bid and ask quotes with small size, it may mean that demand exceeds supply and the broker can get better deals at smaller lots. However, small lots could also be an indication of a broker simply testing the market, which would indicate a quote that is unreliable.

These quotes are referred to as "indicative" in that a counterparty is not obligated to trade with that broker at that price. It is therefore always prudent for a credit manager using broker quotes in its pricing process to verify if those quotes are actionable vs. merely indicative.

Certain pricing vendors assist in the broker diligence process by aggregating broker quotes from bulge bracket firms that concentrate primarily on senior debt and firms focused on less-liquid positions and junk debt. These aggregations are run daily, and correlated quarterly with pricing data from public business development company filings.

Despite the lag in these filings (compared with the valuation date), they contain useful data from multiple investment firms on similar securities with limited liquidity, and can corroborate or discredit aggregated broker quotes on these securities. Getting access to this data will be useful for a credit manager to evaluate the effectiveness of broker quotes used for its own periodic reporting.

Summary

Valuation is the most significant risk area for investors, regulators and auditors of credit funds. While management and the board at credit funds can look to outsource this critical process to increasingly reliable third parties, such as pricing vendors, there must be rigorous oversight over the process. Management must perform the right level of diligence in selecting a pricing vendor, and account for the vendor's pricing effectiveness on asset classes they currently invest in and those they plan to invest in.

It is critical for management to determine how best to monitor their vendors and brokers. They must also stay organized so that they are able to apply the right level of oversight to the process. If management has doubts on the quality of quotes received from vendors and brokers, they can use an internal valuation group or hire a third-party specialist to assist with further evaluation. Management is ultimately responsible to its investor base and its regulators.

About the author

Govind Mohan, CFA

EY Americas FSO Assurance Senior Manager, Wealth & Asset Management

With over 14 years of experience in alternative funds, Govind focuses on serving clients in private equity and private credit. He has advised companies at various stages of growth, including publicly listed firms, on internal control enhancements especially around the valuation function.

He spearheads the robotics and automation capabilities of the Los Angeles alternative fund practice by leading teams to develop efficiency plays using advanced analytics tools. An avid writer, Govind recently co-authored a whitepaper on the resurgence of interval funds.

Beginning his career with EY in Philadelphia, he relocated to Los Angeles in 2015. He earned his MBA in Finance from The Wharton School, an MS in Accounting from The University of Virginia, and a BS in Economics from Ohio Wesleyan University. Additionally, Govind is a CFA charter holder and a CPA in California and Pennsylvania.

How Govind is building a better working world

Govind helps build a better working world by striving to help clients consistently outperform their prior results. He is extremely focused on helping his clients discover new ways to innovate as well as operate efficiently. As technology accelerates at hyper-speed, he seeks to never let his teams or clients fall behind.

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.

This news release has been issued by EYGM Limited, a member of the global EY organization that also does not provide any services to clients.

About EY Wealth & Asset Management
In our wealth and asset management work today, not everything is innovation; a lot of it is evolution. And it's important to know the difference. FinTech disruptors continue to shift the rules, newer investors aren't flocking to older channels and cost pressure is relentless. From data and AI, to tech platforms and partners, the questions have never been bigger, and the stakes have never been higher.

We help clients re-think everything from pricing and operating models to coopetition and convergence. We bring critical questions into focus, which lead to bolder strategies, simplified operations and sustainable growth. Our sharp understanding of the state of play allows us to shift discussion from reacting to change, to helping shape it. Ultimately, we work with clients not just to stay competitive, but to change investing for the better.

Visit ey.com/wealtham to learn more.

© 2019 EYGM Limited.
All Rights Reserved.

EYG no. 002468-19Gbl
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.

ey.com