Fund Valuations: A Moving Target

Northern Trust's Head of Fund Administration Discusses New NAV Solutions—Post-Credit Crisis

With the fund industry landscape constantly changing in response to the credit crisis, *Money Management Executive* asked **Matt Ward**, Head of Fund Administration, North America, **Northern Trust**, for his insights on how fund administrators are being affected.

MME: How has the credit crisis impacted your standard valuation processes?

Matt Ward: One of the most challenging aspects of the credit crisis is the need to revise historical processes to validate security prices. A common industry practice is for administrators to test the propriety of prices by performing vendor comparisons and examining variations outside of typical percentage thresholds. However, where substantial variation in valuations among pricing vendors for fixed income securities exists, particularly those with low trading volumes, it is virtually impossible to complete vendor price comparisons using historical tolerances. In response to such variation, administrators are often required to revise such tolerances to focus on true risks since historical tolerances would suggest nearly every security is an "exception."

Matt Ward

MME: What sort of reaction did this pricing variation illicit from investment managers?

Ward: Without question, these variations have caused a lot of anxiety for investment managers, particularly where managers did not believe vendor prices reflected the true fundamentals of the respective securities. Substantial changes in security valuations from one day to the next without any apparent fundamental changes to the credit quality or cash flows of the security (and in the absence of trade activity) were particularly frustrating for managers, especially when not all vendors covering the security revised their prices at the same time.

A 10-point drop in a day where there was no published news or trades relating to an issuer was not uncommon during the height of the credit crisis, as pricing vendors themselves were in a difficult position of valuing assets in the absence of credible bid and offer data.

MME: Has this led to substantial changes in funds' interactions with pricing vendors?

Ward: Managers are increasingly challenging vendor prices. However, most pricing vendors maintain their prices unless actionable information such as a recent trade or evidence of a change in a security's underlying fundamentals is provided. Pricing vendors do not typically consider substantial differences between their values and other vendor values a compelling reason to perform additional due diligence. In many cases, manager challenges appeared to cause vendors to question whether their models were appropriate in an atypical market, and rather than revise their prices or models, vendors often dropped coverage on such securities. This caused issues where investment managers had preferred vendor hierarchies and their preferred vendors dropped coverage. As a result, more frequent communication with managers is now required to select secondary vendors or revert to an internally developed fair valuation.

MME: How have governance committees responded to challenges in security pricing?

Ward: We have observed governance committees taking meaningful steps to ensure security valuation processes are consistent with industry best practices, including:

- Reassessing pricing policies and procedures.
- More frequent governance committee meetings to discuss valuation issues including fair valuations, vendor challenges and security yields.
- Assessing the propriety of broker-provided prices, including broker qualifications to provide prices, whether or not quotes are binding and whether legal disclaimers are provided on quotes.
- Increasing use of subject matter experts, including auditors and consultants.
- Establishing quality control teams to independently review administrators' valuations, including focused reviews on alternative vendor prices, broker-provided prices, stale prices, defaulted securities, substantial security valuation changes affecting fund NAV, backtesting results, corporate actions and aged receivables.

MME: In addition to valuation considerations, have there been any other substantial challenges that the credit crisis has caused fund administrators?

Ward: The expanding universe of distressed securities and rating downgrades resulting from the credit crisis has caused significant challenges in accurately calculating amortization/accretion, particularly for securities that fall under scope of ASC Topic 325-40, Beneficial Interests in Securitized Financial Assets (formerly, EITF 99-20). Application of Topic 325-40 requires managers to provide yield updates where substantial changes in estimated future cash flows occur. Most accounting software packages are not designed to handle frequent amortization/accretion changes, so offline tracking on Excel is common in order to properly apply the standard. Manual tracking of these complex calculations presents a high risk of error, so many administrators are developing overlay solutions that allow for automated calculation. This is particularly important in the mutual fund industry to ensure that

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income and distributions are calculated properly so as not to jeopardize Regulated Investment Company status.

MME: What other changes have fund administrators put in place in response to the credit crisis?

Ward: As expected, fund administrators have responded to these challenges posed by the credit crisis with an increased focus on people, processes and technology. As part of their service provider due diligence, fund governance committees are frequently asking administrators how their staffing models and technology budgets have been affected by the credit crisis.

Despite the pressure to contain costs, additional investments in resources and technology are prudent ways to reduce operational risk. While such investments may increase servicing costs, the potential loss due to error or reputational risk associated with a substantial valuation or reporting breach could be far greater. Many firms are juggling the competing priorities of cost containment and risk management by reallocating staff to fund administration from lower risk areas.

The credit crisis has, in fact, highlighted an important opportunity for administrators, investment managers, boards and chief compliance officers (CCOs) to revisit their existing processes, challenge the status quo and focus on higher risk transactions. Mitigation of operational, reputational and regulatory risks has fostered an environment of increased communications between administrators and their clients, pricing vendors and subject matter experts. Lessons learned and measures put in place should prepare fund administrators to respond to future challenges. MME

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