



All that's hot in the mutual fund industry

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Demand Swells for Derivatives Valuation Services

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Asset managers wary of relying solely on counterparty valuations for over-the-counter (OTC) derivatives have contributed to record demand for third-party valuations of the complex instruments.

SuperDerivatives, a derivatives pricing provider, reported earlier this month that demand for its valuation business more than tripled over the past year. Asset managers, including those that manage mutual funds, account for a significant percentage of this growth, says Chris Zingo, VP sales and support for the Americas at the New York-based firm.

As mutual funds and other financial institutions have steadily increased their use of derivatives in recent years, firms like SuperDerivatives, a private company founded in 2000, have grown apace. The ongoing financial crisis has rendered valuation of complex securities even more difficult and also has highlighted the risks of relying too heavily on counterparty prices. This has only added to these firms' growth.

Lehman's bankruptcy also has had a big effect on business, in some cases. In mid-September business picked up notably at FastVal, a derivatives pricing service offered by **SunGard Alternative Investments**. A number of firms sought independent valuation of positions they had with Lehman as their counterparty, says Paul Compton, head of product management, SunGard Alternative Investments.

There's a clear trend toward less counterparty valuation and more independent valuations, says Compton, who notes that the increased use of third-party pricing services for valuing derivatives has been happening for the past several years.

"I think it's also true to say that from a fund management point of view, investors may not be satisfied to rely on counterparty valuations when fund net asset value is being calculated," he says.

Sungard does not appear to break out information for Sungard Alternative Investments or the FastVal service in its financial statements. It's the firm's policy not to discuss the performance of individual product lines such as FastVal, say Compton and a spokeswoman for SunGard Alternative Investments.

For some fund groups, it has been common practice to rely solely upon the counterparty's valuation of the derivative contract. But that has changed dramatically over the course of the last year.

"[P]eople are thinking about the fact that there's something a little unusual about entering into a contract with someone else and having that someone else tell you what that contract is worth," says Roger Joseph, partner at **Bingham McCutchen**.

Asset managers and others have increased their use of third-party valuation services even as trading in OTC derivatives has dipped this year. The Bank for International Settlements (BIS) reported in November that the volume of outstanding multi-name credit default swap contracts fell 6.5% in the first half of this year; it's the first decline since BIS started publishing these statistics in 2004, according to Dow Jones.

But the traditional uses of derivatives for hedging strategies against certain exposures or as a means to enhance yields will not go away, says SuperDerivatives' Zingo, who says he believes the use of derivatives will continue to rise in coming years.

Interactive Data, another independent pricing service, has rapidly added new services for valuing different types of derivatives in recent years, and even in recent months.

In October the firm announced a new service that provides valuations for international

equity index futures as well as international exchange-listed and OTC equity options. New services centered on the valuation of different types of derivatives were also announced in September and August. Interactive Data first ventured into valuing derivatives in 2006.

"The services since they've been released have grown," says Liz Duggan, chief operating officer for evaluations at Interactive Data Pricing and Reference Data. "Clients continue to be interested. They're actively tested by many different fund companies and we continue to receive feedback as to areas they'd like to see us extend our services into," she says.

Duggan declined to comment on areas in which the firm's services may expand, given that they are currently in the development and research phase.

Interactive Data's third-quarter revenue grew by 7.7% to \$188.6 million; net income for the period was \$36.7 million. This growth was due to strong performances at Interactive Data Pricing and Reference Data, along with expansion of its Real-Time Services business, according to the firm's most recent earnings report.

The establishment by regulators and private companies of central clearinghouses could reduce the demand for independent valuation services for derivatives because they may lend greater transparency to the prices of the instruments.

But sources say that whether this happens will depend on what types of contracts can be cleared through them. The clearinghouses may not be equipped to clear some of the most complex derivatives, in which case there will likely still be significant demand for third-party pricing services.

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