

## Focus on Data – An Integral Part of Risk Management

Robert Cumberbatch  
Business Lines Director, Pricing and Reference Data  
Interactive Data (Europe)

Published in *Global Securities Lending – December 2008*

---

### **The importance of effective data management as a key component of risk management within financial institutions has been magnified during recent market turbulence**

For many years, data management has been seen as an overhead at financial institutions. In today's market environment, effectively managing data assets across the securities management lifecycle, which includes trade confirmation and settlement, can be viewed as a strategic advantage towards helping firms meet risk management and regulatory demands. Effective data management can also help institutions continue to explore new opportunities and work to grow their business.

The ever-increasing volume of data being consumed by large financial institutions emphasises the importance of effective data management. Firms need to have a high level of expertise and flexibility within their technical infrastructure, not just for systems and applications, but also for personnel who understand what good data is and where to source it.

At the core of data management is the need for comprehensive valuation information and high-quality reference data that can help financial institutions power mission-critical operations.

#### **Prioritising reference data**

By prioritising reference data management and having a more complete understanding of the financial instruments streaming through their applications and databases, institutions can manage risk more effectively. Critical to this approach is the ability to take a 360° view of each financial instrument held by an institution, understanding the behavioural characteristics – both on a stand-alone basis and within the context of the portfolio – under a variety of market scenarios. Determining how an instrument is going to behave under stress is essential to understanding the risk parameters of that instrument. With accurate and consistent reference data, an institution is better positioned to conduct the kinds of analyses which are critical to understanding risk.

At another level, financial institutions want to understand the concentration and exposure they have to various segments of the market; this might include credit exposure and industry segment exposure. Gaining this understanding requires knowledge of the full 'family tree' of a financial instrument. For example, if an institution owns shares in a certain company, they may not realise that it is a far-flung subsidiary of a major auto company going through financial difficulties that could impact their holdings. With reference data, an institution could have a better understanding of their 'concentration risk' in a certain sector or among organisations that are facing challenges. For instance, they could identify that exposure to the auto industry makes up too large a percentage of their portfolio and then make an informed financial decision to address this issue.

Reference data providers can offer clients detailed entity linkage information that connects families of securities and helps institutions understand the relationships of the securities to the corporate family structure. This information is critical to maintaining compliance with

regulations that require institutions to understand their exposure to a given firm, industry or market sector.

It is also essential to have a comprehensive understanding of the underlying elements of a financial instrument. Over the past year, we have read stories about firms that didn't take these steps and have been impacted by the far-reaching tentacles of sub-prime securities. But it wasn't just financial institutions that have invested in structured securities, such as CDOs, that had exposure to sub-prime loans; entities from government organisations to pharmaceutical companies have disclosed losses due to sub-prime-related issues.

Effectively managing and reviewing reference data can help investors understand the underlying dynamics of a security and help them determine their risk exposure. For example, even though a security may have an AAA rating, that rating may be supported by internal or external credit enhancement. To understand the risk profile of that security, it can be crucial to know whether that credit enhancement will hold up under stress. Interactive Data delivers the underlying ratings details of municipal bonds needed to assess the underlying risk profile of insured municipal securities. This information is critical as it provides clients with additional transparency to somewhat opaque investments and can be used to measure their risk exposure. With consistent, timely and accurate reference data, institutions can gain additional transparency into these details.

Interactive Data provides a huge raft of essential reference data, which can help institutions to realise a competitive advantage by making more informed investment decisions.

### **The next level**

Some fundamental issues need to be addressed before we will see the industry making real progress toward realising the goal of transforming reference data into the high octane fuel that institutions need to appropriately manage operational risk. First, the industry must come together to agree upon standard definitions for reference data. The lack of standard data definitions is not due to a lack of trying – over the years a number of different initiatives have been undertaken by industry organisations to establish a standard for legal entity identifiers. Despite sincere efforts to address standards for this critical aspect of reference data, agreement has still not been reached.

In addition, a much greater understanding of data utilisation and data requirements is needed across the data management ecosystem. Individuals given the responsibility for improving data quality and ultimately reducing operational risk must have a detailed understanding of how the data is applied across the organisation and how the business units derive value from the data across the securities management lifecycle. This will result in much richer conversations among suppliers, consumers and all players in between. It is also essential that senior managers make the connection between data management activities and managing operational risk. It might be suggested that forensic analysis of the firm's data to realise quality goals can be seen as a 'root cause' activity for developing effective operational risk management strategies. The drive to understand operational risk across the enterprise is supported by the drive to achieving enterprise-wide data quality.

### **Getting a firm grasp**

When it comes to valuations, transparency and standards are fundamental to the process – investors and regulators expect consistent, transparent and fair pricing across all alternative investment classes. Independent valuations of complex OTC derivatives and structured products, as well as evaluations of fixed income securities, are seeing increased demand. Financial institutions have been working to ensure that they have a firm grasp on the value of their holdings. Assessing risk exposure is a key focus.

In response to this challenge, Interactive Data delivers valuations for a range of alternative instruments, including credit default swaps (CDS), interest rate swaps and bank loan prices<sup>1</sup>. Interactive Data also provides valuations of highly complex OTC derivatives and structured products as part of its wide-ranging pricing and evaluation services through an exclusive agreement with Prism Valuation. Prism Valuation – whose philosophy to valuation is built on three pillars ‘people-data-models’ – provides services that replicate the pricing and risk analysis capabilities of a structured products dealer, with an emphasis on hard-to-value assets.

Providers of independent evaluations can deliver significant value to financial institutions during these turbulent times. For example, Interactive Data has teams of experienced evaluators who incorporate available transaction data, credit quality information and perceived market movements into the evaluated pricing applications and models for fixed income securities.

Global institutions have also been impacted by a lack of liquidity as the credit markets have tightened and they have had to take a step back to determine their risk exposure. Once again, for their portfolio valuation processes, these institutions have looked to independent providers of evaluations who put an emphasis on building relationships with a broad range of market sources that can offer insight into market activity.

### **New compliance procedures**

In recent years, a deluge of new acronyms have taken on almost mythical status in the financial services industry. From the Markets in Financial Instruments Directive (MiFID), to Reg NMS, IAS 39 and UCITS III, new regulations, standards and directives have impacted the industry with new compliance processes and procedures to implement and follow.

In the midst of focusing on managing risk and growing their business, firms must follow processes that can help ensure that they can remain compliant with regulations. MiFID, designed to broaden and strengthen the regulation of financial markets in Europe and help ensure market transparency, has posed a series of challenges for financial institutions. Interactive Data’s real-time and reference data services can help clients with the requirements of pre- and post-trade transparency, evidencing best execution, trade venue selection and reviews of order execution policy, code of conduct and client classification obligations, transaction reporting, managing conflicts of interest and managing risk.

Another main focus for institutions during 2008 was the Financial Accounting Standards Board’s Statement of Financial Accounting Standards No. 157, or FAS 157. This statement has resulted in firms reviewing their existing valuation policies and procedures and having to develop procedures for fair value disclosures in their financial statements. To help clients prepare for FAS 157, Interactive Data has developed a set of informational resources that disclose the types of inputs by asset class that are utilised to prepare evaluations. Interactive Data believes that this enhanced transparency can provide clients with information to establish their own fair value hierarchy determinations as required under FAS 157.

Risk management will continue to be a key focus for financial institutions, and regulation and other mandates will continue to be a main driver. By working closely with clients to understand their workflow, vendors such as Interactive Data are better able to address market data and

---

<sup>1</sup> *Valuations for CDS and bank loans are provided by Markit Group Ltd.*

information needs and develop services that can help clients more efficiently comply with regulatory requirements.

***For further information please contact Bob Cumberbatch.***

***[robert.cumberbatch@interactivedata.com](mailto:robert.cumberbatch@interactivedata.com)***

***Interactive Data Corporation (NYSE: IDC) is a leading global provider of financial market data, analytics and related services to financial institutions, active traders and individual investors. The Company's businesses supply real-time market data, time-sensitive pricing, evaluations and reference data for millions of securities traded around the world, including hard-to-value instruments.***

***Pricing, evaluations and reference data are provided in the US through Interactive Data Pricing and Reference Data, Inc. and internationally through Interactive Data (Europe) Ltd and Interactive Data (Australia) Pty Ltd.***

***[www.interactivedata.com](http://www.interactivedata.com)***

This article is provided for information purposes only. Nothing herein should be construed as legal or other professional advice or be relied upon as such.

---

Interactive Data<sup>SM</sup> and the Interactive Data logo are service marks of Interactive Data Corporation.

